

Cornell Law Review

Volume 65
Issue 3 March 1980

Article 2

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Recommended Citation

Eric M. Holmes, *Is There Life After Gilmore's Death of Contract-Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 Cornell L. Rev. 330 (1980)

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IS THERE LIFE AFTER GILMORE'S DEATH OF CONTRACT?— INDUCTIONS FROM A STUDY OF COMMERCIAL GOOD FAITH IN FIRST-PARTY INSURANCE CONTRACTS

Eric M. Holmes†

INTRODUCTION

Something is awry in common-law contracts. The classical theory of contract¹ does not reflect reality; it does not comport with current judicial treatment of contract-malfeasors. For example, we still confidently parrot the Restatement of Contracts and teach that plaintiffs cannot recover punitive damages in a contract action.² We cannot, however, plausibly justify this black-letter

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The author wishes to thank his J.S.D. chairperson, William F. Young, Jr., for his considerable talents that have lent strength to these articles. A word of appreciation is also due Dr. Grant Gilmore for his encouragement and seasoned comments on an earlier draft of this article. The author, of course, is solely accountable for any verbal or legal infelicities.

¹ Contract theory stems from at least two disparate schools of contract philosophy: (1) the classical school, designed and promoted by Langdell, Holmes, and Williston, and characterized by its slogans of volition, freedom of contract, *laissez-faire*, plain meaning, and judicial nonintervention; and (2) the realist (or neo-classical) school, fashioned by Corbin and Llewellyn, with its ideals of good faith and fair dealing, commercial reasonableness, and conscionability. These two schools are discussed in greater detail in Holmes, *Education for Competent Lawyering—Case Method in a Functional Context*, 76 COLUM. L. REV. 535 (1976). See also G. GILMORE, DEATH OF CONTRACT (1974); Woodard, *The Limits of Legal Realism: An Historical Perspective*, 54 U. VA. L. REV. 689 (1968). Professor Ian Macneil would add a third theory: relational contract law. See Macneil, *Contracts: Adjustments of Long-term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U.L. REV. 854 (1978).

² RESTATEMENT OF CONTRACTS § 342 (1932). Rather than a flat rejection of all punitive damages, the Restatement (Second) provides: "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." RESTATEMENT (SECOND) OF CONTRACTS § 369 (Tent. Draft No. 14, 1979). But for a discussion of the "true" rule, see Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 220-40 (1977).

rule except to say that the matter is contract and not tort. Despite this compelling argument, punitive damages have traditionally been awarded in many types of contract actions: breach of promise to marry,³ breach of contract by a common carrier or public utility, breach of contract when the contractual relationship is of a fiduciary character, fraudulent breach of contract, and contract breach accompanied by an independent tort.⁴ In addition, punitive damages are now frequently awarded for breach of first-party insurance contracts.⁵ A number of courts award a variety of other damages for contract breach that are also reminiscent of tort.⁶

The disintegration of traditional contract damage rules is not the only blow that time has dealt the classical theory. A change in societal values and expectations has also undercut most of its formal external rules⁷ governing contract formation, construction, and breach. This process began no later than the 1930's with the advent of the "legal realists."⁸ Classical theory ostensibly reflected the popular attitudes of the late nineteenth century, which were typified by *caveat emptor* and *laissez-faire*. It emphasized property rights and took a narrow view of the scope of social duty

³ Because the damages are intensely personal, the type of interest abused is similar to the interest protected in a tort action. See, e.g., *Adams v. Griffith*, 51 F. Supp. 549 (W.D. Mo. 1943); *Brown v. Douglas*, 104 Ga. App. 769, 122 S.E.2d 747 (1961).

⁴ See Sullivan, *supra* note 2, at 222-40.

⁵ See Annot., 47 A.L.R.3d 314, 339-46 (1973); notes 241-59 and accompanying text *infra*.

A definition of first-party insurance might be helpful. It generally describes that type of insurance coverage under which the insured or his beneficiary recovers policy benefits directly from the insurer without establishing fault. The insurer's duty to pay runs directly to the insured. Life, disability, fire and other property insurance, health and accident, and title insurance are examples of first-party insurance. It can be contrasted with third-party (liability) insurance under which the insurer has a duty to defend and to make settlement for its insured. The award of damages for excess liability is novel in first-party insurance cases. It is, however, well accepted in third-party insurance cases where the insurer "wrongfully" (i.e., in bad faith or negligently) mishandles the settlement obligation under the liability policy. The annotated bibliography in 3 DEFENSE RESEARCH INSTITUTE, INSURANCE LAW — AVOIDING EXCESS LIABILITY (1973), for instance, catalogues a total of 63 law review articles on third-party excess liability. See generally R. KEETON, BASIC TEXT ON INSURANCE LAW 510-13 (1971).

⁶ See notes 96-156 and accompanying text *infra*.

⁷ That contract is formal, external and objective is the central thesis of classical theory. In the words of Holmes, "The whole doctrine of contract is formal & external." This quote is a handwritten addition by Holmes in his copy of *The Common Law*. For a reproduction, see O.W. HOLMES, THE COMMON LAW 230 (Howe ed. 1963).

⁸ See Holmes, *supra* note 1, at 554-56.

implicit in a civil obligation.⁹ An example of these tendencies in classical contract theory is the postulate that a contracting party is free to choose between performing and paying damages.¹⁰ Today, on the other hand, there is an increasing appreciation of individual rights, a more restrained appraisal of property rights, and a broader concept of social duty. Perhaps the best example of this development is the emerging view that in every contract there exists an implied covenant of good faith and fair dealing¹¹ — a nonconsensual duty prohibiting a party from doing anything that will injure the right of the other party to receive the benefit of his bargain. This covenant represents a fundamental policy shift away from an unbridled freedom from the obligation of contract performance toward the fulfillment of the reasonable expectations of the parties by encouraging performance.

⁹ See I R. POUND, JURISPRUDENCE 429-30 (1959); Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 384-95 (1978).

¹⁰ Classical contract theory secured free individual self-assertion and, influenced by Justice Holmes, recognized no duty to perform any contract obligation. For Holmes, contract liability should be imposed without regard to moral fault. No moral guilt arises because man is not significantly different from a baboon or a grain of sand. Since law is divorced from morals (*i.e.*, amoral), Holmes' bad man theory destroyed any notion of good faith, fair dealing and cooperation in classical contract law. He explained the classical principle that one has not only the power but the *right* to breach his contract:

The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, — and nothing else. . . . If you commit a contract, you are liable to pay a compensatory sum unless the promised event comes to pass, and that is all the difference. But such a mode of looking at the matter stinks in the nostrils of those who think it advantageous to get as much ethics into the law as they can.

Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897). In the insurance context, the classical premise that one can breach so long as he compensates the other party gives rise to a question: Does the classical theory fairly compensate insureds when insurers choose to breach? Unfortunately, the answer in many cases is no. See text at notes 33-35 *infra*.

For a classic explication of the freedom from the obligation to perform, see F. KESSLER & G. GILMORE, *Contract as a Principle of Order*, in CONTRACTS, CASES AND MATERIALS 1-15 (2d ed. 1970).

¹¹ "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tent. Draft No. 5, 1970). Section 231 has no predecessor in the original Restatement, probably because an affirmative obligation of "good faith" was antithetical to classical contract law. Sections 1-201(19), 2-103(b), and 2-203 of the Uniform Commercial Code also recognize the good-faith duty.

The implied duty of good faith and fair dealing illustrates the sweeping difference between modern and classical contract theories. The classical theory envisioned contractual relationships similar to the law school experience — hard to get into, hard to flunk out of and not particularly harmful. Modern theory, on the other hand, allows easier access and egress, but exposes you to greater harm (liability) while you are there.

Such deviations from classical theory prompted Professor Gilmore to declare respectfully that contract is dead.¹² His graveyard theory is premised on the recent expansion of promissory liability and on more flexible damage awards. Classical contract theory narrows the range of liability with its bargained-for-exchange formula¹³ and compensates solely for damage to the expectation interest. Modern realist contract theories, on the other hand, have enlarged contractual obligations with promissory estoppel, moral obligation, unjust enrichment, *culpa in contrahendo*¹⁴ and good-faith duties. Awards of consequential damages, punitive damages, and the once extraordinary remedy of specific performance are becoming commonplace. Offsetting the additional exposure these innovations permit, courts have initiated a parallel expansion of contractual excuses¹⁵ and of policing devices¹⁶ to ensure fairness in contract performance and discharge. Nevertheless, the net effect of these twentieth century developments, which might be characterized as the socialization of contract law, has been an explosion of liability. From these developments, Professor Gilmore concludes that contract is dissolving into the mainstream of tort law from which contract principles emerged over a century ago.¹⁷

Certainly something has changed, but contract is not dead and tort has not absorbed it. The reverse is a more accurate description of the theoretical trend. Tort is moving away from fault

¹² G. GILMORE, *THE DEATH OF CONTRACT* (1974). The reviews of this book demonstrate that the academic community took the "dodo and unicorn" theory seriously. See, e.g., Gordley, Book Review, 89 HARV. L. REV. 452 (1975); Gordon, Book Review, 1974 WIS. L. REV. 1216; Mooney, Book Review, 55 ORE. L. REV. 155 (1976); Reitz, Book Review, 123 U. PA. L. REV. 697 (1975); Speidel, Book Review, 27 STAN. L. REV. 1161 (1975). See also Milhollin, *More on the Death of Contract*, 24 CATH. U.L. REV. 29 (1974).

¹³ The requirement of a bargain was the sole pervasive justification for contract enforcement. The requirement of consideration may appear to be an independent justification, but not just any benefit or detriment incurred by a party would support the enforcement of a promise. The classicists insist that there be a cause and effect relationship between the detriment and the promise which defines the bargain. According to Holmes, the "root of the whole matter is the relation of reciprocal conventional inducement, each for the other, between consideration and promise." O.W. HOLMES, *supra* note 7, at 230.

¹⁴ For a discussion of this continental precontractual duty of care see Kessler & Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964).

¹⁵ New contractual excuses include mistake, commercial impracticability, and frustration.

¹⁶ Reasonableness, conscionability, and good faith are among the recently recognized policing devices.

¹⁷ G. GILMORE, *supra* note 12, at 100-01.

as the sole basis for liability and toward compensation systems; strict liability and worker's compensation are examples of this movement. Contract law has begun to move into the resulting vacuum by relying on fault as an element of liability in an increasing variety of situations. Two equitable concepts, unconscionability and good faith, have been the most important instruments of this process. Unconscionability permits the courts to expunge materially offensive terms from written contracts. Good faith allows the implication of duties for which the parties neglected to provide.

Judicial use of these tools does not signal the death of a consensual contract theory. It merely recognizes the limits of such a theory, which the classicists ignored. By according equal freedom of contract to parties with unequal sophistication, knowledge, and economic power, the classical theorists invited inequitable results. As Professor Kessler suggested, freedom of contract is the cloak under which business enterprises can legislate in an authoritarian manner.¹⁸ Liberty of economic activity is a legitimate policy which the law must accommodate. Courts cannot, however, allow it to dominate the law and reduce contractual relations to a primitive battle for survival of the fittest. Public law as well as private assent structures private relations; contract law must sometimes look beyond assent if it is to regulate a marketplace dominated by boilerplate. Classical theorists also invited unfairness with their assertion that a person was free to perform, or breach and pay compensatory damages. As Professor Farnsworth concluded in his study of contract remedies: "All in all, our system of legal remedies for breach of contract, heavily influenced by the economic philosophy of free enterprise, has shown a marked solicitude for men who do not keep their promises."¹⁹

¹⁸ Kessler, *Contracts of Adhesion — Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 631-33 (1943).

¹⁹ Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1216 (1970). This tendency is related to the traditional limits of the remedy of specific performance. By the seventeenth century, specific performance had become an extraordinary remedy available only when monetary relief at law was deemed inadequate. Because courts treated land as unique, most suits for specific performance concerned land contracts. The extraordinary nature of specific performance probably springs from Coke's pronouncement in *Bromage v. Genning*, 1 Rolle 368, 81 Eng. Rep. 540 (K.B. 1616). According to Coke, a promisor should be permitted to refuse to do whatever he promised to do, even when performance is possible and desired by the promisee, and simply pay damages for any loss suffered by the promisee. Classical contract theorists embraced Coke's philosophy. Not only did Holmes, for example, approve of *Bromage v. Genning* in his famous address *The Path of the Law*, but from it he deduced the right of every promisor to breach his contract and pay compensatory damages. See Holmes, *supra* note 10, at 462.

As this Article will discuss, courts now blend equity, contract and tort principles in requiring parties to exhibit good faith and fair conduct in the performance and discharge of contract duties. Although it is difficult to squeeze this judicial use of separate legal areas into one proper legal classification, this overlap might be labelled "conequitort." Specifically, this Article will undertake to demonstrate, by a close examination of first-party insurance contract cases,²⁰ that courts are recognizing three varieties of contract breach. The first is the traditional *simple breach of contract* for which damages are based on the expectation interest. Fault and blame are irrelevant. The law in this area accords with the classical ideas of strict liability and limited damages for breach: courts do not consider noncompensatory and punitive damages. The second is *bad-faith breach of contract* for which not only compensatory but all nonpunitive damages proximately caused by the breach are recoverable, including attorney's fees, all economic losses, and mental distress. The third is *fraudulent or oppressive breach of contract* for which punitive damages are allowed.

