Business Torts

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MATTHEW BENDER

PART V

INTENTIONAL TORTS

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CHAPTER 23

Bad Faith in Insurance and Other Contracts

by Nancy D. Arnison
James J. Long
David C. Forsberg*
Revised by William L. Winslow**

In certain jurisdictions, a covenant of good faith and fair dealing in performance is held to be implied in every contract; breach of this covenant constitutes the tort of bad faith breach of contract. Although generally applicable to insurance contracts, many courts have been reluctant to make this remedy broadly available in employment-related disputes and have shown even greater misgivings where a commercial contract is involved.

At the heart of this selective application of the right to sue for breach of the implied covenant is a great disparity in the scope of remedies. For simple breach of contract the remedy will normally be out of pocket losses, perhaps even without a provision for recovery of attorneys' fees. By contrast, the remedies available to the victim of an intentional tort are comparatively open-ended in two spheres—general damages and punitive damages—and the average verdict may be several times the usual contract damages recovery.

One consequence is that many decisions are remedy-oriented. A related effect is that it can be difficult to state a rule which reliably predicts, even in one jurisdiction, when a certain course of conduct by a party to a contract will give rise only to traditional contract remedies, and

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when a remedy in tort for bad faith will be allowed. Many factors, stated and unstated, have influenced the appellate courts, so that the law of bad faith is more a jumble of standards than an orderly body of internally-logical rules.

A primary field of development of bad faith law has been third party insurance, in which the insurer agrees to indemnify and defend the insured against liability to third parties. An insurer who has been found liable for bad faith breach may lose its rights in connection with the defense of the insured, become liable up to the policy limits, and face claims by its insured for tort damages.

Some jurisdictions also allow a tort cause of action for a bad faith refusal by an insurer to pay a first party claim; others do not. The primary rationale for rejection of the bad faith tort in first party cases is that the relationship between insured and insurer is adversarial—rather than fiduciary—and therefore no duty of fair dealing arises. The standards for determining bad faith in both third and first party cases focus on the reasonableness of the insurer's conduct.

SYNOPSIS

§ 23.01 Nature and Definition of Good Faith

In many jurisdictions, a covenant of good faith and fair dealing in performance is held to be implied in every contract, and the breach of this covenant can at times be tortious. This covenant is not viewed as an independent duty, but as a limitation on the range of discretion the parties may use.

To understand the tort of bad faith, it is essential to understand its contractual roots. The tort of bad faith was preceded by the development of a body of contract law concerning the implied covenant of good faith and fair dealing. The Restatement of Contracts[1] and the case law in many jurisdictions[2] hold that a covenant of good faith and fair dealing is implied in every contract. Under particular circumstances, breach of this covenant gives rise to a remedy in tort.[3]

(Text continued on page 23-5)

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[1] *See* Restatement (Second) of Contracts § 205.

[2] *See* § 23.01[1], *below.*

[3] Where it is recognized, the tort of bad faith arises out of a failure to use good faith during the *performance* stages of a contract. As used in this chapter, "good faith" means good faith in performance.

Other contexts in which the term "good faith" is used are set out in Restatement (Second) of Contracts § 205 comment a. Good faith in negotiation and the concept of a good faith purchaser are distinguished.

"Good faith" is also used to indicate an absence of fraud. *See, e.g.*, Hilgenberg v. Northup, 134 Ind. 92, 33 N.E. 786, 787 (1893); Combs v. Salyer, 291 Ky. 592, 165 S.W.2d 40, 44 (1942).

For further discussion on good faith at the formation stage, *see also* Kessler & Fine, *Culpa In Contrahendo, Bargaining in Good Faith and Freedom of Contract: a Comparative Study*, 77 Harv. L. Rev. 401 (1964).

(Footnote continued on page 23-5)

The concept of good faith and fair dealing has a venerable history in commercial contracts law.[3.1] According to one authority, this concept first appeared in classical Roman law and by the eighteenth century was a well established principle of English contract law imbuing commercial relationships with the common religious and moral principles of the time.[3.2] In the early twentieth century, American courts first implied the covenant in commercial contracts.[3.3]

Because of the many contexts in which a covenant of good faith may be implied, it has been suggested that it is not possible to state a positive definition of good faith or bad faith performance.[4] This continuing problem in articulating the elements of this tort remedy, of defining its boundaries with even a modicum of precision, is expressed in many opinions and commentaries. One result is a lack of predictability concerning the practical consequences of behavior which might or might not be tortious; counseling the client is made unusually difficult, and litigators are uncertain what to plead. However, many kinds of behavior which violate the covenant may be described.

