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REMEDYING INSURERS' BAD FAITH CONTRACT PERFORMANCE: A REASSESSMENT

*by Robert H. Jerry, II**

In a typical insurance contract, the insurer agrees to perform several duties for the insured. These duties range from reimbursing the insured for losses within coverage to defending the insured against third-party claims.[1] As with any contract, disputes arise from time to time over whether a party has fully performed its obligations. In many of these disputes, an insured might claim that its insurer has been derelict in paying claims or providing a defense. Understandably, an insured who believes it has not received the full measure of its insurer's performance often seeks to recover damages. To maximize the monetary recovery, the insured might argue that the insurer breached an implied duty to deal fairly and in good faith with the insured and that this breach should be recompensed in tort, where the remedies are broader than those available in contract.[2]

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1. The duties that the insurer owes the insured vary depending on whether the insurance is "first-party" or "third-party." In first-party insurance, such as life, accident, health, disability, and property insurance, the insured suffers the loss to person or property and possesses a claim against the insurer. In third-party insurance, the insured obtains the insurance to cover any liability he might have to a third-party who suffers injury to person or property and possesses a claim for that loss against the insured.

2. Tort law and contract law provide different remedies because they protect different interests. In contract, the law protects the interests of the parties in having their promises enforced; thus, obligation in contract is derived from mutual assent, or, more specifically, from manifestations that create expectations in the other party. In tort, the law protects the interests of individuals in being free from certain kinds of harm. The law imposes duties based on social policy, without regard to the existence of any mutual assent or manifestation that creates an expectation. To protect expectations in contract, contract remedies put the aggrieved party in the position he would have been in had the promise been performed. With neither deterrence nor punishment as an objective, contract law gives the aggrieved party the promised performance plus any loss naturally arising from the breach and foreseeable at the time of contracting. In tort law, however, the

The judicial response to such claims has been mixed. In some cases, courts have agreed with the argument that broader tort remedies are needed to prevent insurers from subordinating insureds' interests to their own. Without these broader remedies, it is argued, insurers will not be deterred from taking advantage of their insureds at the time they are most vulnerable—after a loss of person or property or after being sued by a third-party. In a number of cases, insureds prevailing on these claims have recovered substantial sums of money, often greatly in excess of their out-of-pocket losses.

In other cases, however, insureds have failed to convince courts that the insurers' breaches of the implied duty of good faith and fair dealing should be remedied in tort. Insurers have argued that the tort-based judgments awarded to plaintiffs for insurer misconduct distort the normal operation of insurance markets by inducing insurers to pay invalid claims that otherwise would be contested, driving up premium costs or reducing coverage, and even threatening insurer solvency. Those courts accepting the insurers' argument have concluded that the duty of good faith and fair dealing is a contract duty and that damages for its breach should be calculated according to the less generous principles of contract law.[3]

Although both of these viewpoints have some merit, they cannot be reconciled easily. This article argues that a more flexible approach in assessing contract damages can deter insurer overreaching while

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law awards the aggrieved party whatever damages are sufficient to restore him to the place he had prior to the injury. In contrast with contract law, this may include a broader range of consequential damages, such as lost business opportunities, lost profits, emotional distress, or lost employment. Moreover, if necessary to protect vital public policies, tort law often will permit the aggrieved party to recover punitive damages if the perpetrator has demonstrated wanton or malicious conduct, gross bad faith, or reckless indifference to the rights of the insured, or has committed an independent intentional tort, such as fraud. Birnbaum & Wrubel, *Extracontractual Damages Against Insurers: An Overview*, in EXTRACONTRACTUAL DAMAGES 1, 8 (J. Groves ed. 1983).

3. This article examines the implications of the differing remedies provided by tort and contract law, but it should be noted that the tort-contract distinction can have other substantive and procedural implications as well. The nature of available defenses may change depending on whether the cause of action is in contract or tort. If the duty of good faith and fair dealing is a contract duty, the insured's material breach of a contract duty may discharge the insurer's duty of good faith; if the duty of good faith and fair dealing is in tort, the insured's breach of a contract duty may have no effect on the insurer's duty of good faith. *See* Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 577-78, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 487-88 (1973). On the procedural side, characterizing the cause of action as a tort may involve a different statute of limitations than would apply if the action were in contract. *See* Wolfe v. Continental Casualty Co., 647 F.2d 705, 707-08 (6th Cir. 1981) (applying Ohio law and dismissing the suit for failure to bring the action within the statute of limitations applicable to torts).

minimizing the risk and incidence—and therefore the disadvantages—of extravagant judgments.[4] Part I of the article describes the traditional major duties owed by an insurer to an insured and outlines the remedies currently provided in most jurisdictions for the breach of these duties. Part II gives special attention to the insurer's implied duty of good faith and fair dealing; it reviews the historical origins of the duty and describes the alternative ways to categorize it. Part III argues that the duty of good faith and fair dealing should be treated as a contract duty, but that courts should administer the contract scheme of remedies more flexibly in insurance cases. After presenting the rationale for the alternative approach in Part IV, the article suggests two final refinements of this theory in Part V.

I. The Insurer's Traditional Duties

An insurance policy is a contract between insured and insurer. In any contract, the relationship between the parties is a package of reciprocal rights and duties: Each party exchanges a performance, or promise of performance, for a return promise or performance from the other side. When exchanging these promises, each party expects the other to perform its obligation. Neither party would enter into the exchange but for the expectation that its well-being would be enhanced by the reciprocal performances. Thus, when the insured exchanges a promise to pay premiums for the insurer's promise to assume some of the insured's risk, the satisfaction of both the insured and insurer is increased.[5] The nature of the insurer's duties to the insured depends to some extent on the type of insurance issued. Indeed, in a complex policy, an insurer may make several distinct promises.[6] However, only a limited number

4. This article does not address the question of how to determine *when* the duty of good faith and fair dealing is breached. Instead, this article examines the proper remedies for breach after it is decided that a breach has occurred. For a series of articles discussing the difficulties involved in articulating a general theory to determine when the duty of good faith and fair dealing has been breached, see Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968); Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980); Burton, *Good Faith Performance of a Contract Within Article 2 of the Uniform Commercial Code*, 67 IOWA L. REV. 1 (1981); Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810 (1982); Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984).

5. The wealth-maximizing characteristics of an insurance contract are explained in A. POLINSKY, AN INTRODUCTION TO LAW AND ECONOMICS 51-56 (1983).

6. For example, in a typical "Commercial Umbrella Policy," the insurer, in addition to promising to indemnify the insured for liability to a third party, promises to apply recoveries against a third party pursuant to the insurer's subrogation rights in specified ways, to follow specified proce-

of duties constitute material parts of the exchange.[7]

A. *The Duty to Pay Proceeds*

The insurer's duty to pay proceeds in the event of a loss is undoubtedly paramount in the insured's expectations. In first-party insurance, where the insurer promises to reimburse the insured for a loss suffered directly by the insured, the duty to pay proceeds is plainly the most fundamental of the insurer's duties. This duty also exists in third-party insurance, where the insurer promises to indemnify the insured for sums that the insured becomes legally obligated to pay to others.[8]

Because the duty to pay proceeds is created by an express promise of the insurer set forth in the specific language of the policy,[9] an action for breach of the duty sounds in contract. The purpose of contract remedies is to put the aggrieved party in the position he would have occupied had the promise been performed.[10] To accomplish this, the insured entitled to relief for the insurer's breach of the duty to pay proceeds recovers the proceeds payable plus interest.[11]

It is sometimes said that the insurer also has a duty to pay proceeds in a timely fashion, but this duty is not grounded in contract. Some states have statutes providing special remedies for an insurer's nonpayment or late payment of a claim. These remedies typically include liability for the claimant's attorney's fees and perhaps for a penalty calculated as a percentage of the contract benefit due.[12] Where

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dures in the event it chooses to cancel the policy, and to refund an unearned premium in the event of the insured's cancellation of the policy. *See* ALLIANCE OF AMERICAN INSURERS, POLICY KIT 288, 291 (1983).

7. In other words, the insured actually bargains for only a few of the insurer's promises; the duties created by these promises are the objects of the insured's desire.

8. Although the insurer in the third-party setting has duties broader than the duty to indemnify, *see infra* notes 14-31 and accompanying text, the insured's understanding that "if I suffer a loss, the insurer will pay for it" is definitely at the core of the insured's expectations.

9. For what constitutes an "express" promise, see *infra* text accompanying note 143.

10. RESTATEMENT (SECOND) OF CONTRACTS § 347 comment a (1981). *See also supra* note 2.

11. 6A J. APPLEMAN, INSURANCE LAW AND PRACTICE § 4031, at 27 (1972). However, if a court that treats the duty of good faith and fair dealing as a tort duty were to conclude that the failure to pay proceeds was in bad faith, the court might award the plaintiff extracontractual damages. *See infra* notes 32-33.

12. *See* ARK. STAT. ANN. § 66-3238 (1980) (attorney's fees plus 12% damages on the amount recovered from the insurer); GA. CODE ANN. § 56-1206 (1977) (attorney's fees plus 25% penalty in event of loss that insurer does not pay within 60 days); ILL. REV. STAT. ch. 73, § 767 (1973) (attorney's fees plus penalty of $5,000, 25% of judgment, or difference between amount of judgment and amount company offered to pay prior to action in event insurer is guilty of unreasonable and vexatious denial of coverage); ME. REV. STAT. ANN. tit. 24-A, § 2436 (Supp. 1980) (attorney's fees plus interest of 1½% per month after the due date); MICH. COMP. LAWS § 500.1806

courts have recognized a duty to pay proceeds in a timely fashion in the absence of an applicable statute, they have usually held that no contract liability exists for either attorney's fees or late payment penalties.[13]

B. *The Duty to Defend*

In third-party insurance, the insurer, in addition to promising to indemnify the insured, promises to defend the insured in any lawsuit alleging a claim within the policy's coverage. All modern liability policies contain a provision explicitly requiring the insurer to defend such a suit even if it is "groundless, false, or fraudulent." Thus, in effect, the insured buys from the insurer the right to receive a defense should the insured be sued by a third-party for any claim falling within the policy's coverage. The duty to defend is a broader obligation than the duty to indemnify:[14] The insurer need not indemnify the insured against groundless, false, or fraudulent claims because such claims will presumably be defeated at trial.

The duty to defend is expressly created by the contract of insurance. As such, it is a contract duty, and the remedy for breach of the duty is generally calculated according to ordinary contract principles. To place the aggrieved insured in the position he would have enjoyed had the promise been performed, it is necessary to reimburse the insured for the costs of his defense plus the amount of any resulting judg-

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(1971) (12% per annum interest rate); MICH. COMP. LAWS § 500.1830 (1971) (attorney's fees); OR. REV. STAT. § 743.114 (1983) (attorney's fees if plaintiff's recovery exceeds amount of any tender of insurer); S.D. CODIFIED LAWS ANN. § 58-12-3 (1978) (attorney's fees if failure to pay is vexatious and unreasonable); TENN. CODE ANN. § 56-7-105(a) (1980) (a sum not exceeding 25% of the liability for failure to pay within 60 days). *See* R. KEETON, INSURANCE LAW § 7.4 (1971); 6A J. APPLEMAN, *supra* note 11, §§ 4031-39.

13. R. KEETON, *supra* note 12, § 7.4(a), at 456. Such decisions usually turn on the duty that accompanies the insured's statutory right to extracontractual relief if the payment of the claim is not timely. *See* Grants v. National Fire Ins. Co., 127 Kan. 251, 253-54, 273 P. 406, 407 (1929) (statute intended to penalize a company that is delinquent in making prompt payment on policies after loss occurs); Christian v. American Home Assurance Co., 577 P.2d 899, 903, 906 (Okla. 1977) (statute expresses legislative intent to impose on insurance companies an obligation to pay valid claim promptly); *see also* Washington v. Group Hospitalization, Inc., 1984 Life Cas. (CCH) 1018, 1020 (D.D.C. 1984) ("Courts and legislatures have . . . imposed a legal duty upon insurance companies to process and pay claims expeditiously and in good faith. The breach of such duty gives rise to a tort.").

14. Indeed, the cost to insurers of defending claims against insureds accounts for between one-third and one-half of all liability insurance expenditures. *See Sweeping Insurance Changes May Increase Business Costs*, N.Y. Times, June 11, 1985, at D5, col. 2. One insurer was reported recently to have spent $369,000 defending a claim where the policy limit was $100,000. *Id.*

ment up to the policy limits.[15] Most courts do not hold that the insurer must pay the amount of the judgment exceeding the policy limits.[16] The detriment suffered by an insured due to an excess judgment is not caused by the insurer's refusal to defend; presumably the same judgment would have been entered against the insured regardless of who provided the defense.[17]

C. *The Duty to Settle*

The typical liability policy has no express language requiring the insurer to settle a lawsuit brought against the insured. Instead, most policies grant the insurer the privilege of settling claims or suits filed

15. *See, e.g.*, Stockdale v. Jamison, 416 Mich. 217, 228, 330 N.W.2d 389, 394 (1982).

16. *See, e.g.*, State Farm Mut. Auto. Ins. Co. v. Paynter, 122 Ariz. 198, 204-05, 593 P.2d 948, 954-55 (1979); Reis v. Aetna Casualty & Sur. Co., 69 Ill. App. 3d 777, 789, 387 N.E.2d 700, 709 (1978); George R. Winchell, Inc. v. Norris, 6 Kan. App. 2d 725, 730-31, 633 P.2d 1174, 1176-77 (1981); Stockdale v. Jamison, 416 Mich. 217, 227-28, 330 N.W.2d 389, 393-94 (1982). A few courts have held that the insurer is not relieved of the duty to settle when it refuses to defend the insured. These courts reason that the insurer that refuses to defend should not be in a better position than an insurer that defends the action but then unreasonably refuses to settle. *See e.g.*, Samson v. Transamerica Ins. Co., 30 Cal. 3d 220, 237, 636 P.2d 32, 42-43, 178 Cal. Rptr. 343, 353-54 (1981); Jenkins v. General Accident Fire & Life Assur. Corp., 349 Mass. 699, 702, 212 N.E.2d 464, 467 (1965); Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 59, 188 A.2d 320, 322 (1963). A handful of courts have taken a position at the opposite extreme: An insurer that refuses to defend will not be liable for an excess judgment even if the insurer had the opportunity to settle within policy limits. *See, e.g.*, Fidelity & Casualty Co. of N.Y. v. Gault, 196 F.2d 329, 330 (5th Cir. 1952); Lanie v. Century Indem. Co., 390 S.W.2d 558, 562 (Mo. Ct. App. 1965). One court has held an insurer liable in tort for bad faith refusal to defend. *See* Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 758-59 (N.D. 1980). *See also* A. WINDT, INSURANCE CLAIMS AND DISPUTES § 4.31, at 161-62 (1982). If a court treats the duty of good faith and fair dealing as a tort duty and concludes that the failure to defend was in bad faith, the court might award the plaintiff extracontractual damages. *See infra* notes 32-33.

17. Moreover, the damages that can be recovered for breach of contract must be reduced to the extent they were avoidable through reasonable efforts of the injured party. If, for example, after the insurer breached the contract by refusing to provide a defense and the insured deliberately chose to do nothing, thereby allowing a default judgment to be entered, it is fair to conclude, absent extenuating circumstances, that the insured did not take reasonable steps to avoid the consequences of the insurer's breach. As a result, the insured would be prevented from recovering the excess judgment because he could have avoided it by making reasonable efforts to do so after the breach. *See, e.g.*, Fidelity & Casualty Co. v. Gault, 196 F.2d 329, 330 (5th Cir. 1952); Thomas v. Western World Ins. Co., 343 So. 2d 1298, 1303 (Fla. Dist. Ct. App.), *cert. denied*, 348 So. 2d 955 (Fla. 1977).

A different situation would arise if an insurer announced a few days prior to trial that it would not provide a defense and the insured was left without counsel. In that situation, it is reasonably foreseeable that the insured, lacking time to prepare an adequate defense with new counsel, might suffer an excess judgment as a direct result of the insurer's breach. But absent those or similar circumstances, an excess judgment is not ordinarily caused by the insurer's failure to provide a defense.

against the insured as the insurer deems expedient. All jurisdictions now recognize, however, that the insurer owes the insured the duty of settlement under a liability policy, either on the theory that the duty to settle is implied by law or on the theory that it is an implied term of the contract.[18] The most common test for determining whether the insurer has met its obligations is the "good faith" standard: If the insurer conducts itself in accordance with the standard of good faith when deciding whether to accept a settlement offer within the policy limits, the insurer has complied with its duty to settle. Another possible test is the "due care" standard: If the insurer is not negligent in deciding whether to accept a settlement offer within the policy limits, then the insurer has fulfilled its duty.[19] As a practical matter, the distinctions between the tests are obscure,[20] and in most jurisdictions the two standards have coalesced.[21]

Although almost every state allows the insured to recover from the insurer who breaches the duty to settle the amount of the judgment exceeding the policy limits, courts are not unanimous regarding the theory on which this result is based.[22] Regardless of whether the jurisdiction adheres to a good faith standard or a negligence standard for determining when the duty is breached,[23] most jurisdictions have concluded that the breach of the duty to settle is a tort.[24] Tort law makes available to the insured a broad range of remedies, such as damages for emotional distress and punitive damages, that are generally not availa-

18. 7C J. APPLEMAN, *supra* note 11, § 4711, at 367 (1979).

19. *See* W. SHERNOFF, S. GAGE & H. LEVINE, INSURANCE BAD FAITH LITIGATION § 3.03[1](a) (1984).

20. *See* Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1140 (1954).