The recognition of these three types of contract breach demonstrates that modern contract law is concerned with substantive and procedural justice in contract matters. The equitable notions of good faith and fair dealing have breathed a fresh and salutary honesty into what the classicists considered a bare contractual relationship. This evolving contract law recognizes a positive duty that promotes the policy articulated by Dean Roscoe Pound: "In civilized society men must be able to assume that those with whom they deal in the general intercourse of society will act in good faith."²¹

²⁰ For a discussion of the relevance of insurance law to general contract law, as well as an explication of the ideas from insurance law which suggest the future for general contract law, see Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381, 395-99 (1978). Most modern contracts do not mirror the classical model of bargained-for terms. The theory premises that parties bargain and assent to terms that are legally given the status of private law. The only task for courts is to separate expressions of assent that are legally operative from those that are outside the parties' assent. Many courts perform this task by applying a bound-by-what-you-sign rule. According to such a rule, when parties sign a form or pad contract everything in the writing is held to be within the parties' assent. See note 53 *infra*. In the insurance context, however, courts are beginning to evaluate the reality of presumed assent. In that inquiry, courts attempt to avoid contractual overreaching and unconscionable advantage, honor reasonable expectations, and promote good faith and fair dealing. Therefore, to the extent that modern contracts are created by adhesion rather than bargaining, insurance has important implications for the future of contract law.

²¹ 3 R. POUND, JURISPRUDENCE 10 (1959).

I

SIMPLE BREACH OF CONTRACT

A. *Classical Contract Damage Limitations*

Contract law seeks principally to protect the reasonable expectations of the parties by granting them the benefit of their bargain. The benefit-of-the-bargain rule seeks to protect the expectation interest by placing an aggrieved party in the same economic position he would be in if the other party faithfully performed the contract.²² In the insurance context, courts generally classify an insurer's refusal to pay legitimate policy claims as a simple breach of contract. In accordance with the classical view of the benefit-of-the-bargain rule, courts traditionally awarded the insured only the amount due under the policy plus legal interest for simple breach.²³ Since the insured's expectation is to receive the stated sum of the policy, the payment of that amount plus interest for delay supposedly puts him in the position he would have been in had the contract been properly performed.

In addition to this recovery, classical theory permitted "special" or "consequential" damages, subject to limitations.²⁴ Except for the requirement of causation, the barriers to recovery of consequential damages all spring from the rule of *Hadley v. Baxendale*.²⁵ *Hadley* allows only consequential damages "such as may reasonably be supposed to have been in the contemplation of both parties at the time they made the contract, as the probable result of the breach of it."²⁶ Thus when a first-party insurer wrong-

²² In addition to the expectation interest, the reliance and restitutionary interests have strong claims for protection. See Fuller & Perdue, *The Reliance Interest in Contract Damages*, 46 YALE L.J. 52 (1936). Compare RESTATEMENT (SECOND) OF CONTRACTS §§ 89D, 90 (Tent. Drafts No. 1-7 1973). For a discussion of the requirement of a bargain in relation to standardized contracts like an insurance policy, see Dauer, *Contracts of Adhesion in Light of the Bargain Hypothesis: An Introduction*, 5 AKRON L. REV. 1 (1972).

²³ This limited recovery is the general rule. See 16 J.A. APPLEMAN & J. APPLEMAN, *INSURANCE LAW & PRACTICE* § 8881, at 633-38 (1968). See, e.g., *Felder v. Great Am. Ins. Co.*, 260 F. Supp. 575 (D.S.C. 1966); *Mitchell v. Intermountain Cas. Co.*, 69 N.M. 150, 364 P.2d 856 (1961). Nonetheless, courts now recognize a broader theory of recovery, as discussed below. See note 96 and accompanying text *infra*.

²⁴ For a more considered discussion of these limitations, see J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* §§ 14-4 to -10 (2d ed. 1977); D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* § 12.3 (1973); J. MURRAY, *MURRAY ON CONTRACTS* §§ 224-226 (2d rev. ed. 1974).

²⁵ 9 Exch. 341, 156 Eng. Rep 145 (1854). The *Hadley* rule was reformulated in *Victoria Laundry (Windsor), Ltd. v. Newman Indus., Ltd.* 2 K.B. 528, 1 A11 E.R. 997 (1949) which expands the application of the rule to allow consequential damages in a wider variety of situations. See D. DOBBS, *supra* note 24, at 812-14.

²⁶ 9 Exch. at 354, 156 Eng. Rep. at 151.

fully fails to pay benefits, the insured may recover more than the amount due under the policy plus interest if a reasonable person in the insurer's position with its knowledge could have reasonably foreseen the additional damage.²⁷ Note that foreseeability,²⁸ not causation, is the major obstacle to recovering consequential damages.

The *Hadley* rule can justify consequential damages in suits on first-party insurance contracts.²⁹ It seems reasonably foreseeable

²⁷ The extent of recovery is not measured by what the insurer actually foresaw. Instead the objective test of what a reasonable person with particular knowledge should have foreseen applies. One issue is how much knowledge of the special circumstances the breaching party must have. The classical theorists wanted to limit recoveries by requiring that the defaulting party have tacitly consented to assume liability for the damages claimed. Holmes espoused this test: "The extent of liability in such cases is likely to be within [the insurer's] contemplation, and whether it is or not, should be worked out on terms which it fairly may be presumed he would have assented to if they had been presented to his mind." *Globe Ref. Co. v. Landra Cotton Oil Co.*, 190 U.S. 540, 543 (1903). Although the tacit-agreement test has fallen into disrepute, the insurance rule limiting damages to the policy amount plus interest is arguably a special application of this test.

²⁸ Foreseeability, like good faith, is an elastic concept which turns on the presumed as well as actual knowledge of the insurance company. This differs from case to case. The foreseeability test calls for a refined analysis of risk allocation. As Professor Murray suggests, courts applying the *Hadley* test must ask:

Would a reasonable man in the position of the defaulting promisor who knew of the special circumstances at the time the contract was formed normally assume the risk of liability for the special consequences of his breach in light of all the surrounding circumstances and particularly, the consideration he was to receive for performance?

J. MURRAY, *supra* note 24, at 456. Such direct consideration of risk allocation would foster clarity and precision as well as fairness.

²⁹ See, e.g., *Asher v. Reliance Ins. Co.*, 308 F. Supp. 847 (N.D. Cal. 1970) (applying Alaska law). The court held the insured could recover lost rents in a fire insurance suit. Even mental-distress damages should be recoverable in first-party insurance cases under the *Hadley* rule. This assertion runs counter to conventional wisdom. Courts generally do not award mental distress damages for contract breach unless the defendant had reason to know that the breach would cause mental suffering beyond that occasioned by mere pecuniary loss. See RESTATEMENT OF CONTRACTS § 341 (1932). An insurance contract is usually considered commercial and not personal in nature and thus it does not fall into that special class of contracts directly concerned with the nonbreaching party's emotional well-being. Since an insured seeks only a monetary benefit, any mental suffering caused by monetary loss is per se unforeseeable. *Id.* See, e.g., *Cassady v. United Ins. Co. of Am.*, 370 F. Supp. 388, 398 (W.D. Ark. 1974); *Pendleton v. Aetna Life Ins. Co.*, 320 F. Supp. 425, 432 (E.D. La. 1970); *Dawkins v. National Liberty Life Ins. Co.*, 252 F. Supp. 800, 802 (D.S.C. 1966). But, as suggested below, economic and emotional security are intertwined in the insurance obligation. See note 34 and accompanying text *infra*. Although mental-distress damages ought to be recoverable pursuant to the *Hadley* rule, there is a paucity of authority that supports this view. One case that does is *Crisci v. Security Ins. Co.*, 66 Cal.2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967), in which the court held that an insurance contract is not commercial but personal in nature. The court then applied the foreseeability concept to allow recovery of mental distress damages. *Cf. Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1 (7th Cir. 1972). See generally Note, *Damages for Mental Suffering Caused by*

that a disabled insured will incur additional economic losses if he is not promptly paid his disability benefits. Similarly, where the owner of a mortgaged business suffers a material fire loss, it seems reasonably foreseeable that if the insurer does not pay for the covered losses promptly, the businessman may be financially pinched and even bankrupted.³⁰

This application of *Hadley*, however, has encountered judicial resistance; many courts have held that all damages beyond the stated policy amount are outside the contemplation of the parties as a matter of law.³¹ This rule, which limits plaintiff's damages to the policy amount plus the legal rate of interest, has three justifications: (1) it is simple, precise, and predictable; (2) the plaintiff can borrow money at or near the legal rate of interest and thus he cannot lose anything that the policy amount plus interest will not restore to him; and (3) an insurance contract is a commercial contract and parties may bargain for a provision designating specifically who will bear the risk of consequential losses.³²

Insurers: Recent Development in the Law of Tort and Contract, 48 NOTRE DAME LAW. 1303, 1311 (1973).

³⁰ See, e.g., *Reichert v. General Ins. Co. of Am.*, 428 P.2d 860, 59 Cal. Rptr. 724 (1967) (en banc). There, the insured's heavily mortgaged motel was destroyed by fire. Following the insurer's unjustified denial of policy benefits, the insured could not meet his mortgage payments and went bankrupt. Although the carrier argued for the *per se* unforeseeable rule as to the consequential losses, the court held that, because plaintiff's bankruptcy was foreseeable, the carrier was liable for all consequential losses proximately flowing from the breach.

Where the owner of a heavily mortgaged . . . business property suffers a substantial fire loss, the owner . . . may be in jeopardy of losing his property and becoming a bankrupt. A major, if not the main, reason why a businessman purchases fire insurance is to guard against such eventualities. . . . Insurers are, of course, chargeable with knowledge of the basic reasons why fire insurance is purchased, and of the likelihood that an improper delay in payment may result in the very injuries for which the insured sought protection by purchasing the policies.

428 P.2d at 864, 59 Cal. Rptr. at 728.

The *Reichert* decision was vacated upon rehearing because the plaintiff's original claim for relief vested in the bankruptcy trustee. 68 Cal.2d 822, 442 P.2d 377, 69 Cal. Rptr. 321 (1968) (en banc). Nonetheless, Judge Peters, author of the original opinion, vigorously maintained that the plaintiff was entitled to consequential damages. *Id.* at 839, 442 P.2d at 386, 69 Cal Rptr. at 330. See Parks, *Recovery of Extra-Contract Damages in Suits on Insurance Policies*, 9 FORUM 43, 58 (1973).

³¹ See Annot., 47 A.L.R.3d 314 (1973); Note, *Extra-Contractual Damages in Suits on Insurance Policies*, 46 U. CIN. L. REV. 170 (1977); Note, *First Party Torts—Extra-Contractual Liability of Insurers Who Violate the Duty of Good Faith and Fair Dealing*, 25 DRAKE L. REV. 900 (1976); Note, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164 (1976).

³² See Note, *supra* note 31, 45 FORDHAM L. REV. at 169.

Although this rule of per se unforeseeability is undeniably simple and certain, its rationale does not stand scrutiny, even given classical contract jurisprudence. False assumptions underlie the second and third justifications. It is not necessarily true that an insured can secure a loan pending judicial determination of the insurer's legal obligation. Lenders may consider the insured a bad risk. Even if the insured can borrow money he may be forced to pay much more than the legal rate of interest. In times of double digit inflation, the commercial rate may be as much as twice the legal rate of interest.³³ Thus the policy-amount-plus-interest formula will provide inadequate compensation for the insured.

The argument that an insured can bargain for a provision that gives the insurer a duty to pay consequential damages also fails to reflect market reality. An insured does not buy an insurance contract based on an arm's length bargain. Instead he buys protection for himself and his family. In this context the insured reasonably expects protection in the form of prompt payment for the covered contingencies. Insurers are well aware of this expectation, as the slogan "you are in good hands with Allstate" attests. Even Samuel Williston, a principal designer of the classical contract theory, notes:

The final and perhaps most significant characteristic of insurance contracts, differentiating them from ordinary, negotiated commercial contracts, is the increasing tendency of the public to look upon the insurance policy not as a contract but as a special form of chattel. The typical applicant buys "protection" much as he buys groceries.³⁴

Courts that deny all consequential damages encourage insurers to breach rather than perform. The insurer saves money by trying to force each first-party insured to settle.³⁵ It may pay

³³ Legal rates of interest vary among the several states from 5% to 7%. See, e.g., GA. CODE ANN. § 57-101 (1975) (7%); N.Y. CIV. PRAC. LAW § 5004 (McKinney Supp. 1976) (6%). Commercial rates also vary; in January of 1980 the prime rate of interest was hovering around .15%. See Wall Street J., Jan. 21, 1980, at 2, col. 2.