The Restatement[5] provides that "every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." This approach emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party. The Restatement lists examples of conduct which involve bad faith because they violate community standards of decency, fairness or reasonableness.[6] Bad faith is not limited to behavior that

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For further discussion on good faith at the formation stage, *see also* Kessler & Fine, *Culpa In Contrahendo, Bargaining in Good Faith and Freedom of Contract: a Comparative Study*, 77 Harv. L. Rev. 401 (1964).

See generally Farnsworth, *"Good Faith" Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666, 670–671 (1963).

3.1 Good faith and fair dealing concept has a venerable history. *See* Scherer Constr., LLC v. Hedquist Constr., Inc., 2001 WY 23, 18 P.3d 645, 652–653 (Wyo. 2001), citing Story v. City of Bozeman, 242 Mont. 436, 791 P.2d 767, 772–773 (Mont. 1990).

3.2 Concept appeared in Roman law. Farnsworth, *Good Faith Performance and Commercial Reasonableness under the Uniform Commercial Code*, 30 U. Chi. L. Rev. 666, 669–670 (1962–1963).

3.3 Good faith and fair dealing concept applied in early 20th century by American courts. *See* Scherer Constr., LLC v. Hedquist Constr., Inc., 2001 WY 23, 18 P.3d 645, 652–653 (Wyo. 2001), citing Story v. City of Bozeman, 242 Mont. 436, 791 P.2d 767, 772–773 (Mont. 1990).

[4] Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 Cornell L. Rev. 497, 508 (1982).

[5] Restatement (Second) of Contracts § 205.

[6] Comment b of the Restatement sets forth the following as examples of bad faith in performance: "Evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."

is dishonest or fraudulent, but extends to dealing which is candid but unfair.[7]

Two authorities, Professors Robert S. Summers and Steven Burton, have examined the theoretical basis for the judicial implication of the covenant of good faith and fair dealing. Professor Summers has proposed that the most useful way in which to conceptualize good faith is to view it as an "excluder."[8] Good faith functions "as an excluder to rule out a wide range of heterogeneous forms of bad faith."[9] It can be identified only in the context of the circumstances in which a particular act of performance or enforcement takes place and by comparing it "with the specific and variant forms of bad faith which judges [have] decide[d] to prohibit."[10] The essential inquiry is whether the "action falls outside of the reasonable expectations of [the other contracting party] in light of the various factors and the circumstances that legitimately shape those expectations."[11]

Professor Burton's approach focuses upon a contracting party's exercise of discretion in performance. He proposes that:

> [B]ad faith performance occurs precisely when discretion is used to recapture opportunities foregone upon contracting—when the discretion-exercising party refuses to pay the expected cost of performance. Good faith performance, in turn, occurs when a party's discretion is exercised for any purpose within the reasonable contemplation of the parties at the time of formation—to capture opportunities that were preserved upon entering the contract, interpreted objectively.[12]

It must be conceded that the two professors' descriptions contain language which is rather general and vague. Especially, no clear test is provided to separate the kind of case that involves plain breach of contract—the kind which has filled the casebooks of law students for generations and largely formed the sphere of interest of Williston and Corbin—from a bad faith case.

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[7] Comment e lists the following as judicial examples of bad faith in the enforcement of a contract: "Harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, . . . abuse of a power to determine compliance or to terminate the contract"; "conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, . . . falsification of facts"; and carrying on dealings which are candid but unfair, "such as taking advantage of the necessitous circumstances of the other party to extort a modification of a contract for the sale of goods without legitimate commercial reason."

[8] Summers, *"Good Faith" In General Contract Law and the Sales Provisions of the Uniform Commercial Code,* 54 Va. L. Rev. 195, 196 (1968).

[9] Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization,* 67 Cornell L. Rev. 810, 819 (1982).

[10] G. Gilmore, *The Death of Contract* 94 (1986).

[11] H. Collins, *The Law of Contract* 15 (1986).

[12] Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith,* 94 Harv. L. Rev. 369, 373 (1980); Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers,* 69 Iowa L. Rev. 497, 502–503 (1984).