21. *See* Bollinger v. Nuss, 202 Kan. 326, 337-38, 449 P.2d 502, 511-12 (1969); State Farm Mut. Auto. Ins. Co. v. White, 248 Md. 324, 329-33, 236 A.2d 269, 271-73 (1967); 7C J. APPLEMAN, *supra* note 11, § 4712, at 425. For a history of the evolution of the "good faith" and "due care" standards in the context of the duty to settle, see Sackville, *The Duty of the Insurer to Settle Within the Policy Limit—A Case of the Standard Contract of Adhesion*, 1968 UTAH L. REV. 72, 79-98.

22. *See* W. SHERNOFF, S. GAGE & H. LEVINE, *supra* note 19, § 3.03[1](a).

23. The choice of standard is not conclusive on the question of whether the duty sounds in tort or contract. *See infra* notes 59-63 and accompanying text.

24. *See, e.g.*, Jolly v. General Accident Group, 382 F. Supp. 265, 266 (D.S.C. 1974); Duncan v. Andrew Mut. Ins. Co., 665 S.W.2d 13, 18-19 (Mo. Ct. App. 1983); Tennessee Farmers Mut. Ins. Co. v. Hammond, 200 Tenn. 106, 113-14, 290 S.W.2d 860, 863 (1956); Tank v. State Fire & Casualty Co., 38 Wash. App. 438, 441-42, 686 P.2d 1127, 1130-32 (1984); Evans v. Continental Casualty Co., 40 Wash. 2d 614, 630, 245 P.2d 470, 480 (1952); R. KEETON, *supra* note 12, § 7.8(a), at 509; A. WINDT, *supra* note 16, § 5.11, at 205 n.82. *See also* J. MCCARTHY, PUNITIVE DAMAGES IN BAD FAITH CASES 116 (3d ed. 1983).

ble in an action based on a breach of contract.[25] Nevertheless, courts in a few states have concluded that the breach of the duty to settle is contractual in nature.[26]

D. *The Duty to Participate in Appeals*

Closely related to the duty to defend is the the insurer's duty to participate in appeals from trial court judgments involving its insured.[27] Obtaining a successful result in the trial court does not terminate the insurer's defense duty; the insurer is obligated to defend any appeal of the trial court's judgment that the claimant might pursue.[28] Although liability policies generally do not contain language explicitly creating a duty to appeal judgments adverse to the insured, the insurer is obligated to do so as part of its general duty to defend if such an appeal will serve the interests of the insured.[29] As such, the duty to participate in appeals is ordinarily viewed as a contract duty. The usual remedy for the insurer's failure to prosecute or defend an appeal is reimbursement of the insured's expenses for the post-trial proceedings.[30] However, as

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25. *See, e.g.*, Murphy v. Allstate Ins. Co., 17 Cal. 3d 937, 941-42, 553 P.2d 584, 587, 132 Cal. Rptr. 424, 427 (1976) (when insurer breaches its duty to settle within policy limits, the insured may recover the excess over the policy limits, economic loss, physical impairment, emotional distress, and punitive damages); Travelers Indemn. Co. v. Hudson, 15 Ariz. App. 371, 377, 488 P.2d 1008, 1014 (1971) (bad faith of an insurer in failing to settle a claim within policy limits exposes insurer to full liability for judgment thereafter obtained); *See supra* note 2.

26. *See, e.g.*, Douglas v. United States Fidelity & Guar. Co., 81 N.H. 371, 378, 127 A. 708, 712 (1924) (treating duty to settle as derived from contract) (1931); Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 508, 223 A.2d 8, 11 (1966) ("We believe that this recent case law, employing contractual terms for the obligation of the insurer to represent in good faith the rights of the insured, indicates that a breach of such an obligation constitutes a breach of the insurance contract for which an action in assumpsit will lie."); Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on reh'g*, 204 Wis. 1, 235 N.W. 413 (1931); *cf.* Averbach v. Maryland Casualty Co., 236 N.Y. 247, 252, 140 N.E. 577, 579 (1923) (insurer may respond to settlement offer as it chooses without liability for judgment in excess of policy limits); A.A.A. Pool Serv. & Supply, Inc. v. Aetna Casualty & Sur. Co., 121 R.I. 96, 100, 395 A.2d 724, 726 (1978); A. WINDT, *supra* note 16, § 5411, at 205 ("An insurance company's duty to settle is an implied contractual obligation.").

27. *See* 7C J. APPLEMAN, *supra* note 11, § 4688.

28. *See* Travelers Indem. Co. v. East, 240 So. 2d 277, 280 (Miss. 1970); 7C J. APPLEMAN, *supra* note 11, § 4688, at 200-01 (1979).

29. 7C J. APPLEMAN, *supra* note 11, § 4688, at 199-201; *see* A. WINDT, *supra* note 16, § 4.15, at 131-32; Reichert v. Continental Ins. Co., 290 So. 2d 730, 733-34 (La. Ct. App. 1974), *writ denied*, 294 So. 2d 545 (La. 1975).

30. *See* Ginder v. Harleysville Mut. Casualty Co., 49 F. Supp. 745, 747-48 (E.D. Pa. 1942), *aff'd*, 135 F.2d 215 (3d Cir. 1943) (insured allowed costs of appeal when insurer refused to pay the judgment against the insured or to appeal); Reichert v. Continental Ins. Co., 290 So. 2d 730 (La. Ct. App.), *writ denied*, 294 So. 2d 545 (La. 1975) (insurer held liable for attorney's fees incurred in prosecuting appeal insurer refused to undertake); *but cf.*, New York and New Bruns-

with the duty to settle, in appropriate circumstances the insurer might be liable for the amount of the judgment exceeding the policy limits.[31]

II. The Duty of Good Faith and Fair Dealing

In recent years, courts have recognized an additional duty owed by the insurer to the insured: the duty of good faith and fair dealing. Like the duty to settle, this duty is not expressly stated in the contract, but unlike the duty to settle, the duty of good faith and fair dealing is not limited to a particular activity of the insurer. As a result, the recognition of the duty of good faith and fair dealing has precipitated a large number of extracontractual damage awards against insurers.[32]

Two views of the duty of good faith and fair dealing have emerged in the cases. In most decisions, courts have recognized a *tort* of bad faith breach of contract and have held the insurer liable for tort damages.[33] Many of these cases involve situations where insurers have attempted to take advantage of their insureds by refusing to pay bona fide claims, by refusing to defend lawsuits filed against the insured, or by undertaking the defense and failing to protect the insured's interests in that effort. In a few jurisdictions, however, courts have rejected the contention that the duty of good faith and fair dealing sounds in tort

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wick Auto Express Co. v. Mass. Bonding and Ins. Co., 67 N.J. Super. 401, 405, 170 A.2d 519, 521 (1961) (insured denied costs of unsuccessful appeal since such costs were not provided for in the policy).

31. *See* 7C J. Appleman, *supra* note 11, § 4688, at 199, and cases cited *supra* note 17. For example, if the insurer, in disregard of the insured's interests, failed to appeal a trial court judgment against the insured in excess of the policy limits, the failure would effectively preclude the settlement of the claim pending appeal for a sum less than the trial court judgment. In this circumstance, allowing the insured to recover a judgment against the insurer in excess of the policy limits for breaching the duty to appeal would be appropriate. *See* Peterson v. Farmers Casualty Co., 226 N.W.2d 226, 230 (Iowa 1975).

32. The last three decades have seen a considerable amount of litigation regarding claims of "insurer bad faith," and there is no indication that the frequency of litigation will soon abate. Three one-volume works devoted solely to the law of bad faith actions have recently been published; the overwhelming bulk of these volumes is concerned with bad faith in the insurance context. *See* S. Ashley, Bad Faith Actions: Liability and Damages (1984); W. Shernoff, S. Gage & H. Levine, Insurance Bad Faith Litigation (1984); D. Wall, Litigation and Prevention of Insurer Bad Faith (1985).

33. *See, e.g.*, Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916, 924-25, (Ala. 1981); Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 538, 647 P.2d 1127, 1136 (1982); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 575, 510 P.2d 1032, 1037-38, 108 Cal. Rptr. 480, 486 (1973); Crisci v. Security Ins. Co., 66 Cal. 2d 425, 430, 426 P.2d 173, 176, 58 Cal. Rptr. 13, 16-17 (1967); Corwin Chrysler-Plymouth v. Westchester Fire, 279 N.W.2d 638, 643 (N.D. 1979); Christian v. American Home Assurance Co., 577 P.2d 899, 904 (Okla. 1977); Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980); Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 686-87, 271 N.W.2d 368, 374 (1978).

and have confined insureds to the available contract remedies.[34]

A. *Historical Origins*

Over the years, courts have utilized the principle of good faith and fair dealing in diverse ways in American contract law. In many of its applications, good faith has not been conceptualized as an independent duty but has instead been used to describe the range of limitations on the discretion that the parties might exercise during contract performance. For example, in situations where an agreement conditions a party's duty to perform on its satisfaction with the other party's performance, there is considerable potential for overreaching by the party whose duty is conditioned: If a party can refuse to perform if dissatisfied with the other side's performance, there is an obvious temptation to feign dissatisfaction in order to escape onerous contract obligations or to secure more attractive alternative opportunities.[35] In these situations, courts have often construed the agreement to require the party whose duty was conditioned to use "good faith" when forming his judgment as to his satisfaction.[36]

The cases involving conditions of satisfaction do not go so far as to impose a *duty* on the party in control of the condition to act in good faith. Rather, failure to exercise judgment in good faith has the effect of excusing the nonoccurrence of the condition, thereby making the promise of the party in control of the condition immediately due. This

34. *See, e.g.*, Guarantee Abstract & Title Co. v. Interstate Fire & Casualty Co., 232 Kan. 76, 78-79, 652 P.2d 665, 667-68 (1982); Kewin v. Massachusetts Mut. Life Ins. Co., 409 Mich. 401, 419-20, 295 N.W.2d 50, 55 (1980); Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 612-13, 392 A.2d 576, 580 (1978); Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 436-37, 285 N.E.2d 849, 854, 334 N.Y.S.2d 601, 608 (1972).

35. One way to mitigate the potentially harsh effect of such a condition is to construe the condition as requiring "objective satisfaction": If a reasonable person in the same circumstances would be satisfied, the condition of satisfaction has been met. In some situations, however, the contract may clearly provide, either by its express terms or by its context, that the subjective satisfaction of the party is a prerequisite to the party's performance. *See, e.g.*, Gibson v. Cranage, 39 Mich. 49 (1878); Fursmidt v. Hotel Abbey Holding Corp., 10 A.D.2d 447, 200 N.Y.S.2d 256 (1960).

36. *See* Mattei v. Hopper, 51 Cal. 2d 119, 123-24, 330 P.2d 625, 627 (1958); Isbell v. Anderson Carriage Co., 170 Mich. 304, 314-15, 136 N.W. 457, 460-61 (1912); Western Hills, Or. Ltd. v. Pfau, 265 Or. 137, 144-45, 508 P.2d 201, 204-05 (1973). Under this approach, only "honest dissatisfaction" would justify the party's failure to provide the reciprocal performance. *See* Feinberg v. Automobile Banking Corp., 353 F. Supp. 508, 513 (E.D. Pa. 1973); Barbara Oil Co. v. Patrick Petroleum Co., 1 Kan. App. 2d 437, 443, 566 P.2d 389, 393 (1977); Devoine Co. v. International Co., 151 Md. 690, 694-96, 136 A. 37, 38 (1927); Jones v Hollingsworth, 88 Wash. 2d 322, 328, 560 P.2d 348, 351 (1977).

principle is illustrated by the decision in *Baltimore and Ohio Railroad v. Brydon*[37] where a contract for the supply of coal required that the coal be satisfactory to the railroad. The railroad rejected a shipment; the supplier sued, claiming that the rejection was not made in good faith. The Maryland Court of Appeals affirmed a judgment for the supplier:

> [The satisfaction clause] did not give [the railroad] a capricious or arbitrary discretion to reject [the shipment]. It was their judgment which was to decide the question of acceptance, but the law required them to exercise a fair, just and honest judgment on the subject . . . By the terms of the contract the whole decision was committed to them. If they made their decision against the coal in good faith, the defendant would not be obliged to accept it; but if they fraudulently rejected it, their judgment would be without effect in law. . . .[38]

Another situation in which the concept of good faith is important involves contracts in which one of the terms is left to the control or subsequent specification of one of the parties. In these cases, courts have often used the standard of good faith to determine whether the contract has been breached. For example, in *Feld v. Henry S. Levy & Sons, Inc.*,[39] the seller agreed to supply the buyer with all bread crumbs produced by seller at a certain factory. During the term of the agreement, the seller stopped producing bread crumbs because production had become "very uneconomical." The court, in denying cross-motions for summary judgment, said that "[i]n circumstances such as these and without more, defendant would be justified, in good faith, in ceasing production of the single item prior to cancellation only if its losses from continuance would be more than trivial. . . ."[40] In this common usage, good faith is, in effect, the standard against which a party's performance of its contract obligations is measured.

Thus courts have used good faith to set a limit on the exercise of discretion in contracts that contain conditions of satisfaction or that

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37. 65 Md. 198, 3 A. 306 (1886).
38. *Id.* at 220-21, 3 A. at 309-10.
39. 37 N.Y.2d 466, 335 N.E.2d 320, 373 N.Y.S.2d 102 (1975). *See also* HML Corp. v. General Foods Corp., 365 F.2d 77 (3d Cir. 1966); Southwest Natural Gas Co. v. Oklahoma Portland Cement Co., 102 F.2d 630 (10th Cir. 1939); Dickey v. Philadelphia Minit-Man Corp., 377 Pa. 549, 105 A.2d 580 (1954); Weistart, *Requirements and Output Contracts: Quantity Variations Under the UCC*, 1973 DUKE L.J. 599.
40. 37 N.Y.2d at 472, 335 N.E.2d at 323, 373 N.Y.S.2d at 106.

leave the specification of terms to one of the parties.[41] Because good faith simply describes the obligation of the party who is alleged to be in breach, it is not necessary for the plaintiff to allege the existence of an *independent* duty of good faith that had been breached by the defendant.[42]

Perhaps distracted by such cases, a few commentators assumed that the formulations recognizing an implied duty of good faith and fair dealing in contract performance[43] were recent developments in American law.[44] Yet the duty was actually recognized over a century ago. The author of at least one old contract law treatise acknowledged the principle that every contract contains reciprocal implied duties of good faith and fair dealing.[45]

Moreover, a few reported cases in the late eighteenth and early nineteenth centuries, at least some of which arose in the insurance setting, referred to the implied duty of good faith and fair dealing.[46] For example, in *Brassil v. Maryland Casualty Co.*,[47] a 1914 New York case, the court allowed the insured under a liability policy to recover

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41. *See, e.g.*, Pillois v. Billingsley, 179 F.2d 205, 207 (2d Cir. 1950) (contract in which one party determines a reasonable price is not too indefinite to be enforced; the first-party is entitled to have second-party determine price in good faith); Miller v. International Harvester Co. of Am., 179 Kan. 711, 715, 298 P.2d 279, 282 (1956) (contract contains implied promise to make reasonable payment); Tennant v. Fawcett, 1 Tex. 20, 58 S.W. 824 (1900) (contract allowing client to fix attorney's fees required client to fix fees in good faith).

42. Good faith is also the basis for judicially-imposed requirements that one holding an exclusive agency use best efforts to develop, exploit, produce, or make sales of the subject of the exclusive agency. *See* Baldwin v. Kubetz, 148 Cal. App. 2d 937, 307 P.2d 1005, 1009 (1957). It underlies the duty one party has to cooperate with the other so that the other might secure the benefits of the contract. *See* Miller v. Othello Packers, Inc., 67 Wash. 2d 842, 844, 410 P.2d 33, 34 (1966).

43. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981); U.C.C. § 1-203 (1977).

44. *See, e.g.*, Kornblum, *Extracontract Actions Against Insurers: What's Ahead in the Eighties?*, 19 FORUM 58, 59 (1983) ("The law has developed rather dramatically over this past decade."); Wall, *Bad Faith, Excess Liability Actions By or Against Excess Insurers*, 48 INS. COUNS. J. 311, 311 (1981) ("The scope and incidents of the [bad faith] action have developed so quickly. . . .").

45. For example, an 1878 treatise on contracts states: "When parties enter into a contract in terms, the law presumes each of them to be acting in good faith toward the other, and it binds each to the other, to whatever good faith requires." J. BISHOP, BISHOP ON CONTRACTS § 106, at 37-38 (1878).

46. *See* Germania Ins. Co. v. Rudwig & Co., 80 Ky. 223, 235 (1882); City of Wakefield v. Globe Indem. Co., 246 Mich. 645, 650-53, 225 N.W. 643, 644-45 (1929); Kirke La Shelle Co. v. Paul Armstrong Co., 263 N.Y. 79, 87, 188 N.E. 163, 167 (1933); Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 7-8, 231 N.W. 257, 259-60 (1930), *aff'd on reh'g*, 204 Wis. 1, 235 N.W. 413 (1931).

47. 210 N.Y. 235, 104 N.E. 622 (1914).

from the insurer his expenses of prosecuting an appeal that the insurer had refused to take from an adverse judgment against the insured:

> It is enough to say that it would be a reproach to the law if there were no remedy for so obvious a wrong as was inflicted upon this plaintiff. His rights . . . go deeper than the mere surface of the contract written for him by the defendant. Its stipulations imposed obligations based upon those principles of fair dealing which enter into every contract. Even defendant has invoked [in its answer] this implied obligation of good faith and fair dealing not expressed in the terms of its written contract . . . If [it were plaintiff's duty to deal fairly and in good faith with defendant,] it was not less the correlative obligation of the defendant to 'deal fairly and in good faith' with him.[48]

Even though courts had long applied good faith and fair dealing as an implied duty in every contract, the first *Restatement of Contracts* did not include it as a recognized principle of law. Nevertheless, courts continued to refer to the duty in disposing of contract claims.[49] Insurance litigation provided a particularly fertile ground for claims that a party, almost always the insurer, had breached an implied obligation of good faith.[50] The duty of good faith received considerable attention in scholarly articles during the 1960s and early 1970s,[51] at the same time

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48. *Id.* at 242, 104 N.E. at 624.