³⁴ 7 S. WILLISTON, WILLISTON ON CONTRACTS 34 (3d ed. 1957). Courts are beginning to view an insurance contract more as a commodity than a contract. Leff, *Contract as Thing*, 19 AM. U.L. REV. 131 (1970). For a judicial discussion and application of the implied warranty of fitness from the UCC to an insurance "good," see C&J Fertilizer, Inc. v. Allied Mut. Ins. Co., 227 N.W. 2d 169, 177-79 (Iowa 1975).

³⁵ If the insurance company refuses to pay its insured in full, then the insured is almost always better off, considering transaction costs in collecting the full amount, accepting some lesser amount. This is explained and statistically verified in Leff, *Injury, Ignorance and Spite—The Dynamics of Coercive Collection*, 80 YALE L. J. 1 (1970) along with other aspects of

nothing or a settlement figure below the policy amount. At worst, if settlement fails and the insurer is held in breach, it only has to pay the face amount plus legal interest. Moreover, even if the insurer loses the case, if its return on investments approximates the commercial rate of interest, it will earn at least the difference between the commercial rate and the legal rate while litigation drags on.

Thus, recovery of both compensatory and, in the better view, consequential damages for simple breach of first-party insurance contracts comports with classical contract theory.³⁶ Nevertheless, not all courts that have awarded such damages for wrongful denial of first-party insurance benefits, particularly outside the simple breach situation, have relied on *Hadley*. Instead, they have expanded contract itself to reflect the economic, social, and legal realities of the insurer-insured relationship. This process illustrates the changes that have revolutionized contract law generally. But before examining the history and theoretical framework of this process, it may be useful to examine the forces that set it in motion.

contract law that encourage non-performance. The face-amount-of-the-policy-plus-interest rule foments unethical conduct:

In cases involving disability and health policies, certain insurance companies have left insureds and their families destitute and have engaged in malicious and outrageous conduct for the purpose of avoiding meritorious claims. These companies have subjected disabled insureds to unnecessary and burdensome medical examinations, have fraudulently attempted to induce insureds into waiving their rights under their policies, and have verbally abused insureds, going so far as to fabricate accusations of fraud. "[U]nless prevented by the courts, it is to the interest of a disability insurer to engage in protracted and unwarranted litigation creating undue stress which may well precipitate the insured's death."

In the area of fire insurance, the companies have subjected their insureds to costly and time-consuming examinations for the sole purpose of delaying payment. They have initiated allegedly unfounded prosecutions for arson and fraud. By wrongfully delaying desperately needed funds, insurers have forced businesses into bankruptcy.

Other examples of unethical conduct have occurred in cases involving life and accident insurance.

Note, *supra* note 31, 45 *FORDHAM L. REV.* at 165-66 (footnotes omitted).

³⁶ For an excellent single work which demonstrates both the inadequacies of these policy bases and the development of excess-liability in the first-party context, see J. MCCARTHY, *PUNITIVE DAMAGES IN BAD FAITH CASES* 1-94 (2d ed. 1978).

B. *Impetus to Expansion*

Prior to 1870, when Christopher Columbus Langdell embarked to discover the first casebook for law-school teaching,³⁷ there was no general theory of contract. Our legal ancestors saw debt, covenant, account, and assumpsit as distinct, self-contained areas for legal inquiry and reasoning. They did not attempt to find doctrinal bridges or unifying principles.³⁸ Langdell's case system gave the law a theory of contract. He argued that law is an inductive science, that the library is its laboratory, and that the case method of teaching extracts fundamental principles from the raw material of printed decisions in the logical manner of the physical sciences.³⁹ For Langdell, the law of contract was the fundamental, archetypical branch of "legal science" and he awarded it the honor of the first casebook. In compiling his contracts casebook, he discovered a theory of contract which still dominates our thinking today.

Before Langdell, common-law theory assumed that all decisions of all higher courts could be reconciled "on principle" and that all were equally authoritative. Because of the enormous proliferation of decisions, however, many of which contained confused, obsolete, or simply bad law, opinions became increasingly inconsistent.⁴⁰ Nevertheless, theory dictated that courts decide new cases on their factual congruity with previous decisions, not

³⁷ Langdell popularized case study instruction, now almost the exclusive method of legal education, by writing what is generally regarded as the first American casebook. C. LANGDELL, *SELECTION OF CASES ON THE LAW OF CONTRACTS* (1871). Sticklers for detail may, however, challenge the originality of Langdell's concept. Judge Zephaniah Swift published a book in 1810 which consisted of a short 174-page treatise on evidence with an appendix of 68 pages containing the principal cases referred to in the text. See Baldwin, *Education for the Bar in the United States*, 4 AM. L. SCH. REV. 8, 13 (1915). According to Professor Warren, Angell's *A Treatise on the Common Law in Relation to Watercourses*, published in 1824, was the first American casebook. See C. WARREN, *A HISTORY OF THE AMERICAN BAR* 541 (1911).

³⁸ F. KESSLER & G. GILMORE, *CONTRACTS* 96 (2d ed. 1970). Because there was no general common law theory of contracts, many early legal scholars turned to Roman law for rational and scientific analysis. Roman law, however, recognized only specific types of contracts and did not itself succeed in developing a theory of contract. *Id.* at 96 n.3.

³⁹ In pithy language Langdell states these basic premises in his first contracts casebook. C. LANGDELL, *supra* note 37, at vi. Sixteen years later, as Dean of the Harvard Law School, Langdell restated these fundamental premises. Langdell, *Address at the 250th Anniversary of Harvard College*, 3 L.Q. REV. 123, 124 (1887), *quoted in* 2 C. WARREN, *HISTORY OF THE HARVARD LAW SCHOOL* 374 (1908).

⁴⁰ See A. REED, *TRAINING FOR THE PUBLIC PROFESSION OF THE LAW* 375 (1921). For illustrations of the "hopeless contrariety of decisions" due to "simple logical fallacies," see Drake, *The Rule of Law and the Legal Right*, 19 MICH. L. REV. 365 (1921).

on their merits. Lawyers sought cases that were "on all fours" and frequently concealed logical inconsistencies by stressing the letter rather than the spirit of a case. As more cases were decided, the likelihood of finding a case on point increased. Courts soon sought the narrow precedent instead of the appropriately reasoned principle. The factual case governed the law whether or not it comported with sound legal principles. Langdell's scientific theory halted this trend. Rather than granting equal respect to all cases, Langdell discarded the vast majority as useless and critically selected cases that embodied the basic doctrines of common-law contracts. From these the legal scientist was to divine, by induction, the fundamental principles of contract law. In theory, the accurate statement of these first principles would describe a rational, harmonious system.⁴¹

The Langdellian conceptualization dominated contract theory for over eighty years.⁴² Treatise writers, striving "to place the law on a more philosophic and satisfactory basis,"⁴³ did weave contract law into a set of scientific principles stated in an orderly manner. Samuel Williston's treatise, with its ingenious technical refinements to Langdell's conceptual framework, gave contract its definitive form for some decades. These writers transformed the living law of contracts "into a fabric of black-letter rules—a kind of unwritten and sluggishly evolutionary civil code."⁴⁴ The American Law Institute (ALI) carried this approach to its logical extreme. By 1920 it had set out to induce the immutable⁴⁵ first principles of contract from case law and grandly synthesize them in a black-letter text.⁴⁶

⁴¹ Langdell's case system gave the law of contract a harmonious, unified theoretical system. It was easy to accept the sanctity of pure contract principles, because within any inflexible and doctrinal system there is a self-confirming logic and a seductive symmetry. Contract law came to be judged by its logical symmetry, of which Langdell was the master. For an illustration of the master's touch, see C. LANGDELL, *A Summary of the Law of Contracts*, in *CASES ON CONTRACTS* 89 (2d ed. 1880). Langdell taught contract law as a negative, impersonal and bloodless abstraction, frozen into what Professor Page in 1905 called a "rational and harmonious system." I W. PAGE, *THE LAW OF CONTRACTS* 19 (1905).

⁴² Langdell's method of analysis, of course, is still pre-eminent.

⁴³ C. ASHLEY, *THE LAW OF CONTRACTS* vii (1911).

⁴⁴ L. FRIEDMAN, *CONTRACT LAW IN AMERICA* 211 (1965).

⁴⁵ Obviously the first restaters knew there would be more cases. Apparently they thought that periodic collections of new cases annotated to the relevant principles and rules would keep the Restatements current. Such collections were published in a series of volumes entitled *The Restatements in the Courts*. See generally H. GOODRICH & P. WOLKIN, *THE STORY OF THE AMERICAN LAW INSTITUTE, 1923-1961* (1961).

⁴⁶ *RESTATEMENT OF CONTRACTS, Introduction*, at xi (1932).

Yet, by 1952, the ALI had decided that the original Restatements needed restatement; the original restaters' assumption that there was one everlasting system of contract law was unfounded.⁴⁷ Even Williston candidly admitted, as early as the preface to the first edition of his treatise, that there is no single doctrinal unity in contract law: "The law of contracts . . . after starting with some degree of unity now tends from its very size to fall apart. . . . It therefore seems desirable to treat the subject of contracts as a whole, and show the wide range of application of its principles."⁴⁸ Nevertheless, the classicists' attempt to impose an artificial unity on contract theory at best impaired independent analysis of transactional differences among contracts and at worst was misleading.

C. *The Laws of Contracts*

Today, this unified conceptualization of contract is dead — not contract itself, as Professor Gilmore contends. Out of its ashes has arisen a jurisprudence of process, in which law is perceived as responsively adapting to meet the exigencies of changing social conditions.⁴⁹ The science of law has become the science of administration of law.⁵⁰ One result of this rethinking has been the burgeoning of new *laws* of contracts which focus on three distinct aspects: (1) the formational process, (2) the status and relationship of the contracting parties, and (3) special considerations generated by the nature of the underlying transaction. More simply put,

⁴⁷ In his introduction to the Restatement (Second) of Conflicts of Laws, Professor Wechsler underscored this change of emphasis:

The essence of that change has been the jettisoning of a multiplicity of rigid rules in favor of standards of greater flexibility, according sensitivity in judgment to important values that were formerly ignored. Such a transformation in the corpus of the law reduces certitude as well as certainty, posing a special problem in the process of restatement. . . . [This second Restatement] presents a striking contrast to the first Restatement in which dogma was so thoroughly enshrined.

RESTATEMENT (SECOND) OF CONFLICT OF LAWS, *Introduction*, at vii (1971).

⁴⁸ I. S. WILLISTON, *THE LAW OF CONTRACTS* xi (3d ed. 1957).

⁴⁹ See, e.g., Rosenberg, *The New Looks in Law*, 52 MARQ. L. REV. 539 (1969).

⁵⁰ The common area of agreement shared by this essentially eclectic group is perhaps best expressed by the venerable Leon Green:

"[L]aw" as here conceived is the power of passing judgment . . . through formal political agencies for securing social control. . . . [A]ny science of law is at bottom, the science of the administration of law.

Green, *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1014, 1015-16 (1928) (footnote omitted).

courts are grappling with three questions: How was the contract formed? Who are the parties? What kind of contract is it?

1. *Formational Process—Bargain or Adhesion Model?*

Classical contract theorists premised only one transactional model for contracts, a bargained-for exchange. Drawing upon the classical principles of freedom of contract, volition and mutual assent, they assumed that all contracts result from the interaction of parties who meet one another in the marketplace on relatively equal economic terms. Each individual pursues his own interests through arm's length bargaining, and the race is to the swiftest. To protect the fruits that industrious businesspeople acquire through competition, the classical theory condemns official intervention in private transactions and praises government when it governs least.⁵¹ Also, since it is a fundamental principle of classical contract theory that the objective manifestation of mutual assent controls the terms of the contract,⁵² courts often bind both parties to the letter of what they sign.⁵³

This approach is reasonable if parties to a contract actuallyicker over material terms so that both parties not only read but comprehend the terms. No doubt some contracts issue from bargaining, choice, and free will — but not many. Most contracts involve only minimal bargaining over the most elementary terms. A mass standardized contract fitting the adhesion, not the bargain model of contracts, is typical today. Llewellyn powerfully argued

⁵¹ For a discussion of compulsion and restraint in relation to classical contract law, see W. FRIEDMAN, *LAW IN A CHANGING SOCIETY* 92-94 (1959) (English law); Patterson, *Compulsory Contracts in the Crystal Ball*, 43 COLUM. L. REV. 731 (1943) (American law).

⁵² RESTATEMENT (SECOND) OF CONTRACTS § 24 (1973). Ever since courts translated the need for a "meeting of the minds" into a requirement of manifestation of mutual assent, contract law has been concerned with the objective rather than the subjective state of a party's mind. See J. CALAMARI & J. PERILLO, *THE LAW OF CONTRACTS* 22-25 (2d ed. 1977); 1 S. WILLISTON, *supra* note 48, at 34-37.

⁵³ Many courts presume that everything in the written contract is within the ambit of the parties' assent and therefore conclude that the writing is the entire agreement. To reach this presumption of assent, however, a court must conclude that all parties: (1) have a duty to read the contract which in most cases is standardized; (2) can find all material terms in the contract; (3) have the capacity to comprehend all material terms; and (4) have an opportunity to bargain over the material terms of the agreement. The bound-by-what-you-sign rule is based on these four presuppositions; if a court finds that all four are present in a given case, then it *can* fairly conclude that the parties have assented to all material terms in the written contract. For a critical evaluation of the bound-by-what-you-sign rule, see Holmes, *Interpreting an Insurance Policy in Georgia: The Problem of the Evidentiary Condition*, 12 GA. L. REV. 783, 789-804 (1978).

that a party who is proffered a form contract genuinely assents only to the few dickered terms and gives blanket assent to boilerplate terms that do not cause unfair surprise or unreasonably limit the dickered terms.⁵⁴

There is nothing inherently wrong with mass standardized contracts. The pad or form contract serves several useful purposes. It is easier to find one attorney who can skillfully draft a technical form for a million contracts than to find a million who can each draft one satisfactory contract. Standardization also saves time and money. Insurance companies, for example, seek to achieve several goals through standardization: (1) economy in marketing; (2) control over soliciting agents; and (3) assurance of uniform judicial decisions.⁵⁵ On the other hand, standardization eliminates arm's length bargaining and limits freedom of choice in contracting. The adhering party has little or no opportunity to bargain over boilerplate terms and no reasonable opportunity to secure the contracted expectation elsewhere. The essence of assent—volition—is not present. Consequently, courts are now taking cognizance of the degree of genuine assent to standardized forms in formulating contract rules.

The insurance contract is the classic example of the adhesion model;⁵⁶ its fate may suggest the future of the law for standardized contracts generally. Insurance contracts are adhesive for several reasons: the inequality of bargaining power and knowledge between carrier and policyholder,⁵⁷ the technical character of pol-

⁵⁴ The answer, I suggest, is this: Instead of thinking about 'assent' to boiler-plate clauses, we can recognize that so far as concerns the specific, there is no assent at all. What has in fact been assented to, specifically, are the few dickered terms, and the broad type of the transaction, and but one thing more. That one thing more is a blanket assent (not a specific assent) to any not unreasonable or indecent terms the seller may have on his form, which do not alter or eviscerate the reasonable meaning of the dickered terms. The fine print which has not been read has no business to cut under the reasonable meaning of those dickered terms which constitute the dominant and only real expression of agreement. . . .

The queer thing is that where the transaction occurs without the fine print present, courts do not find this general line of approach too hard to understand. . . .

K. LLEWELLYN, *THE COMMON LAW TRADITION* 370 (1960). See also *RESTATEMENT (SECOND) OF CONTRACTS* § 237, Comment f (Tent. Draft No. 5, 1970).

⁵⁵ For an excellent explication of the process of standardization, see R. KEETON, *BASIC TEXT ON INSURANCE LAW* 68-87 (1971).

⁵⁶ Patterson's classic article on life insurance introduced the phrase "contract of adhesion" into the legal vocabulary. Patterson, *The Delivery of a Life Insurance Policy*, 33 *HARV. L. REV.* 198, 222 (1919).

⁵⁷ This factor is actually a combination of other subordinate factors: the aleatory nature of insurance which results in an inequity of values exchanged, the unintelligible form and

icy terms,⁵⁸ the tendency to deliver the policy after contract formation and premium payment,⁵⁹ and their mass-standardized nature.

Courts in the 1920's and 1930's paid lip service to the classical theory of contracts but manipulated classical rules to achieve just results. They frequently used construction as a covert tool,⁶⁰ by holding clear language to be ambiguous, instead of admitting to changing the contract so that substantially oppressive terms were denied enforcement. Professor Kessler criticized this practice:

[C]ourts have made great efforts to protect the weaker contracting party and still keep "the elementary rules" of the law of contracts intact. As a result, our common law of standardized contracts is highly contradictory and confusing, and the potentialities inherent in the common law system for coping with contracts of adhesion have not been fully developed.⁶¹

Recently, however, courts have distinguished the adhesion contract from the classical bargained-for-exchange contract and have created rights at variance with the express terms of a standardized contract. Professor Robert Keeton has identified three policies supporting such judicial regulation and rewriting of policy terms in the insurance context: (1) An insurer should not be permitted an unconscionable advantage in an insurance transaction; (2) the objectively reasonable expectations of applicants and

diction of insurance contracts, and the mass-produced take-it-or-leave-it policy. *See generally* E. PATTERSON, *ESSENTIALS OF THE INSURANCE LAW* 2-3 (1957).

⁵⁸ Former Pennsylvania Insurance Commissioner Herbert S. Denenberg, using a readability scale ranging up to 100, found that the Bible scores 67 in readability, Einstein's relativity theory scores 18, and various insurance contracts score from 10 to minus 2. O'Connell, *Living with Life Insurance*, N.Y. Times, May 19, 1974, § 6 (Magazine), at 34. One court, deploring the wilderness of built-up conditions as a Tower of Babel, decried the technical, uncertain language of insurance contracts: "We reiterate our plea for clarity and simplicity in policies that fulfill so important a public service." *Insurance Co. of N. Am. v. Electric Purification Co.*, 67 Cal. 2d 679, 691-92, 433 P.2d 174, 182, 63 Cal. Rptr. 382, 390 (1967). One response has been an antijargon law which permits "simplified" policies to contain language inconsistent with provisions required by insurance legislation. *See, e.g.*, N.Y. INS. LAW § 168-b (McKinney Supp. 1974).

⁵⁹ *See* Patterson, *supra* note 56.

⁶⁰ The term *contra proferentem* succinctly expresses the "familiar principle that insurance policies be strictly construed against the insurer, and that ambiguities and doubts and equivocal words be construed against the insurer and be resolved in the insured's favor." *Mohan v. Union Fidelity Life Ins. Co.*, 38 Pa. D.&C.2d 401, 410 (1965), *aff'd per curiam mem.*, 207 Pa. Super. Ct. 205, 216 A.2d 342 (1966). This principle masked many departures from orthodox contract theory.

⁶¹ Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 633 (1943).

intended beneficiaries should be honored; and, (3) an insured's detrimental reliance upon the insurer's assurances should be redressed.⁶² Courts are increasingly recognizing that an insured has virtually no opportunity to bargain over who should bear the risk of consequential damages.⁶³ These courts, in taking account of the special nature of adhesion contracts, are recognizing an important new principle for contract law⁶⁴ and repudiating classical theory.

2. *Status and Contractual Relationship*

According to classical theory, parties in arm's length bargaining seek some commercial advantage through the legal device of contract. Since this relationship is inherently antagonistic, the parties do not expect good faith and fair dealing; they define their duties only by their consent. This approach ignores the status and relationship of the parties except to acknowledge that a contractual relation exists. This model is not universally invalid, but it is not universally applicable either. Recognizing this, a number of courts have considered the status and relationship of the parties as a basis for awarding consequential and punitive damages.⁶⁵ For example, when a real estate broker breached his contract Judge (now Chief Justice) Burger allowed punitive damages because of the parties' contractual relationship, stating:

[O]nce it has been shown that one trained and experienced holds himself out to the public as worthy to be trusted for hire . . . and those so invited do place their trust and confidence, and that trust is intentionally and consciously disregarded, and exploited for unwarranted gain, community protection, as well as that of the victim, warrants the imposition of punitive damages.⁶⁶

One might argue that this is a fiduciary duty, not a contractual duty. The relationship which creates the duty is, however,

⁶² The process of identifying the principles for purposive interpretation of insurance contracts was initially accomplished in Keeton, *Insurance Law Rights at Variance with Policy Provisions*, 83 HARV. L. REV. 961, 1281 (1970).

⁶³ See note 96 and accompanying text *infra*.

⁶⁴ In the formation, performance and discharge of insurance contracts, both insurer and insured must have exhibited good-faith conduct according to reasonable standards set by customary practices and by individual expectations. Holmes, *supra* note 9, at 400.

⁶⁵ See cases collected in Annot. 47 A.L.R.3d 314 (1973); Note, *The New Tort of Bad Faith Breach of Contract*: Christian v. American Home Assurance Corp., 13 TULSA L.J. 605, 613-16 (1978); 13 WAKE FOREST L. REV. 685, 704-06 (1977).

⁶⁶ Brown v. Coates, 253 F.2d 36, 40 (D.C. Cir. 1958).

contractual: without the contract, there would be no special relationship of trust and "fiduciary" duty. As Professor Sullivan has explained, "It is disingenuous to treat cases which present breach of fiduciary duty in the contractual context as wholly distinct from ordinary contract actions."⁶⁷ Words and phrases like "fiduciary," "relations of trust," and "confidential" describe contractual relationships requiring implicit duties of good faith and fair dealing. Although these duties are equitable in nature, they are nonetheless contract-based.

In theory societies progress from a law of status to a law of contract.⁶⁸ American contract law may, however, be witnessing a partial reversal as courts acknowledge different rules of conduct based on the status and relationship of parties to a contract. A merchant may have to meet a higher standard of knowledge and care than a consumer in identical transactions.⁶⁹ Similarly, a buyer generally has to meet a lower standard of disclosure than a seller.⁷⁰ The degree of sophistication parties possess concerning the object of the contract is another status criterion which may help determine the applicable rules. When one party has more intelligence, expertise, and experience than the other, their relationship may create obligations and expectations different from those in the ordinary contract. If, because of his status, a contracting party does not have the sophistication to discover relevant facts, he may have to rely on the other party's disclosure. If the other party knows of this reliance and of the expectation of disclosure, the court may recognize a duty to satisfy any justifiable reliance.⁷¹

The ethical ideal of conscientiousness and good faith led equity courts to develop substantive as well as remedial rules. Some of these equitable principles have grown into complex, discrete bodies of doctrine — trust law, mortgage law, and securities

⁶⁷ Sullivan, *supra* note 2, at 299.

⁶⁸ See F. KESSLER & G. GILMORE, *supra* note 10, at 18-35.

⁶⁹ See, e.g., U.C.C. §§ 2-312, -314.

⁷⁰ This general rule is forcefully criticized in Keeton, *Fraud — Concealment and Non-disclosure*, 15 TEXAS L. REV. 1, 21-27 (1936).

⁷¹ See *Vokes v. Arthur Murray, Inc.*, 212 So. 2d 906 (Fla. Dist. Ct. App. 1968). Ms. Vokes, a widow, was induced to purchase over \$31,000 worth of dancing lessons by defendant's false praise regarding the development of her dancing skills. Since she was not in a position to appraise her dancing advancement knowledgeably, the court held that the defendant had a duty to disclose her true dance potential before she contracted for additional instruction. For an example of full disclosure requirements based on an inequality of knowledge during the performance stage of an insurance contract, see *Bowler v. Fidelity & Cas. Co.*, 53 N.J. 313, 250 A.2d 580 (1969).

law, for example. Others, such as equitable conversion, equitable estoppel, and laches, continue to be principles of wide-ranging but sporadic applicability. Equity often provides the raw material for the formulation of new legal duties, particularly contractual duties based on good faith and conscience.⁷² For example, in early cases the chancellors formulated a trustee's duties in terms of good faith. These duties were extended to other fiduciaries and finally applied to parties enjoying a relationship of special confidence and trust. This latter application provided a basis for extending good faith and fair conduct requirements into the formation, performance and discharge of contracts; the accordion-like character of concepts like "fiduciary," "trust," and "confidence" readily permitted the expansion of contractual duties by judicial fashioning of ad hoc confidential relationships.⁷³

Recent insurance cases have recognized such new responsibilities in response to the economic, legal and social realities attending the insurer-insured relationship.⁷⁴ The adhesive nature

⁷² See generally D. DOBBS, *supra* note 24, at 34-45.

⁷³ Phrases like "fiduciary relationship," "relationship of trust," and "confidential relationship" are used interchangeably by courts and the definition of each is vague. Each phrase describes some social policy and is little more than a legal conclusion. See generally Bogert, *Confidential Relations and Unenforceable Express Trusts*, 13 CORNELL L.Q. 237 (1928); Kessler & Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964).

⁷⁴ See generally Comment, *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CAL. W. L. REV. 358 (1978). Although it is generally advanced in the legal literature that insurance contracts are ones *uberrimae fidei*, such an assertion is not necessarily correct. As one noted insurance scholar observes:

As a general rule, the relation between the parties to a contract of insurance is that of . . . one contracting party to another . . . rather than of trustee and cestui que trust, or such as would arise by virtue of a will or other testamentary instrument.

. . . .

. . . Ordinarily, an insurance company stands in no fiduciary relationship to a legally competent applicant for annuity or other insurance contract.