49. *See, e.g.*, Commerce Int'l Co. v. United States, 338 F.2d 81, 85 (Ct. Cl. 1964) ("Unless expressly negatived, [duty of contracting party to carry out bargain reasonably and in good faith] is read into all bargains."); Old Dutch Farms, Inc. v. Mich. Drivers & Dairy Employees Union Local 584, 222 F. Supp. 125, 130 (E.D.N.Y. 1963) ("every contract contains an implied covenant of good faith and fair dealing"); Olsen v. Spomer, 199 Cal. App. 2d 99, 103, 13 Cal. Rptr. 392, 395 (1961) ("It is a general rule that 'in every contract there is an implied covenant of good faith and fair dealing.' ") (quoting Universal Sales Corp. v. California Mfg. Co., 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942)); Perkins v. Standard Oil Co., 235 Or. 7, 16, 383 P.2d 107, 112 (1963) ("In every contract there is an implied covenant [of good faith]. . . .") (quoting A. CORBIN, 3 CORBIN ON CONTRACTS § 561, at 278 (1960)).

50. *See, e.g.*, American Mut. Liab. Ins. Co. v. Cooper, 61 F.2d 446, 448 (5th Cir. 1932) (insurance contract imposes duty upon insurer to act in good faith toward insurer); Boling v. New Amsterdam Casualty Co., 173 Okla. 160, 163, 46 P.2d 916, 919 (1935) (insurance contract places duty for insurer to exercise skill, care, and good faith because insurer assumes insured's right to control settlement).

51. *See* Cox, *The Duty to Bargain in Good Faith*, 71 HARV. L. REV. 1401 (1958); Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); Gilmore, *The Commercial Doctrine of Good Faith Purchase*, 63 YALE L.J. 1057 (1954); Kessler & Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964); Summers,

that the *Restatement of Contracts* was being redrafted. When published in final form in 1981, the *Restatement (Second) of Contracts* included a new provision, section 205, which stated: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[52]

B. *Good Faith As a Contract Duty*

1. The Wisconsin Example

One of the first cases to examine the nature of the duty of good faith and fair dealing in the context of insurance was a 1931 Wisconsin decision, *Hilker v. Western Automobile Insurance Co.*[53] In *Hilker*, the insured under an automobile liability policy sought to recover the amount of a judgment exceeding the policy limits in circumstances where the insurer allegedly could have settled the claims for less than the policy limits.[54] In explaining the "character of the duty which an indemnity insurance company owe[s] to its insured in the matter of making a settlement,"[55] the court took the position that the obligation of the insurer to deal with the insured in good faith arises out of the contract.

One of the questions preoccupying the parties and the court in *Hilker* was whether the insurer who undertakes to settle a claim against the insured "is liable for negligent conduct . . . [or] only when its conduct amounts to bad faith."[56] The court observed that different

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"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 VA. L. REV. 195 (1968).

52. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981). For a discussion of the "legislative history" of section 205, see Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 814-15 (1982).

Although this articulation of the implied duty of good faith and fair dealing in the *Restatement* might lead one to conclude that the implied duty is a contract duty, most courts have nevertheless held that the duty sounds in tort.

53. 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on reh'g*, 204 Wis. 1, 235 N.W. 413 (1931).

54. *Id.* at 3, 231 N.W. at 258.

55. *Id.* at 12, 235 N.W. at 414.

56. The first opinion issued by the supreme court in *Hilker* seemed to apply both a good faith standard ("In determining whether the evidence sustains the findings of the jury that the defendant acted in bad faith. . . ."), *id.* at 8, 231 N.W. at 260, *and* a negligence test ("But the good faith performance of the obligation . . . requires that it be held to that degree of care and diligence which a man of ordinary care and prudence would exercise in the management of his own business were he investigating and adjusting such claims."). *Id.* at 10, 231 N.W. at 261. This confusion led the court to grant a rehearing and to issue a second opinion clarifying the matter. *Id.* at 12, 235 N.W. at 414.

courts used terms "not strictly convertible or synonymous . . . to indicate the same thing. Negligence has been used by some courts to mean the same thing that other courts have designated as bad faith."[57] Instead of attempting to define the terms with precision, the court undertook to give "with some particularity our conception of the duty which *the written contract of insurance imposes* upon the carrier."[58] According to the court, it was not the law or notions of public policy that imposed the duty to settle on the insurer; rather, the duty to settle "is implied as a *correlative duty growing out of certain rights and privileges which the contract confers upon the insurer*,"[59] one of which is "the exclusive right to settle or compromise the claim . . . The exercise of this right should be accompanied by considerations of good faith."[60]

Nothing in *Hilker* suggested that good faith was an independent duty imposed on the insurer by law or by reference to existent public policies. Instead, the court referred to good faith as a *standard* for measuring how the insurer should perform its settlement obligation.[61] The court emphasized that the ultimate source of such obligations, whether expressly stated or implied, was the contract between insurer and insured.[62] Because the duty of good faith was part of this contractual promise, this early Wisconsin opinion viewed it as a contract duty, not a tort duty.[63]

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57. *Id.* at 13, 235 N.W. at 414.

58. *Id.* (emphasis added).

59. *Id.* (emphasis added).

60. *Id.* at 14, 235 N.W. at 414-15. When the court referred to the duty as a "correlative duty," the court presumably meant that the duty was reciprocally related to the rights allowed the insurer by the contract. As an "implication," the correlative duty was necessarily grounded in and "imposed" upon the parties by the contract.

61. The court stated: "[The insurer's] decision not to settle . . . should be an honest and intelligent one. It must be honest and intelligent if it be a good-faith conclusion. In order that it be honest and intelligent it must be based upon a knowledge of the facts and the circumstances upon which liability is predicated, and upon a knowledge of the nature and extent of the injuries so far as they reasonably can be ascertained." *Id.* at 14-15, 235 N.W. at 415.

62. *Id.* at 16, 235 N.W. at 415 ("In all controversies between the parties to the contract, the question is, What are the duties and responsibilities imposed by the *contract*?") (emphasis added).

63. The Wisconsin Supreme Court subsequently recognized the tort of bad faith in the first-party setting in Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 686-87, 271 N.W.2d 368, 374 (1978). In so doing, the court "revised" the *Hilker* opinion by stating explicitly that the tort of bad faith is not the same as a tortious breach of contract and claiming that its recognition of the tort had "its origin" in *Hilker. Id.* at 687, 271 N.W. 2d at 374. Relying on the California decision of Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973), which recognized an action in tort for breaching the covenant of good faith and fair dealing, the *Anderson* court characterized both *Gruenberg* and its own opinion as logical extensions of *Hilker.* 85

2. Disadvantages of the Contract Approach

Treating the duty of good faith and fair dealing as a contract duty entails some disadvantages. Among the most disconcerting is the fact that limiting the damages that the insurer must pay to the face value of the contract minimizes the deterrent to the insurer inclined to take advantage of its insured.[64] In first-party insurance, this limitation means that the insurer has relatively little to lose by refusing to pay the insured's claim and forcing the insured to sue. The most that the insured can recover in the contract action is the amount of the claim plus interest. If commercial rates of interest exceed the legal rates, as has been the case in recent years, the insurer may actually profit by delaying payment of proceeds until a later time.[65] Similarly, in third-party insurance, if the outer limit of the insurer's liability in the event of its refusal to provide a defense is the policy amount plus the cost of the

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Wis. 2d at 689-90, 271 N.W. 2d at 375-76. Beyond the obvious boot-strapping nature of this analysis, the court also ignored the fact that the good faith standard referred to in *Hilker* was a standard for measuring compliance with the contract duty, a standard which, as the court itself observed, need have no relationship at all to a duty in tort. That *Gruenberg* itself was hardly an inevitable decision is discussed in the next section. *See infra* notes 78-105 and accompanying text.

In Allis-Chalmers Corp. v. Lueck, 105 S. Ct. 1904 (1985), the United States Supreme Court had the occasion to describe Wisconsin's law of bad faith when deciding whether section 301 of the Labor Management Relations Act of 1947, 29 U.S.C. § 185(a) (1982), preempts a state tort action for bad faith delay in making disability payments due under a collective bargaining agreement. The Court found "no indication in Wisconsin law that the tort is anything more than a way to plead a certain kind of contract violation in tort in order to recover exemplary damages not otherwise available under Wisconsin law." 105 S. Ct. at 1914.

One commentator reads *Hilker* as a case that "blends" the "covenant of good faith and fair dealing implied in *every* contract . . . [with] the concepts of bad faith and negligence. . . ." S. ASHLEY, BAD FAITH ACTIONS: LIABILITY AND DAMAGES §§ 2.14-2.15 (1984). However, Ashley makes the common error of assuming that all references to "bad faith" denote a reference to a tort theory of recovery, based in part on his failure to recognize that damages exceeding the policy limits *can* be awarded in a contract action if they are within the range of foreseeable consequential damages. *See infra* notes 136-37 and accompanying text.

64. *See* Birnbaum & Wrubel, *supra* note 2, at 5 ("The case law reveals numerous examples of insurers using their superior legal and financial resources to avoid meritorious claims by unreasonably delaying payments, discontinuing benefits on the basis of contrived claims of ineligibility, callously subjecting insureds to protracted and unnecessary medical evaluations, fabricating charges of arson and fraud, and otherwise maliciously seeking to take advantage of the dire financial circumstances of their insureds.").

65. For example, the insured who has suffered a total loss of his residence by fire rarely has the financial resources or the mental fortitude to initiate litigation against the insurer. In such circumstances, the insurer might be able to pressure the insured to settle for less than the amount of the claim. The insurer might even choose to take the chance that its position would be vindicated in court; the insured who is forced to sue the insurer for the amount of the claim is not likely to be reimbursed in full, because the insured must also pay for the costs of recouping the sum from the insurer.

insured's defense, the insurer has little to lose by refusing to provide the defense.[66] Moreover, if the limit of the insured's recovery for breach of the duty to settle is the face value of the policy,[67] the insurer has little incentive to settle the claim against the insured in circumstances where there is a large potential of an excess judgment, because the insurer would not be liable for this excess amount. Finally, the possibility of securing large monetary judgments is arguably what enables aggrieved individuals to obtain legal representation of the quality readily accessible to wealthier entities.[68] By this analysis, if insureds are restricted to recovering contract remedies, attorneys will be less willing to take these cases, since the potential recoveries, from which attorneys take their fees, are reduced.

C. *Good Faith as a Tort Duty*

The reported cases record numerous instances where insurers either have ignored the interests of their insureds or have taken advantage of them during their periods of vulnerability. One way to reduce the incentive for this kind of insurer conduct is to increase the damages that might be awarded the insured who suffers a loss as a result of an insurer's deliberate refusal to perform its promises. Because tort law affords a broader range of damages than contract law,[69] treating the insurer's duties, such as the duty of good faith and fair dealing, as sounding in tort is one avenue available for deterring insurer misconduct. This approach was adopted by courts in California.

1. The California Example

Although earlier California cases recognized that every contract contains an implied covenant of good faith and fair dealing,[70] *Brown v.*

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66. There is a risk that the attorney chosen by the insured will claim an excessive fee; the insurer has less control over the attorney's billing habits if the insurer does not retain the attorney for the insured. However, the risk of paying a high fee, in the insurer's view, may be less important than the opportunity to escape liability altogether. *See* S. ASHLEY, *supra* note 63, at § 11.02.

67. Fortunately, this is not ordinarily the case. *See supra* note 2 and accompanying text.

68. *See* Belli, *Punitive Damages: Their History, Their Use and Their Worth in Present-Day Society*, 49 U.M.K.C. L. REV. 1, 6 (1980) (availability of punitive damages acts as an incentive for attorneys to take cases); Owen, *Punitive Damages in Products Liability Litigation*, 74 MICH. L. REV. 1257, 1287-90, 1295-97 (1976) (punitive damages provide a fund for the payment of litigation expenses and motivate many reluctant plaintiffs to press their claims).

69. *See supra* note 2.

70. *See* Brown v. Superior Court, 34 Cal. 2d 559, 564, 212 P.2d 878, 881 (1949); Nelson v. Abraham, 29 Cal. 2d 745, 750-51, 177 P.2d 931, 934 (1947); Universal Sales Corp. v. California Press Mfg. Co., 20 Cal. 2d 751, 771, 128 P.2d 665, 677 (1942).

Guarantee Insurance Co.[71] was the first California decision to examine the duty of good faith in the insurance setting. In *Brown*, the trial court dismissed plaintiff's complaint alleging that the insurer "did not exercise the good faith required of it by law" when it refused to settle a $15,000 damage claim arising out of an automobile accident for $5,000, the amount of the policy limits.[72] One of the issues for resolution on appeal concerned the insurer's liability for its refusal to settle a claim against the insured.[73]

In holding the insurer liable for the breach of its duty to settle, the appellate court listed three alternative ways to describe the obligation of an insurer who undertakes to defend and enters into settlement negotiations on the insured's behalf: a duty whose scope is defined by the language of the policy; an obligation derived from fiduciary or agency principles, meaning that as a fiduciary the insurer has a duty to settle in "good faith"; or an obligation grounded in tort, which requires the insurer to defend the insured with "due care."[74] The court observed that most courts described liability in terms of good faith for several reasons, including: (1) the fact that the relationship between insurer and insured closely approximates that of beneficiary and trustee, or principal and agent, where a good faith test, rather than a negligence standard, is used; (2) the practical difficulties inherent in determining, from the position of hindsight, whether the insurer acted without negligence; and (3) the absence of a contractual obligation on the insurer to effect settlement within policy limits.[75]

Ironically, the insurer in *Brown* argued that the insured's claim sounded in tort.[76] The insurer hoped to persuade the court that the insured's claim was not assignable and therefore could not be asserted by the plaintiff, who had been assigned the claim by the insured's trustee-in-bankruptcy. Yet the court declined to rule whether the claim sounded in tort or contract, because even if it were a tort claim, it was

71. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

72. *Id.* at 681, 319 P.2d at 70.

73. *Id.* at 682-83, 319 P.2d at 71. The other issue on appeal was whether an insured possesses such an action, and the court resolved that issue with an affirmative answer.

74. *Id.* at 683, 319 P.2d at 71-72 (citing Radcliffe v. Franklin Nat'l Ins. Co., 208 Or. 1, 22-23, 298 P.2d 1002, 1012 (1956)).

75. *Id.* at 687-88, 319 P.2d at 74. The court also observed that making insurers responsible for losses in excess of policy limits could be a significant burden; rather than imposing such a burden for mere negligence, the court reasoned that "substantial culpability" should exist, and that this occurs when the insurer acts in bad faith. *Id.* at 688, 319 P.2d at 74-75.

76. *Id.* at 692-93, 319 P.2d at 77.

not the kind that was unassignable.[77]

One year after *Brown*, the California Supreme Court decided *Comunale v. Traders & General Insurance Co.*[78] There the insured while driving a truck struck Mr. and Mrs. Comunale in a pedestrian crosswalk. When the Comunales sued the insured, the insurer refused to provide the insured with a defense, claiming that no coverage existed because the insured was driving a vehicle he did not own. During the lawsuit, the Comunales offered to settle both claims for a sum below the policy limits.[79] Again, the insurer refused either to defend or to settle. Eventually, the jury returned verdicts in favor of the Comunales in excess of the policy limits.[80] The Comunales then obtained an assignment of the insured's rights against the insurer and sought to recover from the insurer the amount of the judgment exceeding the policy limits.[81]

The court in *Comunale* stated that because the claim asserted against the insured was within the policy's coverage,[82] it gave rise to an express contractual duty by the insurer to defend the insured in any related lawsuit. By "fail[ing] to consider [the insured's] interest in having the suit against him compromised by a settlement within the policy limits,"[83] the insured breached the "implied covenant of good faith and fair dealing," a promise implied "in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."[84] Citing the California damages statute for breach of *contract*, the court rejected the view that the insurer cannot be liable for a judgment exceeding the policy limits where the insurer, believing there is no coverage, refuses to defend and unjustifiably refuses to settle the claim.[85]

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77. *Id.* at 695, 319 P.2d at 79.

78. 50 Cal. 2d 654, 328 P.2d 198 (1958).

79. The policy limits were $10,000 per person and $20,000 per accident. The Comunales offered to settle their claims for $4,000. *Id.* at 657, 328 P.2d at 200.

80. Mr. Comunale recovered a judgment for $25,000 and Mrs. Comunale recovered a judgment for $1,250. *Id.*

81. *Id.* at 658, 328 P.2d at 200.

82. *Id.*

83. *Id.*

84. *Id.* Quoting from Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 4, 231 N.W. 257, 258 (1930), *aff'd on reh'g*, 204 Wis. 1, 235 N.W. 413 (1931), the court said that "the rights of the insured go deeper than the mere surface of the contract written for him by the defendant." 50 Cal. 2d at 658, 328 P.2d at 200-01.