3 G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* § 23:11 (2d ed. 1959). But when the insured reposes special confidence and trust in the superior knowledge and expertise of the insurer, the relationship may become "fiduciary". This higher standard of good faith and fair dealing has been imposed in several instances: (1) third-party excess-liability cases involving the insurer's duty to make good faith efforts to settle pursuant to its liability policy (see, e.g., *Gray v. Nationwide Mut. Ins. Co.*, 422 Pa. 500, 223 A.2d 8 (1966); *Southern Fire & Cas. Co. v. Norris*, 35 Tenn. App. 657, 668, 250 S.W.2d 785, 790 (1952)); (2) cases concerning misrepresentations by insurer or its agent (see, e.g., *Kennedy v. Flo-Tronics Inc.*, 274 Minn. 327, 143 N.W.2d 827 (1966); *Peterson v. Great Am. Ins. Co.*, 74 S.D. 334, 52 N.W.2d 479 (1952); *Bowers v. Springfield Fire & Marine Ins. Co.*, 21 Tenn. App. 227, 108 S.W.2d 798 (1937); *Annot.*, 136 A.L.R. 5 (1942)); (3) cases involving the duty to communicate information to the insured during the performance stage (see e.g., *Meirthew v. Last*, 376 Mich. 33, 34, 135 N.W.2d 353, 355 (1965) (reservation-of-rights notice); *Bowler v. Fidelity & Cas. Co.*, 53 N.J. 313, 250 A.2d 580 (1969)).

of insurance contracts necessitates the insured's reliance on the insurance company's good faith and fair dealing. Since the insured cannot bargain, he does not seek a commercial advantage as in the ordinary contract; rather, he seeks security. Classical contract rules are inadequate to handle insurers that abuse their economic power. Classical contract law neither deters wrongdoing nor fully compensates the insured for covered, first-party losses.⁷⁵ Finally, an insurance company is similar to a utility or an enterprise affected with the public interest. Its relationship to its insureds and society is quasi-public in nature.⁷⁶ In sum, because its business is public, and its contracts adhesive, an insurer should be held to a high standard of conduct. As one 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."⁷⁷

3. *Transactional Nature of the Contract*

Ironically, Langdell's case system of legal instruction helped precipitate the destruction of his unified contract theory. When law teachers and students applied "first principles" to recurrent factual situations, the principles sometimes needed modification. Nevertheless, law teachers were reluctant to acknowledge these factual sub-groupings and cross-groupings, and stubbornly defended a theoretical unity of legal principles.⁷⁸ When different types of contracts were finally separated along transactional lines,⁷⁹ the classicists' unitary law of contract yielded to several laws of contracts. Thus, in recognizing new contractual duties, courts considered the special nature of each underlying transaction as well as the circumstances of the contract's formation and the relationship and status of the parties.

Courts facing the same legal issue may apply different rules depending on whether the contract involves real property, personal services, goods, or construction. For example, contract theory tolerates considerable defaults in a building contract under

⁷⁵ See note 35 and accompanying text *supra*.

⁷⁶ See notes 78-95 and accompanying text *infra*.

⁷⁷ Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App.3d 376, 401, 89 Cal. Rptr. 78, 93 (1970).

⁷⁸ Compare text accompanying note 61 *supra*.

⁷⁹ Typical schisms are employment, construction, manufacturing, government, franchise, commercial and residential real property, and consumer contracts.

the rule of substantial performance,⁸⁰ but requires perfect performance in a sale-of-goods contract.⁸¹ The inquiry shifts from the abstract principles of classical theory to the instant facts. The classical theorists focused on objective, external facts which insulated pure doctrinal cathedrals from the defilement of transactional facts. Holmes, Langdell, and Williston valued the simplicity and certainty of a few first principles and objective standards set by courts instead of unpredictable juries. Also, by eschewing fact-based rules and decisions they differentiated contract sharply from tort.

Today, contract law is focusing more on basic facts than on objective rules,⁸² and there is a corresponding merger of tort and contract.⁸³ Article II of the Uniform Commercial Code illustrates the trend. It directs courts to consider a rich variety of transactional facts in sale-of-goods cases.⁸⁴ As some contextual studies show,⁸⁵ courts and legislatures are developing both special rules

⁸⁰ See J. CALAMARI & J. PERILLO, *supra* note 52, at 411. The distinction is that a buyer of goods can easily return them but a dissatisfied landowner retains the structure. It seems only fair to acknowledge the greater likelihood of unjust enrichment that construction contracts present. *Id.*

⁸¹ But the perfect tender rule of U.C.C. article II is something of a myth. See Comment, *Substantial Performance: The Real Alternative to Perfect Tender Under the U.C.C.*, 12 Hous. L. Rev. 437 (1975).

⁸² "Why ask whether a unilateral contract could be revoked by the offeror prior to full performance? Better to know who the parties were, the circumstances of the bargain, and any relevant background or consequence. Was it a consumer sale? A brokerage contract? A construction contract? Of what type?" Friedman & Macaulay, *Contract Law and Contract Teaching: Past, Present and Future*, 1967 Wis. L. Rev. 805, 806.

⁸³ *Id.*

⁸⁴ See, e.g., U.C.C. §§ 1-102(2)(b), 1-205, 2-202, 2-208, 2-303(2).

⁸⁵ Dissatisfaction with the classical methodology led to the contextual approach to law. See White, *From Sociological Jurisprudence and Social Change in Early Twentieth Century America*, 58 Va. L. Rev. 999, 1000-12 (1972). For a sampling of context studies, see Dauer, *Government Contractors, Commercial Banks, and Miller Act Sureties—A Question of Priorities*, 14 B.C. Indus. & Com. L. Rev. 943 (1973); Havighurst, *Services in the Home—A Study of Contract Concepts in Domestic Relations*, 41 Yale L.J. 386 (1932); Macaulay, *Private Legislation and the Duty to Read—Business Run by IBM Machine, the Law of Contracts and Credit Cards*, 19 Vand. L. Rev. 1051 (1966); McDowell, *Contracts in the Family*, 45 B.U.L. Rev. 43 (1965); Mueller, *Contract Remedies: Business Fact and Legal Fantasy*, 1967 Wis. L. Rev. 833; Schultz, *The Firm Offer Puzzle: A Study of Business Practice in the Construction Industry*, 19 U. Chi. L. Rev. 237 (1952); Sher, *Funeral Prearrangement: Mitigating the Undertaker's Bargaining Advantage*, 15 Stan. L. Rev. 415 (1963); Summers, *Collective Agreements and the Law of Contracts*, 78 Yale L. J. 525 (1969); Whitford, *Strict Products Liability and the Automobile Industry: Much Ado About Nothing*, 1968 Wis. L. Rev. 83. For an example of teaching materials using a contextual approach, see E. FARNSWORTH, W. YOUNG & H. JONES, *CASES AND MATERIALS ON CONTRACTS* 672-816 (2d ed. 1972).

for particular transactional problems and broad standards, such as good faith and fair dealing, which are adaptable to a variety of situations.

Insurance is a recognizable transactional subdivision of general-law contracts which receives special treatment because of its quasi-monopolistic nature. The business and contracts of insurance are heavily regulated through legislative, administrative, and judicial controls because the insurance industry is deemed quasi-public in nature.⁸⁶ Such contractual regulation is neither new nor aberrational. For centuries, contract law has set special rules (such as allowing punitive damages) against anyone with monopolistic power who performs public services.⁸⁷ In fifteenth century England the surgeon, barber, innkeeper, victualler, or carrier probably had a monopoly in the community; consequently courts created special rules to protect the public against exploitation by those engaged in common callings.⁸⁸ Today, the common carrier or public utility rather than the smith or ferryman is affected with a public interest because of its monopoly or quasi-monopoly power. Although the cast of characters has changed, the roots of current law on public service monopolies lie in special legal rules which spring from the regulation of common callings.⁸⁹ The underlying rationale of protection against exploitation or oppression persists.⁹⁰

This policy is especially appropriate in the insurance context.⁹¹ As early as 1882, courts acknowledged the disparity of economic resources, knowledge and bargaining power between in-

⁸⁶ See, e.g., *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App.3d 376, 89 Cal. Rptr. 78 (1970); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976); *Christian v. American Home Assur.*, 577 P.2d 899 (Okla. 1977); *Hinds v. United Ins. Co. of Am.*, 248 S.C. 285, 149 S.E.2d 771 (1966); *Mutual Aid v. Williams*, 219 Tenn. 95, 407 S.W.2d 171 (1966).

⁸⁷ See, e.g., *Wyman, The Law of the Public Callings as a Solution of the Trust Problem*, 17 HARV. L. REV. 156 (1904).

⁸⁸ *Id.* at 160-61.

⁸⁹ *Burdick, The Origin of the Peculiar Duties of Public Service Companies*, 11 COLUM. L. REV. 514, 616, 743 (1911).

⁹⁰ Professor Sullivan concludes that "the fundamental justification for the award of punitive damages in public service corporation cases has been the desire to both punish and protect against the abuse of economic power." Sullivan, *supra* note 2, at 226.

⁹¹ [B]ecause of the great disparity of financial resources which generally exists between insurer and insured and the fact that insurance companies, like common carriers and utilities, are regulated and clearly affected with a public interest, we recognize the wisdom of a rule which would deter refusals on the part of insurers to pay valid claims when the refusals are both unjustified and in bad faith.

Newton v. Standard Fire Ins. Co., 291 N.C. 105, 116, 229 S.E.2d 297, 303 (1976).

surer and insured, and imposed a duty of good faith and fair dealing on the insurer.⁹² The United States Supreme Court in 1914 recognized the monopolistic character of insurance companies and stated that since the insurance business is "clothed with a public interest"⁹³ it is subject to stringent governmental controls. The insurer's duty is therefore greater than that arising in the normal commercial contract. The state, in a sense, is a party to the contract and, because of its vested interest, it imposes duties like good faith and fair dealing.⁹⁴

The progression in contract law is to go beyond abstract first principles. The judiciary now evaluates how the contract was formed, the relationship of the parties to each other, and the nature of the particular transaction. In the first-party insurance area, the result has been the development of a duty of good faith and fair dealing in the claims process.⁹⁵

II

BAD-FAITH BREACH OF CONTRACT

The courts of at least twenty-one states⁹⁶ have recognized that

⁹² *Germania Ins. Co. v. Rudwid*, 80 Ky. 223 (1882).

⁹³ *German Alliance Ins. Co. v. Lewis*, 233 U.S. 389, 415 (1914). *Accord*, *O'Gorman & Young, Inc. v. Hartford Fire Ins. Co.*, 282 U.S. 251 (1931).

⁹⁴ *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 574, 510 P.2d 1032, 1037, 108 Cal. Rptr. 480, 485 (1973).

⁹⁵ The insurance business is governmentally regulated to a substantial degree. It is affected with a public interest and offers services of a quasi-public nature. . . . An insurer has a *special relationship* to its insured and has special implied-in-law duties toward the insured. . . . To some extent this special relationship and these special duties take cognizance of the great disparity in the economic situations and bargaining abilities of the insurer and the insured.

Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 403-04, 89 Cal. Rptr. 78, 95 (1970) (emphasis added) (citations omitted).

⁹⁶ *Old Southern Life Ins. Co. v. Woodall*, 295 Ala. 235, 326 So. 2d 726 (1976), *discussed in* 8 CUMBERLAND L. REV. 241, 258-62 (1977); *Stephan v. Allstate Ins. Co.*, 26 Ariz. App. 367, 548 P.2d 1179 (1976) (dicta); *Findley v. Time Ins. Co.*, 264 Ark. 647, 573 S.W.2d 908 (Ark. 1978) (dicta); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 375 A.2d 428 (1977); *World Ins. Co. v. Wright*, 308 So. 2d 612 (Fla. Dist. Ct. App. 1975); *Ledingham v. Blue Cross Plan*, 29 Ill. App. 3d 339, 330 N.E.2d 540 (1975) (dicta); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 264 Ind. 599, 616-17, 349 N.E.2d 173, 185 (1976); *Sexton v. Meridian Mut. Ins. Co.*, 166 Ind. App. 529, 337 N.E.2d 527 (1975); *Ausden v. Grinnell Mut. Reins. Co.*, 203 N.W.2d 252 (Iowa 1972), *discussed in* 25 DRAKE L. REV. 900 (1976); *Venable v. Import Volkswagen*, 214 Kan. 43, 519 P.2d 667 (1974) (dicta); *Gibson v. National Ben Franklin Ins. Co.*, 387 A.2d 220 (Me. 1978), *noted in* 30 MAINE L. REV. 308 (1979); *Krajenke v. Preferred Mut. Ins. Co.*, 68 Mich. App. 211, 242 N.W.2d 70

plaintiffs may recover extra-contract damages⁹⁷ from first-party insurers who act in bad faith by failing to pay well-founded claims. A number of federal courts have followed suit.⁹⁸ The import of this trend is not yet fully apparent; the seminal case was only decided in 1968.⁹⁹ Nevertheless, legislatures in seventeen states have reinforced the trend by enacting first-party penalty acts that impose liability for bad-faith failure to pay,¹⁰⁰ thereby precluding the need for judicial action.¹⁰¹ Under the circumstances it is safe to call this expansion of contract liability a groundswell of substantial proportion.

(1976) (new trial ordered); *Frishett v. State Farm Mut. Auto Ins. Co.*, 3 Mich. App. 688, 143 N.W.2d 612 (1966); *Larson v. District Ct.*, 149 Mont. 131, 423 P.2d 598 (1967); *Chavez v. Chenoweth*, 89 N.M. 423, 553 P.2d 703 (1976); *Sukup v. State*, 19 N.Y.2d 519, 227 N.E.2d 842, 281 N.Y.S.2d 28 (1967) (dicta); *Frizzy Hairstylists, Inc. v. Eagle Star Ins. Co.*, 89 Misc. 2d 822, 392 N.Y.S.2d 554 (Civ. Ct. N.Y. 1977); *United States Fid. & Guar. Co. v. Peterson*, 91 Nev. 617, 619-20, 540 P.2d 1070, 1071 (1975); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976) (dicta), noted in 13 WAKE FOREST L. REV. 685, 686 (1977); *Kirk v. Safeco Ins. Co.*, 28 Ohio Misc. 44, 273 N.E.2d 919 (1970); *Christian v. American Home Assur. Co.*, 557 P.2d 899 (Okla. 1977), noted in 13 TULSA L.J. 606 (1978); *Diamon v. Pennsylvania Mut. Fire Ins. Co.*, 247 Pa. Super. Ct. 534, 552, 372 A.2d 1218, 1227 (1977); *Kiecker v. Pacific Indem. Co.*, 5 Wash. App. 871, 491 P.2d 244 (1971) (dicta). Cf. *Corley v. Coastal States Life Ins. Co.*, 244 S.C. 1, 135 S.E.2d 316 (1964) (extra-contract damages limited to punitive damages to redress fraudulent breach).

⁹⁷ In the insurance context, extra-contract damages are any in excess of policy amount plus interest.

⁹⁸ See, e.g., *Davenport v. Mutual Benefit Health & Accident Ass'n*, 325 F.2d 785 (9th Cir. 1963); *Alliance Ins. Co. v. Alper-Salvage Co.*, 19 F.2d 828 (6th Cir. 1927) (applying Tennessee law); *Escambia Treating Co. v. Aetna Cas. & Sur. Co.*, 421 F. Supp. 1367, 1369-70 (N.D. Fla. 1976); *Helton v. Reserve Life Ins. Co.*, 399 F. Supp. 1322 (D. Mont. 1975). Cf. *Carter v. Hartford Accident & Indem. Co.*, 423 F. Supp. 827 (E.D. Va. 1976) (only upon showing of malice or oppression); *Short v. Grange Mut. Cas. Co.*, 307 F. Supp. 768 (D.W.V. 1969) (punitive damages only for wanton conduct of a tortious nature).

⁹⁹ *Wetherbee v. United Ins. Co. of Am.*, 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

¹⁰⁰ ARK. STAT. ANN. § 66-3238 (1966); DEL. CODE ANN. tit. 18, § 4102 (1974); FLA. STAT. ANN. 627.428 (West 1972); GA. CODE ANN. § 56-1206 (1977); IDAHO CODE § 41-1839 (1977); ILL. ANN. STAT. ch. 73, § 767 (Smith-Hurd Supp. 1979); KAN. STAT. § 40-256 (1973); LA. REV. STAT. ANN. §§ 22:656, :657 (West 1978); ME. REV. STAT. tit. 24A, § 2436 (Supp. 1979); MO. ANN. STAT. § 375.420 (Vernon Supp. 1980); NEB. REV. STAT. § 44-359 (1978); OKLA. STAT. ANN. tit. 36, § 1219 (West 1976); S.C. CODE §§ 38-9-320, 9-330 (1976); S.D. COMPILED LAWS ANN. § 58-12-3 (1967); TENN. CODE ANN. § 56-1105 (1968); TEX. INS. CODE ANN. arts. 3.62, .62-1, 10.13 (Vernon 1961); WYO. STAT. § 26-15-126 (1977). See Holmes, *A Model First-Party Insurance Excess-Liability Act*, 14 GA. L. REV. — (1980).

¹⁰¹ Some states with first-party penalty acts have nonetheless allowed a judicial claim for relief so that insureds have a rational choice in this excess liability area. See, e.g., *Gibson v. National Ben Franklin Ins. Co.*, 387 A.2d 220 (Me. 1978); ME. REV. STAT. ANN. tit. 24-24A, § 2436 (1974).

A. History of the First-Party Excess Liability Claim

Classical contract theory traditionally prevented courts from awarding damages in excess of the policy amount plus interest to first-party insureds.¹⁰² California courts pioneered the breakdown of this limitation by constructing an independent theory of relief. Their first step was to remove the blindfold imposed by classical theory and investigate the motivations for the breach. Classical limitations still apply to simple breach cases; only if the court concludes that the insurer's conduct is unconscionable, in bad faith, or outrageous, is it likely to turn away from classical rules and adopt a theory of relief that permits broader recovery. The second step was to find an appropriate theory of relief. California courts experimented with several approaches to first-party insurance excess liability claims. They progressed from fraud¹⁰³ to invasion of a protected property interest coupled with intentional infliction of emotional distress¹⁰⁴ and finally to a new theory — bad faith breach of contract.¹⁰⁵

1. Fraud

Most cases of unjustified refusal to pay insurance benefits involve either fraudulent inducement to enter an insurance contract or fraudulent conduct in failing to pay. Thus the earliest cases used the tort¹⁰⁶ action of fraud to allow insureds a broader measure of damages than that available under traditional contract law. The California Court of Appeals in *Wetherbee v. United Insurance Company of America*¹⁰⁷ vitalized this theory by diluting the longstanding requirement that plaintiffs prove fraudulent intent at the time their contract was formed. It held that this requirement could be satisfied by inferring fraudulent intent from the insurer's post-formation conduct, such as willful failure to pay benefits.

¹⁰² See notes 22-34 and accompanying text *supra*.

¹⁰³ *Wetherbee v. United Ins. Co. of America*, 265 Cal. App. 2d 931, 71 Cal. Rptr. 764 (1964).

¹⁰⁴ *Fletcher v. Western Nat'l. Life Ins. Co.*, 10 Cal. App.3d 376, 89 Cal. Rptr. 78 (1970).

¹⁰⁵ *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

¹⁰⁶ Courts often characterized their developing theories of excess liability as tort, not contract. This characterization is preserved in this historical discussion. Properly understood, however, first-party excess liability for bad-faith breach does not fit into any traditional pigeonhole, but draws upon contract, tort, and equity. See notes 157-205 and accompanying text *infra*.

¹⁰⁷ 265 Cal. App.2d 921, 71 Cal. Rptr. 764 (1968).

With an occasional exception,¹⁰⁸ however, cases utilizing this theory actually involve fraud in the performance, not the inducement. Apparently the California courts allow this tortured inference as a fictional expedient to authorize recovery in cases like *Wetherbee*.¹⁰⁹ But this solution is analytically unsound. The theory ought to focus directly on the conduct that gave rise to an insured's grievance—abusive settlement tactics occurring at the performance stage. Moreover, there are practical disadvantages growing out of a fraud action, such as overcoming strict evidentiary rules for proving scienter.¹¹⁰ Because of these theoretical and practical drawbacks, the California quest for a sound, independent theory of relief continued.

2. *Intentional Infliction of Emotional Distress*

Many insureds after a business or personal loss are in a difficult financial situation, prompting some insurers to try economic coercion to force the insured into an unfair compromise.¹¹¹ In 1970, the California Court of Appeals took note of such practices in *Fletcher v. Western National Life Insurance Company*.¹¹² Retreating to the classical contract womb, Western National contended that any failure to make disability payments was a simple contract breach for which damages should be limited to the policy amount. Defense counsel stipulated that the insurer's conduct was outra-

¹⁰⁸ See, e.g., *Davenport v. Mutual Benefit Health & Acc. Ass'n*, 325 F.2d 785 (9th Cir. 1963) (wrongfully obtained releases could support a claim for punitive damages).

¹⁰⁹ Relief was certainly justified in *Wetherbee*. Shortly after the 70-year-old plaintiff purchased the disability policy, she sent it to the company for cancellation. She feared that it would be terminated at the whim of the insurer. The defendant, through its counsel, wrote her a reassuring letter: "When you are sick or hurt you will draw your benefits as long as you live." Upon receipt, she retained her policy and even bought another one. When she was disabled by a stroke, the company issued checks sporadically and two years after the accident wrote her doctor an artful letter: "It appears that patient is not continuously confined within the house. Is this correct?" Following an affirmative reply, the company terminated payments even though the doctor wrote that she required crutches and a wheelchair and had left her house only for medical treatment, church and social club meetings. 265 Cal. App. 2d at 925-27, 71 Cal. Rptr. at 766-67. Ms. Wetherbee eventually recovered policy benefits of \$1,050 and \$200,000 punitive damages. *Wetherbee v. United Ins. Co. of America*, 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1971).

¹¹⁰ For discussions of the disadvantages of the fraud action, see DuBois, *The Spectre of Punitive Damages in First Party Actions—Part II*, 42 INS. COUNSEL J. 242 (1975); Lascher, *The Imposition of Punitive Damages in the Enforcement of Insurance Contracts*, ABA INS. NEGLIGENCE & COMPENSATION SECTION, PROCEEDINGS 220 (1971); Parks, *Recovery of Extra-Contract Damages in Suits on Insurance Policies*, 9 FORUM 43 (1973).

¹¹¹ See note 35 and accompanying text *supra*.

¹¹² 10 Cal. App.3d 376, 89 Cal. Rptr. 78 (1970).

geous. Fletcher had incurred a back injury and submitted a claim for disability benefits. The examining doctors unanimously opined that Fletcher was disabled by a work-related injury. Western National, however, insisted that Fletcher was suffering from a sickness, which would restrict its exposure to two years instead of the duration of the disorder. The claims manager undertook a concerted campaign to compel Fletcher either to forfeit the policy or to accept a disadvantageous settlement. Fletcher sued for both compensatory and punitive damages. As the court explained, the company's claim of mere contract breach

[r]aises the question whether threatened and actual bad faith refusals to make payments under a disability insurance policy, maliciously employed by the insurer in concert with false and threatening communications, for the purpose of causing the insured to surrender his policy or disadvantageously settle a nonexistent dispute, may legally give rise to a cause of action for intentional infliction of emotional distress or some other cause of action sounding in tort.¹¹³

The *Fletcher* court inferred wrongful intent from Western National's harassment and adopted a pure tort theory of relief. It found the commission of two torts—intentional infliction of emotional distress¹¹⁴ and intentional interference with a protected property interest—that invaded two distinct interests—the insured's interest in maintaining peace of mind and his economic interest in full compensation.

Fletcher's two-pronged intentional tort approach admirably defined the interests at stake in first-party suits and may have provided a necessary transition to a more logical theory of relief. Neither theory, however, has proven satisfactory. A cause of action for intentional infliction of emotional distress unduly limits both liability and damages. It limits damages because an insured can only recover general damages for emotional distress and damages for simple breach of contract (policy amount plus in-

¹¹³ *Id.* at 400, 89 Cal. Rptr. at 92.

¹¹⁴ Prior to *Fletcher*, only two cases acknowledged the legitimacy of the tort in this insurance context. *Cluff v. Farmers Ins. Exchange*, 10 Ariz. App. 560, 460 P.2d 666 (1969) (dicta) (relief denied because conduct not outrageous but only hurt insured's feelings); *Frishett v. State Farm Mut. Auto. Ins. Co.*, 3 Mich. App. 688, 143 N.W.2d 612 (1966) (claim for emotional distress stated in complaint that alleged the insurer unjustly withheld payments, made false statements and attempted in bad faith to defeat plaintiff's claim). The tort was well-accepted in California in non-insurance contexts. See *State Rubbish Collectors Ass'n v. Siliznoff*, 38 Cal.2d 330, 240 P.2d 282 (1952) (debt collection).

terest).¹¹⁵ But an insured who is not promptly paid policy benefits can incur economic harm such as lost equity in property, additional lost earnings due to lack of medical care, and even bankruptcy. These economic losses are not recoverable in an emotional distress action.

The emotional distress tort is also restrictive because it imposes liability on a defendant only if a number of requirements are met.¹¹⁶ Perhaps the most restrictive of these is that the defendant must be guilty of outrageous conduct. *Fletcher* recognized that insurers have a privilege to assert their legal rights in good faith and inform insureds of their position. This privilege exists even if it is substantially certain that such conduct will cause mental distress.¹¹⁷ Only when an insurer uses outrageous tactics does a privileged communication become an unprivileged tort. Outrageousness certainly connotes something stronger than bad-faith conduct; it is generally defined as conduct which exceeds all bounds usually tolerated by a decent society.¹¹⁸ The distinction between "outrageous" and "bad faith" lies in the difference between the intent of the actor and the nature of his act. A finding of bad faith involves an inquiry into the insurer's intent; the company must know that it did not have a reasonable basis in law or fact to deny payment.¹¹⁹ Conduct is outrageous only if it leads one to exclaim "outrageous" regardless of the actor's intent.¹²⁰

¹¹⁵ In most jurisdictions he might also recover punitive damages. But a recent case refused to allow punitive damages, stating that since the basis of the action is outrageous conduct, compensatory relief is adequately punitive. *Eckenrode v. Life of Amer. Ins. Co.*, 470 F.2d 1, 5 (7th Cir. 1972) (quoting *Knierim v. Izzo* 22 Ill. 2d 73, 174 N.E. 2d 157 (1961)). Most cases, however, reason that compensatory damages do not match the nature of conduct and are therefore not a sufficient deterrent. See Lambert, *Commercial Litigation*, 35 J. AM. TRIAL LAW ASS'N 164, 223 (1974).