85. 50 Cal. 2d at 660-61, 328 P.2d at 201-202 (citing CAL. CIV. CODE § 3300 (West 1941)). Other issues in *Comunale* involved the assignability of the claim and the statute of limitations that governed it. Regarding the assignment, the court ruled, as had the *Brown* court, that the claim

Up to this point, the *Comunale* opinion gave no indication that the insurer's failure to defend the insured and to respond appropriately to the plaintiff's settlement offer was anything other than a breach of the insurer's contract obligations, for which the insured was entitled to a remedy in contract. Yet in considering the final issue in the case, whether the statute of limitations had run on the insured's claim, the court stated in dictum that the wrongful refusal to settle had generally been treated as a tort.[86] This statement, which permitted an inference that the *Comunale* court considered the insured's claim to sound in both contract and tort, had a critical effect on the direction of California law.[87]

Nearly a decade later, in *Crisci v. Security Insurance Co.*,[88] the California Supreme Court held that breaching the covenant of good faith and fair dealing contained in an insurance contract is a tort. Mrs. Crisci, a seventy year-old widow, had purchased a $10,000 liability policy from Security to cover liability for losses she might suffer in connection with rental property she owned. While the policy was in force, one of Crisci's tenants was injured on stairs outside her building and sued for $400,000 in damages.[89] The insurer refused the tenant's offer of $9,000, even though the attorney employed by Security to represent Crisci and the insurer's own claim manager felt the jury would probably find against the insured in an amount possibly as high as $100,000.[90] Ultimately, the jury did return a verdict against Crisci for $100,000. The company paid $10,000 of the judgment, leaving Crisci

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was assignable whether it sounded in tort or contract. *Id.* at 661, 328 P.2d at 202. California law prescribed a four year statute of limitations for actions "upon any contract, obligation or liability founded upon an instrument in writing" and a two year statute of limitations for the same actions "not founded upon an instrument of writing." (citing CAL. CIV. CODE §§ 337(1), 339 (1) (West 1941)). Because the duty to settle was a promise implied by law, it was not clear which statute of limitations applied. In holding that the four year statute applied because the promise that the law implied was a part of the written policy, *id.* at 662, 328 P.2d at 203, it was not necessary for the court to determine whether the case sounded in contract or tort. *Id.* at 663, 328 P.2d at 203.

86. *Id.* at 663, 328 P.2d at 203, (citing Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954)).

87. *But see* Critz v. Farmers Ins. Group, 230 Cal. App. 2d 788, 799, 41 Cal. Rptr. 401, 407 (1965) (reading *Comunale* as establishing "breach of an implied covenant, that is, breach of contract, as the theoretical basis of the claim"). *Critz* was later specifically criticized for its reading of *Comunale* in Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). *See infra* note 94 and accompanying text.

88. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

89. *Id.* at 427-28, 426 P.2d at 175, 58 Cal. Rptr. at 15.

90. Crisci even offered to pay $2,500 of the $9,000 herself. *Id.* at 428, 426 P.2d at 175-76, 58 Cal. Rptr. at 15-16.

with responsibility for the amount in excess of the policy limits. After Crisci became destitute as a result of her new financial burden, and her health, both physical and mental, declined, she sued Security, alleging that her difficulties were attributable to the insurer's failure to settle the lawsuit.[91]

Relying on *Comunale*, the *Crisci* court first observed that an insurer who breaches the duty to settle is liable "not for a bad faith breach of the contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing."[92] The court then turned to the question of whether Crisci could recover damages for her mental suffering. Under tort law, the injured party can recover for all injury proximately caused by the tortious action, including mental suffering, regardless of whether the injury was foreseen at the time of the act.[93] Interpreting *Comunale* to stand for the principle that the insured's action sounds both in contract and in tort,[94] the *Crisci* court held that the insured was entitled to recover tort damages for mental suffering incurred as a result of the insurer's breach of its duty to settle.

Subsequent lower court decisions in California adhere to the view that an insurer's bad faith breach of contract can constitute a tort. In *Fletcher v. Western National Life Insurance Co.*,[95] an insured alleged that his insurer had intentionally inflicted severe emotional distress by withholding his disability benefits. In allowing the claim, the court stated:

> An insurer owes to its insured an implied-in-law duty of good faith and fair dealing that it will do nothing to deprive the insured of the benefits of the policy . . . [a]s in *Crisci*, the violation of that duty sounds in tort notwithstanding that it also constitutes a breach of contract.[96]

Similarly, in *Richardson v. Employers Liability Assurance Corp.*,[97] the insurer withheld payment of a valid claim under the unin-

91. *Id.* at 428-29, 426 P.2d at 176, 58 Cal. Rptr. at 16.
92. *Id.* at 430-31, 426 P.2d at 176-77, 58 Cal. Rptr. at 17 (citing *Comunale*, 50 Cal. 2d at 658-59, 328 P.2d at 200-01).
93. 66 Cal. 2d at 433, 426 P.2d at 178, 58 Cal. Rptr. at 18.
94. *Id.* at 432-33, 426 P.2d at 178, 58 Cal. Rptr. at 18.
95. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).
96. *Id.* at 401, 89 Cal. Rptr. at 93 (citing *Crisci*, 66 Cal. 2d at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16).
97. 25 Cal. App. 3d 232, 102 Cal. Rptr. 547 (1972).

sured motorist provisions of their policy.[98] The insurer also insisted on an arbitration hearing even though it knew it had no defense to the claim. After the arbitrator returned an award in favor of the insureds, the insurer continued to resist payment and forced the insureds to seek confirmation of the award in court. The court of appeals explained that the insurer's conduct toward its own insured "was unconscionable, and constituted a tortious breach of contract."[99] The *Richardson* court also observed that because the breach of the covenant of good faith and fair dealing was a tort, punitive damages could be awarded.[100]

The California Supreme Court embraced and solidified the analyses of *Comunale*, *Crisci*, and *Richardson* in *Gruenberg v. Aetna Ins. Co.*[101] There the question was whether the plaintiff's complaint against three insurers alleged sufficient facts to state a claim in tort for breach of the implied duty of good faith and fair dealing.[102] The *Gruenberg* court quoted from all three prior cases, reiterating that an action for breach of the implied convenant of good faith and fair dealing sounded both in contract and in tort,[103] that the duty of good faith and fair dealing was "imposed by the law,"[104] and that the duty was "nonconsensual" meaning that a breach of the duty would constitute a tort.[105]

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98. The policy limits were $10,000 per person. Mrs. Richardson's medical expenses exceeded $13,000 and Mr. Richardson's exceeded $3,000. *Id.* at 237-38, 102 Cal. Rptr. at 551. An attorney testified at trial that the reasonable settlement value of Mrs. Richardson's injuries was $60,000 to $80,000. *Id.* at 239, 102 Cal. Rptr. at 552. The jury returned verdicts of $75,000 and $100,000 respectively for Mr. and Mrs. Richardson. *Id.* at 236, 102 Cal. Rptr. at 550.

99. The court also stated:

> The duty violated—that of dealing fairly and in good faith with the other party to a contract of insurance—is a duty imposed by law, not one arising from the terms of the contract itself. In other words, this duty of dealing fairly and in good faith is nonconsensual in origin rather than consensual. Breach of this duty is a tort.

Id. at 239, 102 Cal. Rptr. at 552.

100. *Id.* at 245, 102 Cal. Rptr. at 556 ("[t]he fact that the conduct constituting the tort also involves the breach of a covenant, *implied by law* in the insurance policy, does not prevent the recovery of punitive damages under [the provisions of the Civil Code providing for such damages] by the insured from the insurer.").

101. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

102. In *Gruenberg* the plaintiff alleged that the insurer and its agents had created a false implication of arson in order to avoid paying the plaintiff's claim for fire loss, and that as a result of this conduct, plaintiff suffered economic damage, emotional distress, loss of earnings, and various special damages. Plaintiff also sought punitive damages. *Id.* at 570-72, 510 P.2d at 1034-35, 108 Cal. Rptr. at 482-83.

103. *Id.* at 573, 510 P.2d at 1036, 108 Cal. Rptr. at 484 (quoting *Comunale*, 50 Cal. 2d at 658, 328 P.2d at 200).

104. 9 Cal. 3d at 573-74, 510 P.2d at 1037, 108 Cal. Rptr. at 485.

105. *Id.* at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485 (quoting *Richardson*, 25 Cal. App. 3d at 239, 102 Cal. Rptr. at 552). The court concluded:

Since *Gruenberg*, California courts have on many occasions applied the rule that the breach of the covenant of good faith and fair dealing is a tort.[106] Under these decisions, each party to the contract must "refrain from doing anything which would injure the right of the other party to receive the benefits of the agreement."[107] If the insurer unreasonably refuses to pay benefits due under the terms of the policies or to perform other promised duties, the insurer may be liable in tort for breach of the implied duty of good faith and fair dealing. More recent cases have invited California courts to apply this principle outside the insurance context.[108]

> [I]n every insurance contract there is an implied covenant of good faith and fair dealing. The duty to so act is imminent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.

9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486. *Accord* Hoskins v. Aetna Life Ins. Co., 6 Ohio St. 3d 272, 276, 452 N.E.2d 1315, 1320 (1983) (liability for bad faith breach of duty to settle "arises from the breach of the positive legal duty imposed by law due to the relationships of the parties. . . . This legal duty is the duty imposed upon the insurer to act in good faith and its bad faith refusal to settle a claim is a breach of that duty and imposes liability sounding in tort.").

106. In Jarchow v. Transamerica Title Ins. Co., 48 Cal. App. 3d 917, 122 Cal. Rptr. 470 (1975), the court stated broadly that every "breach of the covenant of good faith and fair dealing provides the injured party with a tort action for 'bad faith' notwithstanding that the acts complained of may also constitute a breach of contract." 48 Cal. App. 3d at 940, 122 Cal. Rptr. at 486. The court said that this rule applied to all insurance contracts. *Id. See also* Merlo v. Standard Life & Accident Ins. Co. of Cal., 59 Cal. App. 3d 5, 130 Cal. Rptr. 416 (1976).

107. Paulfrey v. Blue Chip Stamps, 150 Cal. App. 3d 187, 192, 197 Cal. Rptr. 501-02, 503 (1983). *See also* Austero v. National Casualty Co., 84 Cal. App. 3d 1, 26, 148 Cal. Rptr. 653, 669-70 (1978).

108. *See* Seaman's Direct Buying Serv., Inc. v. Standard Oil Co. of Cal., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (court holds that a party to a contract may incur tort remedies, when, in addition to breaching the contract, the party tries to shield itself from liability by denying in bad faith and without probable cause that a contract exists); Quigley v. Pet, Inc., 162 Cal. App. 3d 881, 208 Cal. Rptr. 394 (1984) (owner of trucking company seeking to recover damages for tortious breach of contract did not have special relationship with other contracting party that would justify an exception to the rule restricting relief to contract damages); Wallis v. Superior Court, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984) (court holds that plaintiff, whose pension was terminated by employer, stated cause of action for tortious breach of covenant of good faith and fair dealing); Wagner v. Benson, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980) (court upholds dismissal of bad faith tort claim where plaintiff claims that a bank's sale of collateral to satisfy loan was unlawful; in dictum, court states that: "A bad faith cause of action sounding in tort has never been extended to contractual relationships other than in the insurance field. . . . This does not mean such claims are limited only to insurance transactions.") 101 Cal. App. 3d at 33, 161 Cal. Rptr. at 520; Sawyer v. Bank of Am., 83 Cal. App. 3d 135, 145 Cal. Rptr. 623 (1978) (rejects plaintiff's contention that bank committed tortious breach of covenant of good faith and fair dealing on the ground that disputing liability under a contract is not the same thing as frustrating enjoyment of contract rights, which is the essence of the tort). For three other cases recognizing the tort of breaching an implied covenant of good faith and fair dealing in the

2. Disadvantages of the Tort Approach

Treating the duty of good faith and fair dealing as a tort-based duty avoids the disadvantages associated with the contract approach. Yet the tort solution entails disadvantages of its own.[109] First, treating the duty as a tort duty has increased the incidence of large jury awards,[110] some of which are difficult to justify on the reported facts of the cases.[111] Because these judgments must be paid by the insurer, they are ultimately reflected in increased premiums, a detriment to policyholders.[112] Moreover, large punitive awards are arguably contrary to

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employment setting, see Tameny v. Atlantic Richfield Co., 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980); Smithers v. Metro-Goldwyn Mayer Studios, Inc., 139 Cal. App. 3d 643, 189 Cal. Rptr. 20 (1983), *remanded in light of Seaman's*, 38 Cal. 3d 257, 696 P.2d 83, 211 Cal. Rptr. 690 (1985); Cleary v. American Airlines, 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980).

109. *See generally* Note, *Excess Liability of Insurers for Bad Faith Refusal to Settle: A Boon to the Individual Insured That Works to the Detriment of Consumers*, 18 SUFFOLK U.L. REV. 377 (1984).

110. *See* Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 534, 538, 647 P.2d 1127, 1132, 1136, *cert. denied*, 459 U.S. 1070 (1982) ($3,000,000 punitive award against insurer for bad faith refusal to pay health benefits); Pistorius v. Prudential Ins. Co., 123 Cal. App. 3d 541, 555-56, 176 Cal. Rptr. 660, 668-69 (1981) ($1,000,000 punitive award for insurer's bad faith disregard of insured's rights under disability policy); Liberty Mut. Ins. Co. v. Altfillisch Constr. Co., 70 Cal. App. 3d 795, 797, 139 Cal. Rptr. 91, 95 (1977) ("the presence of this implied covenant as a part of all insurance contracts has been increasingly the source of spectacular jury awards based on tort theory. . . ."); Kornblum, *Recent Cases Interpreting the Implied Covenant of Good Faith and Fair Dealing*, 30 DEF. L.J. 411, 412 nn.5-8 (1981).

On October 10, 1985, a Los Angeles Superior Court jury ordered Allstate Insurance Company to pay a woman nearly $500,000 in damages for emotional distress and $8,500,000 in punitive damages after concluding that the insurer wrongfully attached and withheld $13,000 from her. *Insurance Co. Must Pay $8.5M Punitive Award*, The Nat'l L.J., Oct. 28, 1985, at 9, col. 1 (discussing Banter v. Allstate, No. 282106 (L.A. Super. Ct., Cal. Oct. 10, 1985)).

111. *See* Wetherbee v. United Ins. Co. of Am., 265 Cal. App. 2d 921, 924, 71 Cal. Rptr. 764, 767 (1968), where a jury awarded $500,000 in punitive damages and only $1,050 in compensatory damages to an insured who claimed successfully that her insurer fraudulently represented the benefits of a health and accident policy. The punitive damages award, which was later reduced to $200,000, was purported to be reasonable on the ground that it amounted to less than one week's after-tax income for the insurer. 18 Cal. App. 3d at 271-72, 95 Cal. Rptr. at 681-82. *See also* Neal v. Farmers Ins. Exch., 21 Cal. 3d 910, 927 n.11, 582 P.2d 980, 990 n.11, 148 Cal. Rptr. 389, 399 n.11 (1978) (upholding an award of $740,000 in punitive damages where only $9,011.48 in compensatory damages were assessed); Chodos v. Insurance Co. of N. Am., 126 Cal. App. 3d 86, 100-04, 178 Cal. Rptr. 831, 838-41 (1981) (upholding a punitive award of $200,000 against an insurer when compensatory damages were only $146.71); Austero v. National Casualty Co., 84 Cal. App. 3d 1, 18, 148 Cal. Rptr. 653, 664 (1978) (in a suit against a disability insurer, the jury awarded the insured $33,600 in unpaid policy benefits, $33,600 in damages for emotional distress, $336,000 in punitive damages, and $2,800 in interest).

112. *See* DiMarzo v. American Mut. Ins. Co., 389 Mass. 85, 109, 449 N.E.2d 1189, 1204 (1983) (Hennessey, C.J., concurring) (the insured's recovery "is at the expense of other consumers"). Of course, there are mechanisms in the system for reviewing excessive judgments and for preventing punitive damages claims for getting to the jury. *See* Comment, *Extracontractual In-*

the public interest, because it is in the public's interest for insurers to remain solvent.[113]

Second, the possibility of securing a high damage award encourages some insureds to file marginal lawsuits.[114] Litigation over relatively insignificant claims adds to the already very high costs of insurer-provided defenses; the recent increases in such costs threaten to reduce the scope of coverage made available to the public.[115]

Finally, the risk of suffering a high judgment encourages insurers to settle some insured's claims at sums exceeding their real value.[116] As one appellate court observed, "[e]xperience shows that in looking ahead no one can predict what any particular jury will do."[117] The precise scope of the duty of good faith and fair dealing is inevitably unclear,[118]

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surance Damages: Pennsylvania Insureds Demand a "Piece of the Rock", 85 DICK. L. REV. 321, 331-33 (1981). That these devices are applied effectively and consistently is far from clear. Moreover, the mere *risk* of a large judgment can have detrimental effects. *See infra* notes 116-118 and accompanying text.

113. *See* Blake v. Aetna Life Ins. Co., 99 Cal. App. 3d 901, 924, 160 Cal. Rptr. 528, 542 (1979) (insurer has "obligation to other policy holders and to stockholders not to dissipate its reserves through the payment of meritless claims"); Austero v. National Casualty Co., 84 Cal. App. 3d 1, 30, 148 Cal. Rptr. 653, 672 (1978) ("[b]esides the duty to deal fairly with the insured, the insurer also has a duty to its other policyholders and to the stockholders . . . not to dissipate its reserves through the payment of meritless claims"); Note, *Damages Assessed Against Insurers for Wrongful Failure to Pay*, 10 WM. & MARY L. REV. 466, 475 (1968).

114. *See* Gould v. Mutual Life Ins. Co., 735 F.2d 1165 (9th Cir. 1984); DiMarzo v. American Mut. Ins. Co., 389 Mass. 85, 109, 449 N.E.2d 1189, 1204 (1983) (threat of suit may impair bargaining position of insurer in cases where there is no bad faith conduct by insurer). For some cases where insurers prevailed in defeating such marginal claims, see Allender v. Guardian Life Ins. Co. of Am., 592 F. Supp. 541 (N.D. Ill. 1984); Armstrong v. Life Ins. Co. of Va., 450 So. 2d 1377 (Ala. 1984); Federated Guar. Life Ins. Co. v. Wilkins, 435 So. 2d 10 (Ala. 1983); Prudential Ins. Co. v. Coleman, 428 So. 2d 593 (Ala. 1983); Manis v. Hartford Fire Ins. Co., 681 P.2d 760 (Okla. 1984).

115. *See* N.Y. Times, June 11, 1985, at 1, col. 2 (reporting on "sweeping insurance changes," their effects on business costs, and a proposal to subtract legal costs from the policy limits).

116. *See* Creedon, *Punitive Damages for Breach of Contract—Does the Punishment Fit the Crime?*, 4 DET. C.L. REV. 1149, 1153 (1983) (author, a president and chief executive officer of a large insurance company, claims that punitive damage awards can encourage companies to pay improper claims); Comment, *Liability Insurers and Third-Party Claimants: The Limits of Duty*, 48 U. CHI. L. REV. 125, 133 (1981) ("[t]he prospect of [a bad-faith] suit is so unattractive to an insurer that it is likely to settle when it could win on the merits").

117. Hodges v. Standard Accident Ins. Co., 198 Cal. App. 2d 564, 575, 18 Cal. Rptr. 17, 24 (1961). For a lawyer's first-hand account of the vagaries of jury decision making, see Anonymous, *Impressions of a Not-So-Average Juror*, 7 AM. J. TRIAL ADVOC. 141 (1983).

118. *See* Rogers, *Insurers' View of Cases in Excess-of-Policy Limits—Third-Party-Bad-Faith Cases*, in EXTRACONTRACTUAL DAMAGES 55, 58 (1983) (counsel for insurance company states that "[t]he exact content of the implied covenant of good faith has proved to be nearly as difficult to ascertain as was the definition of 'bad faith' when that factor, rather than the breach of the implied covenant of good faith, was the touchstone of excess liability"); Comment, *The Expecta-*

and the impact of this uncertainty is magnified when the potential damage recoveries for persons asserting breach of the duty are very high.[119] Like the cost of excessive judgments, the cost of settling claims at prices exceeding their worth is ultimately borne by the consumer.

III. AN ALTERNATIVE APPROACH

Today, virtually every state allows the insured to recover damages exceeding the policy limits in a third-party situation where the insurer fails to accept a reasonable settlement offer. As noted above, however, the courts are not unanimous regarding the theory on which this conclusion is based. Most jurisdictions have adopted a tort rationale as the basis for recoveries against the insurer exceeding the policy limits.[120] This "tort" is often referred to as a "bad faith breach of contract," presumably because "good faith" is the touchstone for whether the duty has been breached in most jurisdictions.[121] Approximately twenty

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tion of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts, 56 S. CAL. L. REV. 1345, 1374 (1983) ("[a] colorable claim of unreasonableness can conceivably be made in virtually every case of erroneous denial of insurance benefits").

119. Because punitive damages are usually justified on the basis of deterrence, punitive damages that deter *beneficial* behavior are contrary to public policy. If a potential defendant perceives, correctly or incorrectly, that a jury is likely to determine liability and assess damages based on passion or prejudice and the award of damages is not likely to be subjected to meaningful judicial review, the potential defendant is likely to be "overdeterred." Moreover, when plaintiffs, encouraged by their attorneys, promote their self-interest by attempting to maximize the monetary recovery, no incentive exists in the system to limit the recovery of damages to the minimum necessary to deter wrongful conduct. Wheeler, *The Constitutional Case for Reforming Punitive Damages Procedures*, 69 VA. L. REV. 269, 306-08 (1983).

120. *See supra* note 24 and accompanying text. Obtaining an accurate count of the tort jurisdictions is by no means a simple task. This is due in large measure to the imprecision with which the term "bad faith" is used. For example, the mere fact that the insured recovers proceeds exceeding the policy limits does not mean that the insured's action was in tort; yet one commentator has referred to such cases as exemplary of the tort action for bad faith. *See* S. ASHLEY, *supra* note 63, at § 1.03. Some states have refused to recognize a generic "tort of bad faith." *See, e.g.*, Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 922-26, 611 P.2d 149, 155-58 (1980); Kewin v. Massachusetts Mut. Life Ins. Co., 409 Mich. 401, 423, 295 N.W.2d 50, 54 (1980), *modifying*, 79 Mich. App. 639, 263 N.W.2d 258 (1977) ("[w]e decline . . . to declare the mere bad-faith breach of an insurance indemnity contract an independent and separately actionable tort and to thereby open the door to recovery for mental pain and suffering caused by breach of a commercial contract"); Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 614, 392 A.2d 576, 581 (1978) ("allegations of an insurer's wrongful refusal or delay to settle a first-party claim do not state a cause of action in tort").

121. *See supra* notes 18-21 and accompanying text; Savio v. Travelers Ins. Co., 678 P.2d 549, 553 (Colo. Ct. App. 1983) (insured who "unreasonably and in bad faith withholds a claim of its insured" is subject to liability in tort); U.S. Fidelity & Guar. Co. v. Peterson, 91 Nev. 617, 620, 540 P.2d 1070, 1071 (1975) (insurer's conduct "may give rise to a cause of action in tort for

jurisdictions have extended the principle that a tort action exists for bad faith breach of contract in the third-party setting to the first-party setting.[122] About twelve states have refused to extend the principle in this way on the ground that the first-party situation lacks certain characteristics crucial to the existence of a tort duty in the third-party situation, such as the insurer's assumption of a fiduciary duty by virtue of taking over the insured's defense.[123] Fewer cases have addressed the specific question of whether the implied covenant of good faith and fair dealing sounds in tort or contract, but most of the courts to consider this issue have said that the duty is grounded in tort.[124]

Neither the contract nor the tort approach toward the duty of good faith and fair dealing is free from disadvantages.[125] The tort approach balances the competing interests of insured and insurer excessively in favor of the insured, while the contract approach, as currently understood and applied by courts, balances these interests excessively

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breach of an implied covenant of good faith and fair dealing").

122. S. ASHLEY, *supra* note 63, at § 2.22. *See, e.g.*, Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916, 924-25 (Ala. 1981); Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 538, 647 P.2d 1127, 1136, *cert. denied*, 459 U.S. 1070 (1982); Christian v. American Home Assur. Co., 577 P.2d 899, 904 (Okla. 1977); Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980); Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 686-87, 271 N.W.2d 368, 374 (1978).

123. S. ASHLEY, *supra* note 63, at § 2.22. *See, e.g.*, Duncan v. Andrew County Mut. Ins. Co., 665 S.W.2d 13, 18-19 (Mo. Ct. App. 1984); Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 922-26, 611 P.2d 149, 155-58 (1980); Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 614, 392 A.2d 576, 581 (1978); Santilli v. State Farm Life Ins. Co., 278 Or. 53, 62-63, 562 P.2d 965, 970 (1977); Beck v. Farmers Ins. Exch., 701 P.2d 795, 799-200 (Utah 1985).

124. *See, e.g.*, Craft v. Economy Fire & Casualty Co., 572 F.2d 565 (7th Cir. 1978) (applying Indiana law); Eckenrode v. Life of Am. Ins. Co., 470 F.2d 1, 3-4 (7th Cir. 1972) (applying Illinois law); Phillips v. Aetna Life Ins. Co., 473 F. Supp. 984, 990 (D. Vt. 1979) (applying Vermont law); Robertson v. State Farm Mut. Auto Ins. Co., 464 F. Supp. 876, 883 (D.S.C. 1979) (applying South Carolina law); Gulf Atl. Life Ins. Co. v. Barnes, 405 So. 2d 916, 924-25 (Ala. 1981); United Servs. Auto. Assoc. v. Werley, 526 P.2d 28, 33 (Alaska 1974); Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 647 P.2d 1127 (1982); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 578, 510 P.2d 1032, 1040, 108 Cal. Rptr. 480, 488 (1973); Amsden v. Grinnel Mut. Reins. Co., 203 N.W.2d 252, 254-55 (Iowa 1972) (quoting Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 401-04, 89 Cal. Rptr. 78, 93-95 (1970)); United States Fidelity & Guar. Co. v. Peterson, 91 Nev. 617, 619-20, 540 P.2d 1070, 1071 (1975); Firemen's Fund Ins. Co. v. Sec. Ins. Co., 72 N.J. 63, 72-73, 367 A.2d 864, 869 (1976); State Farm Gen. Ins. Co. v. Clifton, 86 N.M. 757, 759, 527 P.2d 798, 800 (1974); Corwin Chrysler-Plymouth v. Westchester Fire, 279 N.W.2d 638, 643 (N.D. 1979); Hoskins v. Aetna Life Ins. Co., 6 Ohio St. 3d 272, 276, 452 N.E.2d 1315, 1320 (1983); Christian v. American Home Assurance Co., 577 P.2d 899, 904 (Okla. 1977); Diamon v. Pennsylvania Mut. Fire Ins. Co., 247 Pa. Super. 534, 553-54, 372 A.2d 1218, 1228 (1977); Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980); MFA Mut. Ins. Co. v. Flint, 574 S.W.2d 718, 721 (Tenn. 1978); Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 686-87, 271 N.W.2d 368, 374 (1978).

125. *See supra* notes 64-68 & 109-119 and accompanying text.

in favor of the insurer. Contract law is capable, however, of balancing these competing interests in a reasonable, fair way. Specifically, by relaxing the foreseeability limitation on the recovery of damages in contract, it would be possible to broaden the damages recovered by the insured in contract without exposing the insurer to the full measure of tort remedies.

As a general rule, the injured party's remedy in contract consists of two elements: the benefit of the bargain for which he contracted,[126] plus incidental and consequential damages.[127] Because consequential damages are potentially extremely high, courts have traditionally constrained the amount recoverable for breach of contract by the foreseeability limitation articulated in the old English case *Hadley v. Baxendale*:[128] The nonbreaching party can recover those damages that arise naturally from the breach and that were foreseeable by the parties at the time they entered into the contract.[129] Most courts have taken a fairly rigid view of this limitation in the insurance context and have declined to allow recovery for many kinds of consequential damages arising from breach of the insurance contract, including damages for emotional distress,[130] loss of employment and impaired health,[131] and loss of credit and property.[132] The underlying principle is that such damages are too remote for the insurer's breach of contract to be considered reasonably foreseeable at the time the contract is formed.

This rigid, traditional contract approach fails to take into account the realities of many insurance transactions. Consumers often purchase insurance because they are unable to bear the financial losses associated with certain kinds of casualties: The typical household is often unable to absorb the expenses associated with the destruction of the

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126. The loss of the benefit of the bargain can be measured by calculating the value of the other side's performance that was not received (e.g., the difference in value between what the breaching party promised to do and what the breaching party did) and subtracting expenses saved as a result of the breach.

127. Incidental damages are essentially those costs incurred in a reasonable (even if unsuccessful) effort to avoid the consequences of the other party's breach. Consequential damages include injury to person or property resulting from breach (e.g., lost profits). *See* RESTATEMENT (SECOND) OF CONTRACTS § 347 comment c (1981).

128. 9 Ex. 341, 156 Eng. Rep. 145 (1854).

129. *Id.* at 354-55, 156 Eng. Rep. at 151.

130. *See, e.g.*, Dawkins v. National Liberty Life Ins. Co., 252 F. Supp. 800, 802 (D.S.C. 1966); National Security Fire & Casualty Co. v. Vinson, 414 So. 2d 49, 52 (Ala. 1982); Spencer v. Aetna Life & Casualty Co., 227 Kan. 914, 920, 611 P.2d 149, 153-54 (1980).

131. *See* Meridian Mut. Ins. Co. v. McMullen, 152 Ind. App. 141, 282 N.E.2d 558 (1972).

132. *See* Gross v. Connecticut Gen. Life Ins. Co., 390 S.W.2d 388 (Tex. Ct. App. 1965).

home, the death or disability of the principal wage earner, or the costs of major medical care. Insurers know this when they sell insurance to consumers; indeed, insurers and their representatives often emphasize the effects of such casualties in attempting to convince the consumer to purchase insurance. Thus, it is inaccurate to claim that the emotional distress that results when an insurer refuses to pay for the destruction of a house, to make disability payments, to pay death benefits, or to reimburse major medical expenses is not foreseeable by the insurer at the time that the insurer enters into the contract.[133] Compensating the insured for this damage to peace of mind will involve some calculation difficulties, but these will be no more severe than those dealt with routinely by courts in other settings.[134]

Consumers also purchase insurance to avoid the costs—including consequential costs—associated with certain kinds of losses. For example, a person operating a small business may purchase business interruption insurance not only for the limited purpose of maintaining a stream of income but also to maintain the insured's ability to pay fixed costs that, if not paid, would result in the business' termination and bankruptcy. In this context, it is foreseeable to the insurer at the time of contracting that the failure of the insurer to pay valid claims could result in consequences well beyond the decline in the firm's short-term profits.

Contract remedies are not inherently incapable of redressing the kinds of losses and injuries frequently suffered by insureds when insurers fail to perform their obligations. Insureds should be able to recover those extracontractual damages that naturally flow from the insurer's breach and are foreseeable at the time of contracting. This alternative approach is really no different than that followed by courts that allow insureds to recover excess judgments when the insurer unreasonably

133. *See* Paulfrey v. Blue Chip Stamps, 150 Cal. App. 3d 187, 195, 197 Cal. Rptr. 501, 505 (1983) ("the purpose of health and accident insurance is [to protect against loss and] to provide peace of mind and security"); Farris v. United States Fidelity & Guar. Co., 284 Or. 453, 479 n.4, 587 P.2d 1015, 1028 n.4 (1978) (Lent, J., dissenting) (typical insurer advertising campaigns demonstrate that "the relationship between insurer and insured does not merely concern indemnity for monetary loss"); D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co., 262 Pa. Super. 331, 342-43, 396 A.2d 780, 786 (1978), *aff'd*, 494 Pa. 501, 431 A.2d 966 (1981) (advertising slogans engender insured's expectation that company will support the insured in time of need); Slawson, *Mass Contracts: Lawful Fraud in California*, 48 S. CAL. L. REV. 1, 38 (1974) (insurers advertise the sale of peace of mind); Comment, *The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts*, 56 S. CAL. L. REV. 1345, 1346-48, 1362 (1983).

134. *See* Comment, *supra* note 133, at 1374-75 n.184.

refuses a settlement offer within the policy limits.[135] Moreover, this approach would not confront insurers with exorbitant awards; the "naturally arising from" limitation would exclude damages that are caused by factors other than the insurer's breach. Thus, a person who claims that his business was bankrupted by the insurer's failure to pay the proceeds of a policy would not have a valid claim for consequential damages if the evidence showed that the firm was losing money and destined for bankruptcy before the loss.

In effect, the alternative approach recognizes that most insurance transactions are more than ordinary commercial transactions.[136] In a negotiated bargain between two sophisticated businesses, the parties are expected to foresee possible losses and to take steps in the contract to allocate the risks of those losses thought to be significant. Such parties do not expect to be liable for, or to be able to recover, damages for such injuries as emotional distress. Yet contract law has long recognized that some kinds of contracts are designed to protect peace of mind and that nonperformance can lead to serious mental anguish.[137] In these areas, courts have expanded the range of foreseeability, permitting parties aggrieved by breaches to recover more than allowed under the traditional contract remedy. The alternative approach urged here places insurance contracts in the same category as those contracts where extracontractual damages have been awarded in the past. At the same time, this approach insulates insurers from the kinds of damage awards that are most volatile, especially punitive damages. The insurer who knows that it must compensate the insured for all legitimate compensatory damages, including impairment of the peace of mind for which the insured bargained, is likely to be deterred from treating the insured unreasonably.

A few courts have indicated a willingness to view the foreseeability limitation less strictly in the insurance setting.[138] For example, in *Law-*

135. Such damages are a natural result of the breach, reasonably foreseeable at the time of contracting, should the insurer fail to perform properly its duty to settle. *See supra* notes 85-92 and accompanying text.

136. *See infra* notes 171-73 and accompanying text.

137. *See, e.g.*, Chelini v. Nieri, 32 Cal. 2d 480, 196 P.2d 915 (1948) (contract to embalm a deceased relative); Windeler v. Scheers Jeweler, 8 Cal. App. 3d 844, 88 Cal. Rptr. 39 (1970) (contract to care for heirloom jewelry); Westervelt v. McCullough, 68 Cal. App. 198, 228 P. 734 (1924) (contract to provide residence for an elderly person); Mentzer v. Western U. Tel. Co., 93 Iowa 752, 62 N.W. 1 (1895) (contract for delivery of death message); *see* Comment, *supra* note 133, at 1354.

138. *See, e.g.*, Asher v. Reliance Ins. Co., 308 F. Supp. 847, 852 (N.D. Cal. 1970) (applying Alaska and California law); Olson v. Rugloski, 277 N.W.2d 385, 388 (Minn. 1979) (lost profits

ton v. Great Southwest Fire Insurance Company,[139] the court held that restricting the insured to the policy limits in a first-party case would often be an inadequate remedy.[140] The *Lawton* court explained that in an appropriate case, consequential damages exceeding the policy limits—to compensate the insured for foreseeable financial injuries such as loss of business opportunity and loss of use of the property—might be recoverable.[141] The issue of whether alleged consequential injuries were foreseeable at the time of contracting would be a question of fact for determination by a jury.[142] The *Lawton* case thus illustrates how the alternative contract approach can offer an effective way to balance the competing interests of insurer and insured without exposing the insurer to exorbitant damage awards not necessary to deter overreaching. Under this approach, the duty of good faith and fair dealing is properly viewed as a promissory obligation outside the scope of the concerns of tort law.

IV. RATIONALIZING THE ALTERNATIVE APPROACH

A. *The Nature of Implied Terms*

1. The Inevitability of Gaps in Contracts

The most common method of creating a contract involves exchanging words or symbols. In setting the terms of the contract, parties can state them orally, reduce them to writing, or declare them by some combination of written and spoken manifestations. It is also possible for parties to infer contract terms entirely or partly from conduct. A contract term that is manifested by a party through words or conduct is an "express" term.[143]

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recoverable); *cf.* Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 2d 914, 918, 611 P.2d 149, 152 (1980) ("when an insured purchases insurance, he is purchasing more than financial security; he is purchasing peace of mind").