¹¹⁶ The court in *Fletcher* adopted the requirements set forth in the Restatement (Second) of Torts:

One who by extreme and outrageous conduct intentionally or recklessly causes severe emotional distress to another is subject to liability for such emotional distress, and if bodily harm to the other results from it, for such bodily harm.

RESTATEMENT (SECOND) OF TORTS § 46(1) (1965). The requirements of intent to do harm, extreme and outrageous conduct, and severe emotional distress pose problems for any plaintiff. Regarding severe mental suffering, *Fletcher* mollified the problem by adopting in part Comment j to § 46 of the Restatement (Second) of Torts which defines severe emotional distress to include "highly unpleasant mental reactions such as fright, grief, shame, humiliation, embarrassment, anger, chagrin, disappointment or worry." 10 Cal. App. 3d at 397, 89 Cal. Rptr. at 91.

¹¹⁷ 10 Cal. App. 3d at 395-96, 89 Cal. Rptr. at 89.

¹¹⁸ *Amsden v. Grinnell Mut. Reins. Co.*, 203 N.W.2d 252 (Iowa 1972); RESTATEMENT (SECOND) OF TORTS § 46, Comment d (1965).

¹¹⁹ See note 149 and accompanying text *infra*.

¹²⁰ See RESTATEMENT (SECOND) OF TORTS § 46, Comment d (1965):

It has not been enough that the defendant has acted with an intent which is

When an insurer uses high pressure tactics or harassment to force the insured to settle for less than his due, many courts hold the conduct to be outrageous.¹²¹ Apparently, no court has found outrageous conduct without affirmative conduct. Thus, a mere denial of liability or refusal to pay, even though unreasonable and in bad faith, is not deemed outrageous. In an Iowa case, for instance, the insurer's conduct was not outrageous when it only waited until an arson investigation was completed so the parties could fix the amount of loss by agreement.¹²² In contrast, non-feasance can constitute bad faith conduct.¹²³

3. *Intentional Interference With a Protected Property Interest*

The *Fletcher* court asserted as the second ground of its holding that the defendant's conduct was an intentional, tortious interference with the insured's protected property interest in the policy proceeds. This theory fosters an appealing symmetry. Since courts protect contractual interests from intentional harm inflicted by a third party stranger,¹²⁴ *a fortiori* the same interests should be protected from intentional harm by a party to the contract. Contracting parties should not be held to a lower standard of conduct than a stranger. This theory acknowledges that in an executory contract the parties may not only have *in personam* but also *in rem* rights. The *res* in the insurance context is the promised monetary benefit that the insurer holds in a quasi-trust as a quasi-fiduciary. This proposition is well-accepted in the third-party context where the insurer holds the *res* and must exercise due care and good faith when using it to settle claims brought by third-party claimants.¹²⁵ If an insured has an *in rem* interest in monies that the

tortious or even criminal, or that he has intended to inflict emotional distress, or even that his conduct has been characterized by "malice," or a degree of aggravation which would entitle the plaintiff to punitive damages for another tort.

¹²¹ See *Eckenrode v. Life of Amer. Ins. Co.*, 470 F.2d 1 (7th Cir. 1972) (insurer contrived a defense to force widow to settle deceased's husband's life insurance policy); *World Ins. Co. v. Wright*, 308 So. 2d 612 (Dist. Ct. App.), *cert. denied*, 322 So. 2d 913 (Fla. 1975); *Miller v. Mutual of Omaha Ins. Co.*, 235 So. 2d 33 (Dist. Ct. App.) (insulting and slandering insured), *cert. denied*, 238 So. 2d 423 (Fla. 1970).

¹²² *Amsden v. Grinnell Mut. Reins. Co.*, 203 N.W.2d 252 (Iowa 1972).

¹²³ See note 142 and accompanying text *infra*.

¹²⁴ For a discussion of this tort, see Comment, *Contractual Relations: When Are They Also a Tort*, 28 BAYLOR L. REV. 687 (1976).

¹²⁵ See *Gray v. Nationwide Mut. Ins. Co.*, 422 Pa. 500, 223 A.2d 8 (1966).

insurer must use in good faith to pay *on his behalf* in liability disputes then it is logical to recognize that same *in rem* interest and the corresponding duty when the insurer must pay the monies to its insured in the first-party context.

The problem with this theory is that, with one exception,¹²⁶ no court has adopted, or even discussed, the expansive tort of intentional interference with a protected property interest. Nevertheless, courts may have ratified this theory under a different label: the tort of bad faith.¹²⁷

4. *Bad Faith*

California law on the tort of bad faith has its roots in third-party excess liability cases, beginning with *Comunale v. Traders & General Insurance Co.*,¹²⁸ decided in 1958. In *Comunale*, the California Supreme Court held that a covenant of good faith and fair dealing is implicit in every contract and extended that duty to every insurance contract. It also held that all parties have a duty to do nothing which will injure the other party's right to receive contractual benefits, and that the insurer must accord the insured's interests at least as much consideration as its own.¹²⁹ Any insurer who violates this covenant by not reasonably settling does so at its own risk; insureds are compensated for all resulting detriment, including judgments in excess of policy limits.

This implied covenant of good faith and fair dealing was not applied to first-party claims until 1972 when the California Court of Appeal decided *Richardson v. Employers Liability Assurance Corp.*¹³⁰ In response to the insurer's argument that the tort of

¹²⁶ The California Supreme Court adopted the *Fletcher* rationale in *Gruenberg v. Aetna Ins. Co.*, 9 Cal.3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

¹²⁷ See *Gruenberg v. Aetna Ins. Co.*, 9 Cal.3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (established tort of bad faith breach of contract); notes 133-36 and accompanying text *infra*. The *Gruenberg* court made an approving reference to *Fletcher's* intentional interference rationale:

[T]he existence of a contractual relationship does not insulate defendant insurers from liability that is "ordinarily visited upon tortfeasors" for interfering with a property interest of the insured in receiving the benefits of the agreement. Therefore, even though the duty allegedly assumed by defendant insurers arises from an existing contractual relationship, this duty is independent of the performance of plaintiff's contractual obligations.

Id. at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488. Thus *Fletcher* may lie disguised but accepted in *Gruenberg*.

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

¹²⁹ *Id.* at 656, 328 P.2d at 201.

¹³⁰ 25 Cal. App.3d 232, 102 Cal. Rptr. 547 (1972).

bad faith as nurtured in third-party actions like *Comunale* should be limited to third-party claims, the court stated:

This implied obligation requires an insurer to deal in good faith and fairly with its insured in handling an insured's claim against it. Here, Employers deliberately, willfully and in bad faith withheld payment of the Richardson claim months after it knew the claim to be completely valid.¹³¹

Although the court extended the covenant of good faith to cover first-party cases, *Richardson* added little to the developing limits of this new tort. Because coverage was obvious, it was easy for the court to conclude that the company's denial was unreasonable, unwarranted and in bad faith. The court did not, however, suggest the appropriate response to a situation where liability under a policy is questionable and the insurer is questioning by refusing to pay. In addition to this shortcoming, *Richardson* seemed to tie recovery for emotional distress to the outrageous conduct and severe distress requirements of the intentional infliction tort which was recognized in *Fletcher*.¹³²

In *Gruenberg v. Aetna Insurance Co.*,¹³³ the California Supreme Court made progress toward remedying these deficiencies. After fire destroyed the insured's restaurant and cocktail lounge, he brought an action for the loss against his three insurers. An adjuster retained by the carriers informed the arson squad that Gruenberg was over-insured. Arson charges were filed against him. An attorney representing the three companies requested that the insured submit to an examination under oath in compliance with the policies' cooperation clauses. When the insured asked for a postponement until completion of the felony prosecution, he was informed that coverage would be denied if he did not cooperate. After he failed to appear for questioning, coverage was denied. The arson charges were later dismissed, but the insurers still refused to pay, claiming noncooperation.

Gruenberg contended that the adjuster supplied information to the police to create a false impression that he had a motive for arson and give the insurers an excuse to deny coverage. He sued for severe economic damage, severe emotional distress, loss of earnings and various consequential damages, and sought both

¹³¹ *Id.* at 239, 102 Cal. Rptr. at 552.

¹³² *Id.* at 241, 247, 102 Cal. Rptr. at 553, 557-58.

¹³³ 9 Cal.3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (en banc with Roth, J., dissenting).

compensatory and punitive damages. The complaint alleged that these damages were a "direct and proximate result of the outrageous conduct and bad faith of the defendants."¹³⁴ By intermixing allegations of outrageous conduct, severe distress, and bad faith in the same complaint the plaintiff touched all bases. Evidently he was unsure how to state his claim accurately. The court held that a claim of tortious, bad-faith breach of contract had been stated.¹³⁵ It allowed Gruenberg to recover "extra-contract" damages, including damages for mental distress, on a theory unfettered by the outrageous conduct and severe emotional distress requirements of the intentional infliction tort.¹³⁶ *Gruenberg* thus originated an independent bad faith tort, a significant advance over *Richardson*.¹³⁷

¹³⁴ *Id.* at 572, 510 P.2d at 1035, 108 Cal. Rptr. at 483.

¹³⁵ *Id.* at 581, 510 P.2d at 1042, 108 Cal. Rptr. at 490.

It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.

Id. at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485 (emphasis omitted).

¹³⁶ *Id.* at 580-81, 510 P.2d at 1042, 108 Cal. Rptr. at 490:

In *Fletcher*, plaintiff's theory of recovery expressed in his complaint . . . was predicated on the tort of intentional infliction of emotional distress alone. Quite naturally, therefore, the court concluded that severe emotional distress is a requisite element of recovery. However, the mere fact the action there involved the liability of an insurer for its tortious conduct, measured by the elements [of] the intentional infliction of emotional distress, does not mean that those same elements must be applied where, as in the instant case, recovery is sought on a totally distinct theory.

¹³⁷ Two other aspects of *Gruenberg* are worthy of comment. First, the elimination of the outrageous conduct requirement for recovery of emotional-distress damages was a mixed blessing for insureds. Proof of outrageous conduct was originally required to help prevent spurious claims. See RESTATEMENT (SECOND) OF TORTS § 46 (1965). In *Gruenberg*, no proof of outrageous conduct was mandated because there was property loss. 9 Cal.3d at 580, 510 P.2d at 1041-42, 108 Cal. Rptr. at 490. *Accord*, *Escambia Treating Co. v. Aetna Cas. & Sur. Co.*, 421 F. Supp. 1367, 1371 (N.D. Fla. 1976). This holding seems to require corroborating evidence of economic loss before mental suffering damages could be recovered in a bad faith action. Because *Gruenberg* did not indicate how substantial the loss must be to justify mental-distress damages, this ingredient could have circumscribed the new tort. Later cases, however, indicate that the loss can be minimal, such as incurring attorney's fees or loss of the use of money. See *Eagan v. Mutual of Omaha*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976); *Mustachio v. Ohio Farmers Ins. Co.*, 44 Cal. App. 3d 358, 363-64, 118 Cal. Rptr. 581, 584-85 (1975). With such broad constructions of economic loss, this requirement does not impose a serious barrier to the award of mental-distress damages in a bad faith action.

Gruenberg's final notable aspect concerns the "unconditional" nature of the insurer's duty to act in good faith. Some commentators have read the *Gruenberg* opinion as holding

The final case in this historical discussion is *Silberg v. California Life Insurance Co.*,¹³⁸ decided in 1974. Silberg had a hospitalization policy with defendant. The policy excluded coverage of "any loss caused by or resulting from . . . injury or sickness for which compensation is payable under any Workmen's Compensation . . . Law." Plaintiff severed his right foot while working for his landlord under a rent reduction agreement. He filed a claim with both defendant and his workmen's compensation carrier. The workmen's compensation carrier denied coverage on the

that the good faith duty is absolute, and have concluded that it is a one way street which encourages dishonest, contract-breaching insureds to take advantage of insurers. See, e.g., Houser, *First Party Claims for More Than Insurance Policy Limits—A Defendant's Viewpoint*, 11 FORUM 529 (1976). Some argue, for example, that an insurer cannot insist, under a cooperation clause, that an insured comply with proven investigation methods and that therefore the ability to avoid fraudulent claims is seriously hampered. See, e.g., Comment, *Good Faith and Fire Insurance Contracts*, 22 U.C.L.A. L. REV. 847 (1975); Comment, *An Independent Duty of Good Faith and Fair Dealing in Insurance Contracts—Gruenberg v. Aetna Insurance Co.*, 11 SAN DIEGO L. REV. 492, 500 (1974). There is language in the opinion which seems to suggest this view:

We conclude, therefore, that the duty of good faith and fair dealing on the part of defendant insurance companies is an absolute one. At the same time, we do not say that the parties cannot define, by the terms of the contract, their respective obligations and duties. We say merely that no matter how those duties are stated, the non-performance by one party of its contractual duties cannot excuse a breach of the duty of good faith and fair dealing by the other party while the contract between them is in effect and not rescinded.