139. 118 N.H. 607, 392 A.2d 576 (1978).

140. *Id.* at 612, 392 A.2d at 579. The court stated that such action "would unnecessarily encourage insurers to delay settlement in an attempt to coerce a financially pressured claimant into accepting an unfair settlement because its only liability would be to pay its original obligations and interest." *Id.*

141. 118 N.H. at 611-12, 392 A.2d at 579. ("The policy limits restrict the amount the insured may have to pay in the performance of the contract, not the damages that are recoverable for its breach."). *Id.* at 611, 392 A.2d at 579.

142. *Id.* at 612, 392 A.2d at 579-80.

143. The common assumption that express terms of a contract must be reduced to writing or conveyed orally is incorrect: Terms manifested from one party to another by conduct are just as

Of course, parties never enter into a contract that contains express terms for all the contingencies that might arise during the contract's performance. The parties will negotiate over and agree upon several key terms, but there will be some matters on which the parties will have no subjective expectations at all.[144] Furthermore, the parties will not want to attempt to discuss and reach agreement on all imagined or unimagined situations that might arise during contract performance, because that effort would be far too time consuming and expensive.[145] Accordingly, after the parties complete the process of contract formation, it is inevitable that the contract will have gaps.

2. Implication from Actual Intent

Usually, the inevitable failure of the parties to provide a contract term for every situation that might arise during contract performance is inconsequential. Sometimes, however, a dispute arises as to how an unexpected situation should be managed. If the parties cannot resolve the dispute on mutually acceptable terms, one of the parties may seek relief in court. The common law process of case-by-case adjudication has resulted in the development and evolution of various well-settled principles of law that provide the substance with which courts fill the gaps left by parties in their contracts.[146]

One way to fill such gaps is, in Corbin's words, by "implication."[147] Consider the following example. S enters into a contract with B to provide services for B, but the parties fail to say anything in their

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express as terms spoken by or written from one party to another. J. MURRAY, MURRAY ON CONTRACTS § 9, at 14-15 (1974).

144. *See* Farnsworth, *Disputes Over Omission in Contracts*, 68 COLUM. L. REV. 860, 869-71 (1968).

145. *See* Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 371 (1980). The excessive costs associated with negotiating individual contracts often lead to standardization of forms and language. If such standardization is cost-effective, the same economic incentives pointing away from negotiation of discrete transactions will result in gaps in negotiated contracts.

146. Some of these principles are now statutorily codified for goods transactions. *See, e.g.*, U.C.C. § 2-305(1)(a) (1978) (where parties say nothing as to price, the contract price is "a reasonable price at the time for delivery"); § 2-306(1) (a term that measures quantity by output of seller or requirements of buyer means "such actual output or requirements as may occur in good faith"); § 2-307 (where contract is silent, delivery must occur in one lot and payment is due upon tender); § 2-308 (in absence of agreement, place for delivery or shipment where contract is silent is seller's place of business); § 2-309 (in absence of agreement, time for delivery or shipment where contract is silent is a reasonable time); §§ 2-312, 2-314 to 2-315 (implied warranties of title, merchantability, and fitness for a particular purpose).

147. *See* A. CORBIN, 3 CORBIN ON CONTRACTS § 561, at 278 (1960).

contract about the quality of the services. S subsequently performs the services for B, but B believes the services to be of unacceptably low quality and refuses to pay for them. S believes that B is acting unreasonably in the circumstances; S's considerable efforts to convince B to pay for the services are unsuccessful. As a last resort, S files a lawsuit against B seeking payment for the services. At trial, the evidence is clear that the parties intended to and did in fact enter into a contract with each other, but did not say anything in their contract about the quality of the services to be provided.

The question of whether S has a valid claim against B therefore depends on how the court fills the gap in the contract. In the implication process, the court will examine the transaction for indicators of what the parties actually intended. If there is some evidence in the language of the contract or in the circumstances of the transaction indicating that both parties understood that B must be satisfied with the services before being obligated to pay, the court will imply a term in the contract that B must be satisfied with S's performance. If B's dissatisfaction was reasonable, B will prevail, the gap about quality in the contract having been filled by implication from the actual intent of the parties as revealed by their agreement.[148]

3. Purpose Implication

It may be the case that the court cannot locate any evidence of the parties' actual intent regarding how a gap in a contract should be filled. In this event, there are two models that describe the process by which the court might supply a term the parties left open: purpose implication and public norm implication. In the purpose implication process, the court inquires into what the parties would have said about the subject of the open term had they thought to say anything about the matter at all.[149] Assume in the foregoing example that no indication of actual

148. *See, e.g.*, Sacramento Navigation Co. v. Salz, 273 U.S. 326 (1927); Wigand v. Bachmann-Bechtel Brewing Co., 222 N.Y. 272, 277-78, 118 N.E. 618, 619 (1918) ("Every contract implies good faith and fair dealing between the parties to it. . . . The continuance in good faith of the beer-brewing business without a voluntary and intentional discontinuance of the same is inferred not alone for the extent and obligations of the contract, but from the promissory words, namely, '[quotation from contract follows]' "); U.C.C. §§ 2-305(2), 2-306, 3-311(1) (1978); Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 394-402 (1980).

149. *See* Goetz & Scott, *The Limits of Expanded Choice: An Analysis of the Interactions Between Express and Implied Contract Terms*, 73 CALIF. L. REV. 261, 264 (1985) ("courts and commentators view the purpose of contract interpretation as a determination either of what the contracting parties subjectively intended or of what the contract itself objectively means").

intent exists and that the parties had no intent on the matter at all. The court will assume that the parties agreed that services would be of reasonable quality. Because the court will determine a reasonable quality in accordance with the circumstances, such as by reference to the quality of services provided in similar transactions, this process can be thought of as an implication from *presumed* intent, rather than from expressed, *actual* intent.

The purpose implication model is applicable not only to open term cases but also to situations where unexpected events render one party's performance impracticable. To borrow the facts of *Taylor v. Caldwell*,[150] assume that A agrees to lease a recital hall to B, but the hall is destroyed by fire without A's fault before B's use of the hall commences. The contract between A and B contains no provision that specifies the rights and obligations of the parties in the event the recital hall is accidentally destroyed between the time of the execution of the contract and the time of performance. Indeed, it did not occur to either A or B that such a disaster might occur prior to the time for performance. B makes arrangements to lease other premises at a greater cost, and B sues A to recover the difference between the price B has to pay for the replacement hall and the rental specified in the contract between A and B.

Under the model of purpose implication, A will prevail in the suit brought by B. The court will impute to the intention of the parties a term that reasonable parties under the circumstances would have included had they thought it worthwhile to say anything in the contract about the matter; the imputed term is actually a general principle of law—when the performance of one party to a contract becomes impracticable without his fault by the occurrence of an event the non-occurrence of which is a basic assumption on which the contract was made, that party's performance is excused.[151]

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150. 3 B. & S. 826, 122 Eng. Rep. 309 (K.B. 1863).

151. *See* RESTATEMENT (SECOND) OF CONTRACTS § 261 (1981). In *Taylor v. Caldwell*, Justice Blackburn excused the lessor's performance by imputing to the intention of the parties "an implied condition that the parties shall be excused in case, before breach, performance becomes impossible from the perishing of the thing" which is the object of the contracting. 3 B. & S. at 833-34, 122 Eng. Rep. at 312; *See also* West Los Angeles Inst. for Cancer Research v. Mayer, 366 F.2d 220, 223 (9th Cir. 1966), *cert. denied*, 385 U.S. 1010 (1967); Dorsey v. Oregon Motor Stages, 183 Or. 494, 503, 194 P.2d 967, 971 (1948).

4. Public Norm Implication

Over the years, courts and commentators have disparaged the purpose implication model and urged instead a public norm implication model.[152] Even Corbin, who thought many cases were decided by implication, became convinced that many additions to contracts could not be justified by resort to the expressed intention of the parties. Thus, because the parties in *Taylor v. Caldwell* had no intent whatever regarding what performance, if any, should ensue if the recital hall burned, Corbin thought it nonsense to speak of implying a term in such a setting.[153] Instead Corbin thought that many implications occurred by a different process, which he labeled "construction."[154] Corbin contrasted construction, which he described as the process of determining the "legal operation" of contracts, with implication, which he described as the process of determining what ideas the contract induces in other persons.[155]

The *Restatement (Second) of Contracts* also recognizes an alternative implication process in a comment that explicitly takes the position that purpose implication is a pretense for incorporating public norms into the contract:

> The process of supplying an omitted term has sometimes been disguised as a literal or a purposive reading of contract language directed to a situation other than the situation that arises. Sometimes it is said that the search is for the term the parties would have agreed to if the question had been brought to their attention . . . But where there is in fact no agreement, the court should supply a term which comports with community standards of fairness and policy rather than analyze a hypothetical model of the bargaining process.[156]

152. In a Scottish case, the court commented that "[i]t does not seem to me somewhat far-fetched to hold that the non-occurrence of some event, which was not within the contemplation or even the imagination of the parties, was an implied term of the contract." Scott & Sons v. Del Sell, 1922 Sess. Cas. 592, 596, *aff'd*, 1923 Sess. Cas. 37 (H.L.) More recently, Professor Farnsworth wrote that "basing an implied condition on imputed intention is difficult to justify." E. FARNSWORTH, CONTRACTS § 9.5, at 676 (1982).

153. A. CORBIN, 3 CORBIN ON CONTRACTS § 565, at 299-301 (1960).

154. *Id.* § 534, at 8-12.

155. *Id.* § 534, at 9.

156. RESTATEMENT (SECOND) OF CONTRACTS § 204 comment d (1981). *See also id.* at § 5 comment b. ("Much contract law consists of rules which may be varied by agreement of the parties. Such rules are sometimes stated in terms of presumed intention, and they may be thought of as implied terms of an agreement. They often rest, however, on considerations of public policy

Professor Farnsworth effectively summarizes the essence of the "public norm implication": "Where the parties have reduced expectations to contract language, or where they have expectations that have not been so reduced, those expectations should be respected; otherwise, basic principles of fairness and justice should be applied, with no attempt to hypothesize either expectation or contract term."[157]

5. Coalescence of the Implication Models: The Promissory Nature of Implied Terms

Although much has been made of the supposed distinctions between purpose implication and public norm implication, the differences are more formal than real.[158] Public norms are the sum total of what reasonable people believe to be fair and just under the circumstances. Purpose implication, therefore, is actually a process of filling gaps in the private agreement of the parties with public norms as to what a private agreement should contain. Purpose implication may involve constructing a scenario of hypothetical bargaining between reasonable people in the position of the parties, but the terms that emerge from this construction are reasonable terms that will be market supporting, efficient, and otherwise consistent with public norms.[159] The question in omitted-terms cases is what term should be used to fill the gap; the two models properly applied will give the same answer.

A related misconception involves the assertion that the implication

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rather than on manifestation of the intention of the parties.").

157. Farnsworth, *supra* note 144, at 880-81.

158. Plainly there *is* a difference between an implication where the expectations of the parties on the open term are known and where the expectations are not known. This was Corbin's distinction between implication and construction, *see supra* note 155 and accompanying text. When there is no basis in the parties' dealings for determining what their actual intent might be, and a court nevertheless adds a term to the agreement, the court is constructing—in effect, writing—the contract for the parties. *See* State Highway Dep't v. MacDougald Const. Co., 102 Ga. App. 254, 260, 115 S.E.2d 863, 869 (1960) ("It is the duty of our courts, where the contract is clear and unequivocal and violates no rule of law or public policy to give it full effect and to exercise caution in judicially re-writing its terms."); Carson v. Imperial "400" Nat'l, Inc., 267 N.C. 229, 233, 147 S.E.2d 898, 901 (1966) ("Courts cannot under the guise of construction rewrite contracts executed by the litigants.").

159. Assume, for example, that the open term in a contract for the sale of services is the price. The court will fill the gap with a term upon which reasonable persons in the position of the parties would have agreed; the parties to the contract are presumed to have this intention. Reasonable parties would choose the prevailing market price as the contract price. The occurrence of the sale at this price would be efficient, thus furthering one of the central norms of contract law. To the extent the policies of contract law are to promote good faith and fair dealing, reasonable people would choose terms that further these norms.

of terms from presumed intent amounts to imposing duties by "law" rather than by "agreement."[160] This interpretation ignores the process by which gaps in contracts are filled. Whether one uses the purpose implication model to determine to what the parties *would* have agreed had they considered the matter, or the public norm implication model to determine to what the parties *should* have agreed, the process involves inserting obligations into a *contract*, the parties' promissory exchange. The terms added by this process are either promissory obligations of the parties or conditions to those obligations. To the extent that the terms reflect public norms, the public norms assist in determining the substance of promissory obligations. In short, then, the terms added to contracts where the parties leave gaps in their agreement create or condition promissory obligations, not nonpromissory obligations such as those found in the law of torts.[161]

It is a rare contract in which the parties expressly state that their performances will be governed by the standard of good faith and fair dealing. Thus, virtually every contract has a gap regarding what standard of conduct will govern the parties' performances. To fill in this gap, a court will look first to the manifested intent of the parties for evidence of an agreed-upon standard of faithfulness. If the court finds no such indication, which is likely to be the case, the court will look next to what reasonable persons in the circumstances of the parties would say about the standard of faithfulness. Reasonable persons would say that their performances are to be governed by the standard of good faith and fair dealing; accordingly, the court will impose this standard on the parties as a promissory obligation. If, during contract performance, one of the parties conducts itself in bad faith, that behavior constitutes a breach of the contract. Thus, the implied duty of good faith and fair dealing is a contract term, and the remedies for the breach of that term, like any contract term, should be those provided

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160. *See, e.g.*, Guarantee Abstract & Title Co. v. Interstate Fire & Casualty Co., 232 Kan. 76, 79, 652 P.2d 665, 667 (1982) ("The difference between a tort and contract action is that a breach of contract is a failure of performance of a duty arising under or imposed by agreement; whereas, a tort is a violation of a duty imposed by law."); Marshel Invs., Inc. v. Cohen, 6 Kan. App. 2d 672, 683, 634 P.2d 133, 142 (1981) (duty owed by insurance agent to insured is both a contract duty as an implied contractual term of the undertaking and a fiduciary duty sounding in tort devolving from the principal-agent relationship).

161. Tort rules impose on each person in society a duty to conduct his affairs with due care so as to avoid causing injuries or harm to others; this duty exists in the *absence* of a promissory relationship between the parties. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 comment c (1981).

by the law of contracts.[162]

6. Tort Duties Devolving from Implied Contract Terms: A Critique

Although remedies for bad faith performance of a contract are available in contract, most courts have nevertheless held that an insurer who breaches the duty of good faith and fair dealing commits a tort. Courts have offered a variety of rationales for this treatment, none of them convincing. First, it has been argued that because the duty of good faith and fair dealing is not disclaimable,[163] the duty must be in tort.[164] This analysis is incorrect; the prohibition on disclaiming the duty of good faith and fair dealing is functionally identical to the substantive limitations imposed on all contract terms.

Our system has always recognized that a contract violative of public policy might be declared unenforceable even though the parties satisfied the formal prerequisites for forming a contract. Disclaiming the duty of good faith is tantamount to providing through express terms that the parties may deal with each other in bad faith. It is in precisely such situations, where one party appears to be taking advantage of another, that courts have policed the private bargain by disallowing cer-

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162. This conclusion is consistent with the scheme contemplated by the drafters of the *Restatement (Second) of Contracts.* Section 205 provides that "[e]very *contract* imposes upon each party a duty of good faith and fair dealing in its performance and enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (emphasis added). Section 5(2) recognizes that terms supplied by courts through the process of gap-filling constitute *contract* terms: "A term of a contract is that portion of the legal relations resulting from the promise or set of promises which relates to a particular matter, *whether or not the parties manifest an intention to create those relations.*" *Id.* at § 5. (emphasis added). Comments to section 205 state that breach of the duty of good faith and fair dealing is a breach of contract, and "remedies for bad faith *in the absence of agreement* are found in the law of torts or restitution." *Id.* at comment c. *Cf.* RESTATEMENT (SECOND) OF CONTRACTS § 4 comment b (1981) (stating that quasi-contracts are the subject of the *Restatement of Restitution*); *id.* ch. 16, Topic 4 reporter's note (stating that topic of restitution generally is dealt with in *Restatement of Restitution,* and confining scope of the topic to five situations that are closely related to contracts).

163. *See* Industrial & Gen. Trust, Ltd. v. Tod, 180 N.Y. 215, 225-26, 73 N.E. 7, 9-10 (1905).

164. Contract obligations can be rescinded by mutual agreement of the parties, but the disclaimability of tort obligations by the parties to a contract is limited. *See, e.g.,* Threadgill v. Peabody Coal Co., 34 Colo. App. 203, 208-09, 526 P.2d 676, 679 (1974) (generally parties cannot contract away their own negligence); Hunter v. American Rentals, Inc., 189 Kan. 615, 617, 371 P.2d 131, 133 (1962) (one cannot avoid his own liability for negligence via contract); Roll v. Keller, 336 N.W.2d 648 (N.D. 1983) (stipulation that one is not liable for future torts is unenforceable); Leidy v. Deseret Enter., 252 Pa. Super. 162, 381 A.2d 164 (1977) (contract against liability is enforceable under certain enumerated, limited circumstances); Union Pacific R.R. v. El Paso Natural Gas Co., 17 Utah 2d 255, 259, 408 P.2d 910, 913 (1965) ("[T]he law does not look with favor upon one exacting a covenant to relieve himself of the basic duty which the law imposes on everyone.").

tain terms or avoiding the contract altogether. Contracts have long been held voidable or have been subject to reformation on the grounds of inadequate consideration, fraud, mistake, and duress.[165] More recently, contracts that severely and unfairly disadvantage one of the parties have been reformed or voided under the doctrine of unconscionability.[166] Judicial unwillingness to allow the parties to disclaim the duty of good faith does not mean that the duty of good faith is not a contract term; rather, it is simply another example of judicial regulation of contract. Moreover, although the parties are not free to disclaim the obligation to perform in good faith, they are free to determine by agreement the standard—within a particular zone of reasonableness—that good faith will permit or require of them.[167] In this respect, the good faith term is no different from any other contract term.[168]

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165. *See, e.g.*, Kannavos v. Annino, 356 Mass. 42, 247 N.E.2d 708 (1969) (fraud); Newman & Snell's State Bank v. Hunter, 243 Mich. 331, 220 N.W. 665 (1928) (insufficient consideration); Sherwood v. Walker, 66 Mich. 568, 33 N.W. 919 (1887) (mistake); Austin Instrument, Inc. v. Loral Corp., 29 N.Y.2d 124, 272 N.E.2d 533 (1971) (duress); McKinnon v. Benedict, 38 Wis. 2d 607, 157 N.W.2d 665 (1968) (inadequate consideration).

166. *See, e.g.*, Williams v. Walker-Thomas Furniture Co., 350 F.2d 445 (D.C. Cir. 1965) (reversing trial judge's holding that he lacked the power to refuse to enforce contract containing cross-collateral clause on the ground of unconscionability); Johnson v. Mobil Oil Corp., 415 F. Supp. 264 (E.D. Mich. 1976) (contract provision excluding consequential damages is unconscionable); Jones v. Star Credit Corp., 59 Misc. 2d 189, 298 N.Y.S.2d 264 (N.Y. Sup. Ct. 1969) (applying U.C.C. § 2-302 to reform price term).

167. *See, e.g.*, Allis-Chalmers Corp. v. Lueck, 105 S. Ct. 1904, 1914 (1985) ("under Wisconsin law it appears that the parties to an insurance contract are free to bargain about what 'reasonable' performance of their contract obligations entails"); Mechanical Ice Tray Corp. v. General Motors Corp., 144 F.2d 720, 726 (2d Cir. 1944) ("The exercise of good faith in exploiting the licensed patents did not require the defendant to refrain from doing whatever the plaintiffs had expressly agreed that it might do."), *cert. denied*, 324 U.S. 844 (1944); VTR, Inc. v. Goodyear Tire & Rubber Co., 303 F. Supp. 773, 777 (S.D.N.Y. 1969) ("the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise have been forbidden by an implied covenant of good faith and fair dealing"); Milstein v. Security Pac. Nat'l Bank, 27 Cal. App. 3d 482, 486, 103 Cal. Rptr. 16, 18 (1972) ("California law implies in any contract whose terms do not negative its application a covenant of good faith and fair dealing."). *See also* C. KAUFMAN, CORBIN ON CONTRACTS § 568, at 600-01 (Supp. 1984).

168. The parties' permissible range of discretion in determining specific kinds of behavior permissible during the contract's performance is no different from their discretion in arriving at the contract's terms. For example, the parties are not free to set *any* price for the item being exchanged; so long as the price is within a zone of reasonableness, courts will not disturb the parties' agreement. But if the parties choose a price that is so unreasonably high or low that it appears oppressive or grossly unfair, a court might intervene at the request of a party and utilize one of several established contract doctrines to reform or rescind the contract. *See, e.g.*, American Home Improvement v. MacIver, 105 N.H. 435, 201 A.2d 886 (1964) (contract not enforceable because of, inter alia, unconscionable price); McKinnon v. Benedict, 38 Wis. 2d 607, 157 N.W.2d 665 (1968) (contract not enforceable because consideration inadequate, where for substantial restric-

Second, in support of the argument that breaching the duty of good faith and fair dealing is a tort, it has been observed that courts have held conduct constituting a breach of contract to be tortious in a number of non-insurance settings. By this analysis, the duty of good faith and fair dealing can sound in both tort and contract, if there are public policy reasons for recognizing a tort duty essentially coterminous with the contract duty. This argument begins with the proposition that tort duties are based on relationships. For example, the driver of an automobile has a relationship to other drivers and pedestrians, and it is the duty of the driver to operate his vehicle with due care so as not to risk harm to others. Courts have also imposed duties of affirmative action on the basis of relationships. For example, the shopkeeper has been held to owe a duty to take reasonable affirmative steps to protect his business guest and the host has been held to owe such a duty to his social guest.[169]

A contract is, of course, a relationship between two or more parties. There are several contractually based relationships in which courts have recognized affirmative duties to conduct one's affairs in ways that do not harm the other party; common examples include common carrier and passenger, landlord and tenant, bailor and bailee, trustor and trustee, owner of land and independent contractor, and hotel and guest. A closer look at the hotel-guest relationship will illustrate this principle. When a hotel undertakes to provide a room for a paying guest, the relationship created by their contract imposes on the hotel certain affirmative duties, such as protecting the guest from the foreseeable actions of third parties or from unsafe conditions in the hotel. These duties are grounded in both contract and tort. On the contract side, it is

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tion on use of land the "only monetary consideration" was a $5000 interest-free loan). Similarly, if the parties opt for a standard of behavior outside the zone of reasonableness, a court should intervene at a party's behest to police the transaction.

The analysis of the extent to which courts will allow parties to have the discretion to negotiate contract terms is confluent with the analysis of the process by which courts fill gaps in contracts. In the absence of a designated price, a court would supply a reasonable price to fill the open term. *See* U.C.C. § 2-305 (1978); RESTATEMENT (SECOND) OF CONTRACTS § 33 comment e (1981) (indefinite price). This reasonable price would be determined by reference to objective indicators, such as the prevailing market price or the price of the same services in similar transactions. *See supra* note 159 and accompanying text. The parties are free to alter the law's choice of a reasonable price, so long as they do not agree on an oppressive or unconscionable price.

169. *See* W. PROSSER & W. KEETON, PROSSER AND KEETON ON TORTS 376-77 (1984) (similar duties exist for a jailer to his prisoner or a school to its pupil). *See also* Hutchinson v. Dickie, 162 F.2d 103, 106 (6th Cir.), *cert. denied*, 332 U.S. 830 (1947); L.S. Ayres & Co. v. Hicks, 220 Ind. 86, 95, 40 N.E.2d 334, 337 (1942).

unlikely that the express contract between hotel and guest will specify what protective services the hotel will provide the guest. Nevertheless, there is an implied promise in the contract that the hotel will take all reasonable steps to protect the guest; the guest possesses a contract claim if the hotel breaches the implied promise. On the tort side, the relationship of hotel and guest creates obligations that exist independently of the contract obligations. The injured guest has a tort claim for the hotel's breach of its duty to take affirmative steps for the guest's protection, a duty that exists as a matter of public policy without regard to the manifested intent of the parties in their express contract.[170]

In the insurance context, it is clear that a special relationship exists between insurer and insured,[171] that the insurer has a strong bargaining position over the insured,[172] and the transaction has many characteristics not found in a typical commercial relationship.[173] It is relatively easy to conclude, therefore, that the insurer makes an implied promise to the insured to act in good faith, but this implied promise is coextensive with a tort-based duty of the insurer to act in certain ways for the insured's benefit. In this analysis, the insurer commits a tort when it violates the special relationship by failing to act in good faith.

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170. *See* Moorman Mfg. Co. v. National Tank Co., 91 Ill. 2d 69, 96, 435 N.E.2d 443, 455 (1982) (Simon, J., specially concurring) ("The true significance of physical harm is that it usually represents an invasion of a right existing apart from any contract—a tort interest. . . . On the other hand, if a product simply fails to live up to its promise, if it does not accomplish what it was supposed to the way it was supposed to, that is only an invasion of a contract-like interest: the user has lost the benefit of his bargain."); Speidel, *The Borderland of Contract*, 10 N.KY. L. REV. 163, 168-74 (1983) (summarizing the doctrinal differences between tort law and contract law).

171. *See* German Alliance Ins. Co. v. Lewis, 233 U.S. 389, 415 (1914) (business of insurance is "clothed with a public interest"); Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 820, 598 P.2d 452, 457, 157 Cal. Rptr. 482, 487 (1979), *appeal dismissed*, 445 U.S. 912 (1980) ("[A]s a supplier of a public service rather than a manufactured product, the obligations of the insurer go beyond meeting the reasonable expectations of coverage.") (quoting Goodman & Seaton, *Forward: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 Calif. L. Rev. 309, 346-47 (1974)); Bekken v. Equitable Life Assurance Soc'y of U.S., 70 N.D. 122, 138, 293 N.W. 200, 210 (1940) ("It has long been recognized that the business of insurance is quasi public in character."); Christian v. American Home Assurance Co., 577 P.2d 899, 902 (Okla. 1977) ("[T]he insurance industry has a quasi-public nature that involves the public interest.").

172. *See Egan*, 24 Cal. 3d at 82, 598 P.2d at 457, 157 Cal. Rptr. at 487 ("The relationship of insurer and insured is inherently unbalanced; the adhesive nature of insurance contracts places the insurer in a superior bargaining position."); *Christian*, 577 P.2d at 902 ("The consumer has no bargaining power and no means of protecting himself against the kinds of abuses set forth in appellant's position.").

173. *Bekken*, 70 N.D. at 142, 293 N.W. at 212 (the purposes, nature, and duties of insurance contracts are "unlike those incident to contracts and negotiations for contracts in ordinary commercial transactions"); *see supra* text accompanying note 140.

Treating the insurer's failure to act in good faith as a tort would not be troublesome if the typical insured sought relief for a *physical* injury allegedly caused by the insurer's breach of the duty of good faith. As a general rule, a party is liable in tort for negligent affirmative conduct that causes physical injury to persons or tangible property.[174] The fact that this affirmative conduct occurs during the performance of a promise does not deprive the insured of his action in tort.[175] Subjecting the insurer to tort remedies when the negligent performance of its contract with the insured causes physical injury to the insured does not confound the boundary between tort and contract.

Beyond the physical injury cases, however, there are some areas where courts have ill advisedly imposed tort duties on parties *because of* a special contractual relationship of the parties. In general, there is no duty to exercise reasonable care to avoid intangible economic loss to others that does not arise from physical harm to persons or tangible things.[176] Nevertheless, courts have sometimes recognized concurrent tort and contract duties even where two parties are in a contractual relationship involving no measurable risk of physical injury. These courts were presumably motivated by reasons of fairness to allow the aggrieved party a broader measure of damages than that permitted by standard contract remedies.[177] Unfortunately, they underestimated, and perhaps overlooked entirely, the potential of more flexibily applied contract remedies. By allowing these contract claims to be pursued on tort theories, the courts blurred unnecessarily the uneasy demarcations between contract law and tort law.[178] Further, these cases encouraged

174. W. PROSSER & W. KEETON, *supra* note 169, at 657.

175. Even though the party may make, as part of the contract, an implied promise to perform the duty in a non-negligent manner, all persons have a general duty—whether or not there is an underlying contract that might support a contract claim—to act in a manner that avoids physical harm to persons and tangible property. For example, negligent operation of an automobile that results in physical harm to a passenger will render the driver liable in tort, and the driver will still be liable in tort if the driver has a contract with the passenger to deliver the passenger safely to a specified destination.

176. W. PROSSER & W. KEETON, *supra* note 169, at 657.

177. *See supra* note 63.

178. *See* W. PROSSER & W. KEETON, *supra* note 169, at 655. The proper relationship of tort and contract law has been a fertile area for scholarly inquiry. *See generally* G. GILMORE, THE DEATH OF CONTRACT (1974); Bishop, *The Contract-Tort Boundary and the Economics of Insurance*, 12 J. OF LEGAL STUD. 241 (1983); Diamond, *The Tort of Bad Faith Breach of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions?* 64 MARQ. L. REV. 425 (1981); Note, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME LAW. 510 (1985).

parties to invite courts to apply tort doctrine in a variety of ordinary commercial settings, historically the exclusive domain of contract law, in the hope of taking advantage of the broader damage possibilities.[179]

B. *Reprise: The Insurer's Duties*

As discussed above, the duty to defend and the duty to pay proceeds are express obligations of the insurer under the contract of insurance. These duties therefore sound in contract.[180] The duty to settle and the duty of good faith and fair dealing, which are not expressly stated in the contract, have usually been denominated tort duties. A reexamination of these duties, however, reveals that they are more appropriately viewed as based in contract.

1. The Duty to Settle

Most courts have concluded that because no contract language requires the insurer to settle claims against the insured, the obligation to settle is a tort duty.[181] However, the duty to settle is, in fact, merely one aspect of the contractually based duty to defend. Providing a defense means no more than appearing at trial to protect the insured. It embraces all aspects of litigation, including investigating the plaintiff's claim and possible defenses to it: preparing and filing pleadings; preparing, filing, and responding to motions; and preparing for and participating in pretrial conferences.[182] Settlement discussion is always a critical aspect of preparing to try a lawsuit; in many lawsuits, the best defense is to settle the claim. The insurer therefore has a duty to explore reasonable settlement possibilities, to make and respond to settlement offers where appropriate, and presumably to accept reasonable settlement offers.

Because the duty to defend is a contract duty, the sub-duty to settle must also be a contract duty. It is a promise of the insurer, the breach of which should render the insurer liable in contract. If the insurer is ultimately found to have breached the duty to settle, the insurer is liable for all damages naturally flowing from the breach that

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179. *See supra* text accompanying notes 25 and 109-18.

180. The scope of the duty to participate in appeals is less frequently litigated, but here, too, it seems clear that the duty is subsumed within the more general duty to defend and therefore also sounds in contract. *See supra* notes 27-31 and accompanying text.

181. *See supra* notes 120-24 and accompanying text.

182. Moreover, because the duty to defend does not terminate when the trial ends, the insurer also has a duty to appeal adverse judgments and to defend the insured when the claimant appeals. *See supra* notes 27-31 and accompanying text.

were foreseeable at the time of contracting.[183] This includes the policy limits plus the amount of the judgment exceeding those limits because it is foreseeable that if an insurer acts unreasonably in rejecting a settlement offer, a judgment exceeding the policy limits could be entered against the insured.[184]

2. The Duty of Good Faith and Fair Dealing

Like the other duties of the insurer, the duty of good faith and fair dealing should be treated as a contract duty, not a tort duty. Although most courts have reached a contrary conclusion, a review of their reasoning demonstrates that these courts, particularly the California courts that led the way in treating the duty as tort-based, never comprehended the important promissory characteristics of the duty.

In *Brown v. Guarantee Insurance Co.*,[185] the first California decision to examine the duty of good faith in the insurance setting, the court declined to decide whether the insurer's duty to settle is grounded in tort or contract. Nevertheless, the *Brown* opinion set the groundwork for later decisions that would denominate the insurer's duty to settle as a tort duty.[186] A reexamination of *Brown* reveals that nothing in the

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183. This, of course, is the foreseeability limitation rule espoused in *Hadley v. Baxendale*, which is discussed at *supra* notes 128-129 and accompanying text.

184. Early cases using the contract theory limited the insured's recovery to the amount of the policy limits when the insurer refused to accept a settlement offer at or below the policy limits. *See, e.g.*, Neuberger v. Preferred Accident Ins. Co., 18 Ala. App. 72, 89 So. 90, *cert. denied*, 206 Ala. 700, 89 So. 924 (1921); Kingan & Co. v. Maryland Casualty Co., 65 Ind. App. 301, 115 N.E. 348 (1917); Rumford Falls Paper Co. v. Fidelity & Casualty Co., 92 Me. 574, 43 A. 503 (1899); Streat Coal Co. v. Frankfort Gen. Ins., 237 N.Y. 60, 142 N.E. 352 (1923); Wisconsin Zinc Co. v. Fidelity & Deposit Co., 162 Wis. 39, 155 N.W. 1081 (1916).

A few courts have held that an insurer has a duty to initiate settlement negotiations where the insurer is defending the insured and there is a reasonably foreseeable possibility that a judgment exceeding the policy limits might be entered against the insured. *See, e.g.*, Coleman v. Holecek, 542 F.2d 532, 536-37 (10th Cir. 1976) (applying Kansas law); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 65 N.J. 474, 493, 323 A.2d 495, 507 (1974). It is possible to argue from these precedents that an insurer who unjustifiably refuses to provide a defense is nevertheless liable for an excess judgment on the ground that such a judgment is a foreseeable consequence of the insurer's failure to take reasonable affirmative steps to initiate settlement discussions. By this argument, the failure to undertake the defense is automatically the failure to make reasonable settlement offers, a foreseeable consequence of which is a judgment exceeding policy limits. Yet because it is impossible to foresee that a settlement offer would be accepted, it is not a foreseeable consequence of the failure to provide a defense that in all cases a judgment would be entered in excess of policy limits.

185. 155 Cal. App. 679, 319 P.2d 69 (1957).

186. *Brown* was followed one year later by *Comunale*, a case that directed the California courts toward recognition of *tort* duties in the context of insurance law. *See supra* notes 78-87 and accompanying text.

court's opinion was inconsistent with the proposition that the duty of good faith and fair dealing owed by the insurer to the insured is a contract duty. First, the court in *Brown* observed that the insurer had no contract obligation to effect settlement within policy limits.[187] That statement was both absolutely correct and eminently sensible.[188] Indeed, it is beyond dispute that many settlement offers within policy limits will be excessive; insurers should not be required to accept all of them. Recognizing a duty to settle necessarily implies, however, that some settlement offers should be accepted. Once a court acknowledges that some, but not all, settlement offers should be accepted, it must articulate a standard for determining where to draw this line. The court in *Brown* rejected the negligence standard because it was too strict—a mere mistake in judgment when responding to a settlement offer might impose liability in many instances[189]—and opted instead for the "good faith" test to determine whether the insurer had fulfilled its duty to settle.[190]

The *Brown* court's approval of the good faith standard was not tantamount to treating bad faith contract performance as a tort. The court used good faith simply to indicate when the duty to settle is breached.[191] *Brown* did not take the duty to settle out of the contractually-based duty to defend;[192] rather, *Brown* is more properly read as standing for the proposition that because the insurer has a duty to

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187. 155 Cal. App. at 687-88, 319 P.2d at 74 ("Nor within the policy limits has the insurer any contract obligation to effect settlement, as the policy contains no promise that it will do so under any and all conditions or circumstances, and none is to be implied, and beyond the policy limits the insurer has of course no authority to bind the assured by compromise in any amount whatsoever.").

188. A rule *requiring* the insurer to effect settlement within the policy limits would encourage plaintiffs to file inflated or frivolous claims and then make settlement offers within policy limits but far in excess of the claims' reasonable values. Requiring insurers to accept such offers would deplete insurers' reserves and drive up insurance premiums, all for the benefit of individuals lacking bona fide claims.

189. 155 Cal. App. at 687-88, 319 P.2d at 74. Under the negligence standard, an insurer breaches its duty to settle if, in rejecting a settlement offer, it fails to exercise the care that a reasonable insurer would exercise in the same circumstances. *See supra* notes 74-75 and accompanying text.

190. 155 Cal. App. at 688-89, 319 P.2d at 74-75.

191. Similarly, had the court opted for the negligence standard instead of the good faith standard, the failure of the insurer to use due care in carrying out the contract duty would not automatically convert the breach of contract into a tort.

192. For a number of years courts debated whether the insurer is liable for "bad faith" settlement or for failing to exercise "due care" in responding to settlement offers. Both standards were simply ways to place some kind of limitation on the scope of the duty to settle. In recent cases, the standards coalesce. *See supra* notes 19-21 and accompanying text.

make and respond to settlement offers in good faith, failure to accept reasonable settlement offers is a breach of contract.[193]

Although the question of plaintiff's damages was not before the court in *Brown*, the decision left no doubt that the insurer who breaches the duty to settle could be liable for damages in excess of the policy limits.[194] Yet this is not tantamount to allowing the insured to recover in tort.[195] In a proper case, a party seeking damages for breach of contract may recover consequential damages reasonably foreseeable at the time the contract was made. In an insurance contract, it is a foreseeable consequence of an insurer's failure to exercise good faith to settle a lawsuit within policy limits that a judgment exceeding the policy limits might be entered against the insured.[196]

Unfortunately, in later decisions the California courts did not probe the logic of *Brown*, but instead marched toward the conclusion that the duty of good faith is grounded in tort. One year after *Brown*, in *Comunale v. Traders & General Insurance Co.*,[197] the California Supreme Court stated in dictum that the wrongful refusal to settle had generally been treated as a tort.[198] Contrary to later interpretations, the *Comunale* court did not explicitly declare that in California a claim for wrongful refusal to settle sounds in tort.[199]

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193. Courts have also articulated standards for measuring the duty to settle, such as requiring the insurer to give the insured's interests "equal consideration," or to disregard the policy limits when settling on behalf of the insured. S. ASHLEY, *supra* note 63, §§ 2.07-.13.

194. This issue was not before the court, but the court clearly contemplated that the $15,000 judgment the insured suffered as a result of the failure to accept the settlement offer of $5,000 was a proximate result of the breach of duty. 155 Cal. App. at 692, 319 P.2d at 77. Plaintiff's complaint sought damages of $10,000. *Id.* at 682, 319 P.2d at 70. The propriety of this request was not at issue.

195. One reason for the considerable confusion in the area of bad faith litigation is the false assumption that any time a court uses the phrase "bad faith," the court is allowing a recovery in tort. *See supra* note 63.

196. Early courts routinely allowed insureds to recover damages in excess of the policy limits in situations where the insurer conceded coverage and undertook the defense, but then breached the duty to settle by unreasonably rejecting a fair settlement offer. *See, e.g.*, Cavanaugh Bros. v. General Accident Fire & Life Assurance Corp., 79 N.H. 186, 106 A. 604 (1919); Cowden v. Aetna Casualty and Sur. Co., 389 Pa. 459, 134 A.2d 223 (1957).

197. 50 Cal. 2d 654, 328 P.2d 198 (1958).

198. *Id.* at 663, 328 P.2d at 203, (citing Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954)). *See supra* notes 86-87 and accompanying text.

199. It is noteworthy that the court in *Comunale* upheld a judgment for the plaintiff exceeding the policy limits even though the insurer's mistake was its refusal to provide a defense to the lawsuit. If refusing to defend the insured had been the insurer's *only* mistake, the insurer should have been held liable only for the judgment rendered against the insured up to, and not exceeding, the policy limits. *See supra* notes 78-87 and accompanying text. *Comunale*, however, involved more than the insurer's failure to provide a defense, because the *Comunale* insurer also rejected a

When the court affirmed that portion of a judgment compensating the insured for her mental distress a decade later in *Crisci v. Security Insurance Co.*,[200] it did explicitly approve the principle that the breach of the covenant of good faith and fair dealing contained in an insurance contract is a tort.[201] In this instance, however, the court could have reached the same result by treating the insurer's liability as based in contract.[202] By asking whether mental suffering was a foreseeable consequence of the insurer's breach of contract—a question that could easily have been answered yes[203]—the *Crisci* court could have both upheld the mental suffering award and preserved the proper contractual basis of relief.

Subsequent California opinions echoed without further analysis the view that breaching the duty of good faith and fair dealing constitutes a tort,[204] and this view spread quickly to other jurisdictions.[205]

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settlement offer by the claimant. According to the court, this constituted a breach of the implied covenant of good faith and fair dealing, thereby making the insurer liable for all of the judgment rendered against the insured, including that portion in excess of the policy limits. 50 Cal. 2d at 660, 328 P.2d at 200-01. In *Johansen v. California St. Auto. Ass'n Inter-Ins. Bureau*, the California Supreme Court expanded upon this holding by rejecting the insurer's contention that the holding in *Comunale* does not apply to an insurer whose refusal to settle is based on a bona fide belief that the policy does not provide coverage. 15 Cal. 3d 9, 15-16, 538 P.2d 744, 748, 123 Cal. Rptr. 288, 292-93 (1975).

A notable and slightly different scheme is that in New York, where: (1) for breach of the duty to defend, the measure of damage is the cost of defense and the amount of the recovery, if any, against the insured; (2) for breach of the duty to settle by failure to make reasonable settlement within the policy limits, the measure of damage is the policy limits, *unless* there is also a breach of the implied conditions of the contract to act in good faith, in which case the damages may exceed the policy limits. *See* Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 436-37, 285 N.E.2d 849, 854 (1972).

200. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

201. *See supra* notes 88-94 and accompanying text.

202. The court rejected an invitation by amicus curiae to hold that "whenever an insurer receives an offer to settle within the policy limits and rejects it, the insurer should be liable in every case for the amount of any final judgment whether or not within the policy limits." The court found the evidence "clearly sufficient to support the determination that Security breached its duty to consider the interests of Mrs. Crisci in the proposed settlements." 66 Cal. 2d at 430, 426 P.2d at 177, 58 Cal. Rptr. at 17.

203. As the court explained, "insurers are well aware . . . [that] peace of mind and security" is one of the insured's legitimate expectations and that if the insurer does not meet this expectation mental suffering is likely to result. *Id.* at 433, 58 Cal. Rptr. at 19, 426 P.2d at 179.

204. *See, e.g.*, Sawyer v. Bank of Am., 83 Cal. App. 3d 135, 138, 145 Cal. Rptr. 623, 625 (1978); Jarchow v. Transamerica Title Ins. Co., 48 Cal. App. 3d 917, 934-940, 122 Cal. Rptr. 470, 486 (1975); Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 460-61, 521 P.2d 1103, 1108-09, 113 Cal. Rptr. 711, 716-17 (1974); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 574-76, 510 P.2d 1032, 1037-38, 108 Cal. Rptr. 480, 485-86, (1973); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 400-01, 89 Cal. Rptr. 78, 93 (1970).

205. *See supra* note 33.

These results were encouraged by a desire to assist insureds who were aggrieved by insurer conduct. Like the *Crisci* court, however, these courts disregarded available means to reach the same results without treating the duty of good faith and fair dealing as a tort.[206] In some of these cases, the insurer's conduct was sufficiently egregious that an independent tort could probably have been found on the facts, thus making it unnecessary to resort to the principle that the duty of good faith is grounded in tort in order to obtain the broader damage recoveries for the insured.[207]

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206. One of the reasons often offered by courts for labeling the breach of the duty of good faith and fair dealing as a tort is that the duty is "non-consensual" because it is "imposed by law" instead of "arising from the terms of the contract itself." Richardson v. Employers Liab. Assurance Corp., 25 Cal. App. 2d 232, 139, 102 Cal. Rptr. 547, 552 (1972). This analysis is troublesome; although the duty of good faith and fair dealing is non-consensual in the sense that the parties do not expressly say anything about it and in the sense that the duty cannot be disclaimed, these two considerations do not convert the contract covenant into a tort duty. The duty is, of course, an incident to the agreement of the parties. Further, the duty is implied "by law" in the sense that a court adds the term to the agreement, the duty is an implied *contract* term.

207. In *Richardson*, for example, although the evidence in the case may not have supported the tort of outrage, there was sufficient evidence of malice and oppression to support an inference that the insurer had committed fraud by entering into a contract without intending to perform its obligations if a valid claim were presented. 25 Cal. App. 3d at 245-46, 102 Cal. Rptr. at 556. *See also* Miller v. National Am. Life Ins. Co. of Cal., 54 Cal. App. 3d 331, 338-39, 126 Cal. Rptr. 731, 735 (1976) ([W]hen the insured alleged that the insurer breached a policy of disability insurance and claimed fraud in the inducement of the contract, the court specifically noted that "subsequent conduct of an insurer . . . in processing a claim may support an inference of prior intent not to fulfill its representations.").

It has always been the case that the insured has a tort action against the insurer when the insurer commits acts that constitute an independent tort. *See, e.g.*, Employers Equitable Life Ins. Co. v. Williams, 282 Ark. 29, 665 S.W.2d 873 (1984) (court invoked "bad faith tort" when facts made out an action for fraud); Miller v. National Am. Life Ins. Co., 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1974) (inferences permitted to overcome difficulties of proving the insurer's fraudulent intent); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 401, 89 Cal. Rptr. 78, 93-94 (1970) (intentional infliction of mental distress; tortious interference with protected property interest); Wetherbee v. United Ins. Co. of Am., 265 Cal. App. 2d 921, 932, 71 Cal. Rptr. 764, 770 (1968) (fraud); Metropolitan Life Ins. Co. v. McCarson, 429 So. 2d 1287 (Fla. Dist. Ct. App. 1983) (intentional infliction of emotional distress); Kingan & Co. v. Maryland Casualty Co., 65 Ind. App. 301, 312, 115 N.E. 348, 351 (1917) (fraud); Service Mut. Liab. Ins. Co. v. Aronofsky, 308 Mass. 249, 252, 31 N.E.2d 837, 839 (1941) (fraud or negligence); Johnson v. Hardware Mut. Casualty Co., 108 Vt. 269, 281-82, 187 A. 788, 794 (1936) (fraud, negligence, or bad faith); *See also* Comment, *The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts*, 56 S. CAL. L. REV. 1345, 1352 (1983) (citing cases in which courts have allowed insureds to recover damages from insurers for various kinds of torts, including fraud, misrepresentation, deceit which induces an insured to purchase a policy, and intentional infliction of emotional distress).

V. Summary: Achieving the Best Balance

The question of what constitutes the proper remedy for the insured aggrieved by the insurer's bad faith performance of its obligations under the insurance contract has no self-evident answer. Insurers argue that the broad remedies permitted by tort law are injurious to them, to their policyholders, and ultimately to the public as a whole. Insureds argue that the narrower remedies allowed by contract law are insufficient to deter insurers from taking advantage of their customers. That there is some force to both arguments suggests that the best policy choice must lie somewhere in between. This article contends that contract law provides a flexible remedial scheme allowing the achievement of the diverse goals reflected in the differing answers: compensating fairly insureds who are victims of insurer overreaching, deterring insurers bent on abusing their insureds, and insulating insurers from the unfair costs of excessive judgments.

Magicians seem to find it easy to get rabbits out of hats but well nigh impossible to reverse the process. By analogy, it may be too wrenching for courts to reverse years of precedents holding that the duty of good faith and fair dealing sounds in tort. In the long run, however, repeated litigation over the question of whether a particular breach of contract in a particular context constitutes a tort may involve intolerable costs for a legal and commercial system where it is widely assumed that parties can breach their promises without exposing themselves to the broader range of damages awarded in tort. The decision to ground the duty of good faith and fair dealing in tort was hardly inevitable, and the junction at which this choice was made was passed long ago; however, if the costs of treating the duty as resting in tort prove to be unacceptably high and if no cogent basis emerges for confining the tort duty to a few discrete fields, it may be wise for courts to retrace their steps and choose a different path leading from the junction.

Should courts one day decide that the duty of good faith and fair dealing is a contract duty and not a tort duty, and should experience with this approach reveal that established principles of contract law, without supplementation, are inadequate to deter insurer overreaching, two refinements of the system should be considered. First, expanding the availability of attorney's fees in breach of contract actions could increase the incentives for good faith performance. Many states already have statutes allowing the recovery of attorney's fees in the event an insurer fails to pay a claim in a timely manner.[208] If the scope of these statutes were expanded to apply to a breach by the insurer of *any* of its duties, including the duty to defend or the duty to settle, presumably insurers' breaches of these duties would be deterred at least to the extent that existing statutes deter insurers' breaches of the duty to pay proceeds.[209] Moreover, it is at least arguable that the insured's expenditure of attorney's fees is a foreseeable consequence of the insurer's failure to perform its obligations.[210]

A second refinement that should be considered if experience with a flexibly-administered contract remedy scheme fails adequately to protect the interests of insureds is to make punitive damages more widely available in contract actions. Most jurisdictions recognize punitive or exemplary damages as proper in tort cases when public policy requires them to deter conduct that is fraudulent, malicious, oppressive, wanton, or reckless.[211] However, most jurisdictions do not permit the award of punitive damages for breach of contract, regardless of the willfulness of the breach.[212] A few jurisdictions now provide as a matter of statutory

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208. *See supra* note 12.

209. Some states have held that statutes imposing penalties on insurers who fail to pay claims in a timely manner establish the exclusive remedy against the insurer. *See, e.g.*, Tate v. Aetna Casualty & Sur. Co., 149 Ga. App. 123, 253 S.E.2d 775 (1979) (interpreting GA. CODE ANN. §56-1206 (1962)); D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co., 494 Pa. 501, 431 A.2d 966 (1981).

210. One objection to limiting insureds to contract based remedies is that attorneys will be less willing to represent insureds with claims against their insurers because the possible damages, from which the attorneys take their fees, are substantially reduced. The possibility of large monetary judgments, it is argued, ensures adequate representation for aggrieved insureds. If experience proves this objection to be meritorious, refining the contract remedies scheme to allow recovery of attorney's fees should meet the objection squarely. *See supra* text accompanying note 68. *Compare* Mustachio v. Ohio Farmers Ins. Co., 44 Cal. App. 3d 358, 363, 118 Cal. Rptr. 581, 584 (1975) (where "the insurer's tortious conduct makes it reasonable for the insured to seek the protection of counsel, the insurer is responsible for that item of damages") *with* Twentieth Century-Fox Corp. v. Harbor Ins. Co., 85 Cal. App. 3d 105, 114, 149 Cal. Rptr. 313, 319 (1978) (insured may not recover attorney's fees expended in prosecuting bad faith claim). *See* Comment, *Attorney's Fee Recovery in Bad Faith Cases: New Directions for Change*, 57 S. CAL. L. REV. 503 (1984).

211. *See* Walbrun v. Berkel, Inc., 433 F. Supp. 384 (E.D. Wis. 1976); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); Karp, *Extracontractual Damages in Property Insurance Cases: A Defense Lawyer's View*, in EXTRACONTRACTUAL DAMAGES 79, 84-88 (J. Groves ed. 1983).

212. *See* Otto v. Imperial Casualty & Indem. Co., 277 F.2d 889 (8th Cir. 1960); First Nat'l State Bank v. Commonwealth Fed. Sav. & Loan Ass'n, 455 F. Supp. 464 (D.N.J. 1978); White v. Benkowski, 37 Wis. 2d 285, 291, 155 N.W.2d 74, 77 (1967). *See also* RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981) ("Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.").

law for a limited exception for punitive damages where insurers fail to pay their claims.[213]

There is a possibility, of course, that once the recovery of punitive damages is permitted in contract, they will be awarded at levels that lead to the same disadvantages as the broader tort remedies in the current system. For this reason, punitive damages should be made available only if lesser measures prove inadequate as a deterrent to overreaching. To eliminate altogether the possibility of excessive judgments, the amount of an individual plaintiff's recovery could be limited to a percentage of the compensatory damages awarded in a particular action.

213. *See, e.g.*, ARK. STAT. ANN. § 66-3238 (1980); GA. CODE ANN. § 33-4-6 (1982); IDAHO CODE § 41-1839 (1977); ILL. REV. STAT. Attorney Fees Act § 155, ch. 73 § 767 (1973); MO. ANN. STAT. § 375.420 (Vernon Supp. 1985); NEB. REV. STAT. § 44-359 (1984) (attorney's fees); TEX. INS. CODE ANN. art. 3.62 (Vernon 1981).