9 Cal. 3d at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488.

A careful reading of this language, however, reveals that the court merely reiterated the obvious: A tort duty is independent, not conditioned upon another's tort duty. The court stated that the tort duty of good faith is not bound by the contract doctrine that, in a bilateral contract, each party's promise (or duty) is constructively conditioned upon the other party's promise.

For an excellent discussion of constructive conditions in contract law, see J. MURRAY, MURRAY ON CONTRACTS 301-09 (rev. ed. 1974). The court quoted *Comunale* just before the passage quoted above to make the point that the duty of good faith is an implied covenant that neither party will injure the other's contractual rights. 9 Cal. 3d at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488. Moreover, the duty pertains to acting fairly in performing contract duties. If an insured fails to cooperate, hampers an investigation or otherwise fails to fulfill any required condition precedent to payment under the policy, the insurer's duty to pay is not activated. As long as the insurer's contract duty to pay is dormant, it does not violate its tort duty of good faith by refusing to pay. Courts have not specifically followed this line of reasoning, but they have found that an insurer's failure to pay is justified when the insured fails to cooperate (*Hodge v. Cimmarron Ins. Co.*, 338 F.Supp. 910 (E.D. Mo. 1972) (insurer entitled to defend on ground that insured failed to supply proof of loss and business records)) or fails to fulfill a condition precedent established by the policy (*Englemann v. Standard Mut. Ins. Co.*, 4 Ill. App. 3d 55, 58, 280 N.E. 2d 240, 242 (1972)). See also *Billington v. Interinsurance Exch.*, 71 Cal. 2d 728, 456 P.2d 982, 79 Cal. Rptr. 326 (1979).

¹³⁸ 11 Cal.3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

ground that Silberg was not an employee. Although California Life knew that workmen's compensation coverage was doubtful, it nonetheless denied coverage under the exclusion quoted above.¹³⁹

At the time of the accident, Silberg was 39 years old, had two minor children, and earned \$500 per month. His severed foot was surgically restored, but he needed five additional operations. Because the insurer did not pay Silberg's medical bills, he had to resort to ruses to be admitted to hospitals and had to use different surgeons. His unpaid medical bills made him a poor credit risk; he could not borrow money and his business failed. He had to move five times because of nonpayment of rent; his utilities were shut off several times for nonpayment; his wheelchair was repossessed; on several occasions he could not afford medication to ease his constant pain; he suffered two nervous breakdowns. Silberg sued seeking to recover the policy benefits, damages for mental and physical distress, and punitive damages. A jury awarded him \$75,000 in compensatory damages¹⁴⁰ and \$500,000 in punitive damages. The trial court, granting the insurer's motion for a new trial, held that the evidence was insufficient to support the verdict and that the damages were excessive.¹⁴¹ On appeal, the California Supreme Court reversed the trial court and reinstated the verdict as to compensatory damages, but ratified the new trial as to punitive liability.

The appellate court's opinion clarifies the bad-faith tort in several respects. First, it shows that the bad faith theory, unlike the tort of intentional infliction of emotional distress,¹⁴² requires no affirmative conduct to justify recovery. The defendant in *Silberg* merely refused to pay without adequate grounds.¹⁴³ Second, *Silberg* segregated "good faith" from mere negligence; the standard for testing an insurer's good faith is not just the typical objective tort standard for negligence. California Life's first defense was based on the customary practice in the industry of denying benefits when an application for workmen's compensation had been made. Assuming such inaction is the customary practice within the industry,¹⁴⁴ then arguably the merchant-insurer has

¹³⁹ *Id.* at 457-58, 463-64, 521 P.2d at 1106-07, 1111, 113 Cal. Rptr. at 714-715, 719.

¹⁴⁰ "Compensatory damages" in this case included nonpunitive extra-contract damages. See note 97 *supra*.

¹⁴¹ 11 Cal.3d at 457-59, 521 P.2d at 1106-08, 113 Cal. Rptr. at 714-16.

¹⁴² See text accompanying note 123 *supra*.

¹⁴³ Silence in the face of a duty to speak is an example of inaction that constitutes bad-faith conduct. See Holmes, *supra* note 9, at 432-49.

¹⁴⁴ At trial there was sharp conflict in the evidence as to the customary practice. One expert testified that the customary practice was for the insurer to pay the claim and then

acted objectively in good faith by following industry practices. But the *Silberg* court implicitly acknowledged the equitable origin of "good faith"¹⁴⁵ by scrutinizing the custom to ascertain if it was repugnant to societal expectations of good faith and fair dealing. The court states that the duty to act fairly is prescribed and defined by law rather than by industry customs.¹⁴⁶ Given the strong probability that *Silberg* would not receive any workmen's compensation, the insurer should have paid *Silberg's* medical bills. If *Silberg* subsequently received a worker's compensation award, California Life could effectively protect its interest by placing a lien on that award.¹⁴⁷ The court, in effect, said that what is customarily done may have some evidentiary value on the question of what ought to be done, but that what ought to be done is fixed by a legal standard of reasonable prudence and fair play in paying claims. The insurer's duty, according to the court, is "to give the interests of the insured at least as much consideration as it gives to its own interests."¹⁴⁸

protect its interest by placing a lien on a workmen's compensation award. *Id.* at 459-60, 521 P.2d at 1108, 113 Cal. Rptr. at 716.

¹⁴⁵ For a discussion of the equitable origin and nature of the concept of good faith, see Holmes, *supra* note 9, at 384-95.

¹⁴⁶ 11 Cal. 3d at 462, P.2d at 1109, 113 Cal. Rptr. at 717. Statutory and case law may differ regarding the binding effect of usage of trade or customary practices. The U.C.C. implied warranty of merchantability, for example, codifies the customary standard by using a no-worse-than-anybody else ethic. To be merchantable goods must be "at least such as . . . pass without objection in the trade under the contract description, and . . . are fit for the ordinary purposes for which such goods are used." U.C.C. § 2-314(2)(a), (c). Some courts seem reluctant to scrutinize the fairness of the industry standard. See, e.g., *First Nat'l Bank of Philadelphia v. Anderson*, 7 Pa. D. & C. 2d 661 (1954). There, the bank argued that it had complied with customary commercial practices in response to a charge that it had not acted in good faith. The court held that the bank had acted in good faith and said: "True, [UCC] section 1-201 defines good faith as being honesty in fact. . . . No evidence was presented, however, indicating that the [bank's] failure to make inquiry . . . was in any sense a divergence from common banking or commercial practice." *Id.* at 666.

¹⁴⁷ 11 Cal. 3d at 460-61, 521 P.2d at 1108-09, 113 Cal. Rptr. at 716-17.

¹⁴⁸ *Id.* at 460, 521 P.2d at 1109, 113 Cal. Rptr. at 717. See notes 208-10 and accompanying text *infra*. The point to underscore is that the *Silberg* court held insurers to this standard of equal consideration regardless of the customary practices. Of course, the ordinary negligence standard may or may not require more than compliance with the usual and customary conduct of others. Although some courts tried to turn the inference from custom into an immutable test of negligence, it is clear that ordinary usages and customs must meet a test of reasonableness. See generally W. PROSSER, LAW OF TORTS 165-68 (4th ed. 1971). As Judge Hand explains,

Indeed in most cases reasonable prudence is in fact common prudence; but strictly it is never its measure; a whole calling may have unduly lagged in the adoption of new and available devices. It never may set its own tests, however persuasive be its usages. Courts must in the end say what is required. . . .

The T.J. Hooper, 60 F.2d 737, 740 (2d Cir. 1932).

Silberg also helps clarify the bad-faith tort by showing that both subjective and objective inquiries are involved in a finding of bad faith, even where the court fails to distinguish them. The first question a court must address is objective: Did the insurer have reasonable grounds for rejecting the claim? Few courts are likely, however, to assess damages against a defendant for bad faith simply because it was objectively wrong in refusing to pay. Usually, to invoke the law's wrath an insurer must also refuse to pay knowing, or having reason to know, that its refusal is unreasonable.¹⁴⁹ In *Silberg* the court ignored this subjective element. It held that the exclusion clause was, "[a]t best"¹⁵⁰ ambiguous and construed it against the insurer in accord with the principle of *contra proferentem*.¹⁵¹ This holding seems to make the defendant liable for a mere error. Arguably, California Life's only fault was to misconstrue an ambiguous provision. As the court pointed out, however, the principle of *contra proferentem* is a "settled [rule] of construction."¹⁵² The court could reasonably charge California Life with knowledge of this rule and of the ambiguity in its own contract.¹⁵³ Thus the defendant in *Silberg* did have reason to know that it was without justification in denying payment. It was liable because it combined subjective dishonesty with objective error.

The final illuminating aspect of the opinion concerns the issue of intent. Given the traditional spectrum of tort classifications — innocent to negligent to intentional — the court held by negative implication that the bad-faith tort is not an intentional one. *Silberg*

¹⁴⁹ The Wisconsin Supreme Court recently held that knowledge of the absence of a reasonable basis "may be inferred and imputed to an insurance company where there is a reckless disregard or a lack of a reasonable basis for denial or a reckless indifference to facts or to proofs submitted by the insured." *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 693, 271 N.W.2d 368, 377 (1978). See also Parks & Heil, *Insurers Beware: "Bad Faith" is in Full Bloom*, 9 FORUM 63, 67 (1973). Recovery without this subjective element is based on a strict liability theory, not bad faith. Some courts do apply strict liability to breach of insurance contracts. Nonetheless, bad faith is likely to remain the dominant standard, at least in the first party context. See notes 211-21 and accompanying text *infra*.

¹⁵⁰ 11 Cal. 3d at 465, 521 P.2d at 1112, 113 Cal. Rptr. at 720.

¹⁵¹ *Id.* at 465-66, 521 P.2d at 1112, 113 Cal. Rptr. at 720. See note 60 *supra*.

¹⁵² *Id.* at 466, 521 P.2d at 1112, 113 Cal. Rptr. at 720.

¹⁵³ The exclusion in question stated that the policy did not cover "any loss caused by . . . injury . . . for which compensation is payable under any Workmen's Compensation . . . Law." *Id.* at 463, 521 P.2d at 1111, 113 Cal. Rptr. at 719. This language could be construed to mean either (1) the insurer would pay any medical expenses not paid for under workmen's compensation, or (2) the insurer was not required to pay anything if the insured recovered any amount under workmen's compensation.

held that a mere finding of bad-faith conduct does not entitle the insured to a punitive damage award. Basing its decision on a California statute, the court stated that to justify a punitive damage recovery the insurer's conduct must be oppressive, fraudulent or malicious.¹⁵⁴ Therefore, punitive damages can only be awarded for the commission of an intentional tort. The insurer must act with "intent to vex, injure or annoy, or with a conscious disregard of the plaintiff's rights."¹⁵⁵ Since the court seemed reluctant to infer malice from the insurer's conduct,¹⁵⁶ an insured must prove actual malice to recover punitive damages. Thus, the new tort of bad-faith conduct does not require fraudulent, malicious oppressive or outrageous conduct. Intentional conduct or intent to harm is a prerequisite only to the recovery of punitive damages.

In sum, *Silberg* touched on four aspects of the bad-faith tort. First, liability can be predicated on either action or inaction. Second, an insurer is held to a higher standard of conduct than the ordinary negligence standard; the carrier must put the insured's interests on par with its own. Third, this equal-consideration requirement necessitates both a subjective inquiry into the insurer's state of mind and an objective inquiry into the reasonableness of his conduct. Finally, the bad faith tort is not of the intentional variety; fraud, malice, oppression or outrageous conduct need not be proven. But these factors do determine whether the insurer is liable for punitive damages as well as extra-contract compensatory damages for breach of his covenant of good faith.

B. *Theory and Standard for the New Extra Contract Claim*

1. *Theory*

What theory should courts use to justify the recovery of extra-contract damages? They can characterize bad faith denial or delay of legitimate first party insurance claims as a breach of contract, a violation of a legislatively imposed duty,¹⁵⁷ or a violation of a judicially imposed duty springing either from tort or

¹⁵⁴ 11 Cal. 3d at 462, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

¹⁵⁵ *Id.*

¹⁵⁶ See, e.g., *Walton v. Anderson*, 6 Cal. App. 3d 1003, 1009-10, 86 Cal. Rptr. 345, 349-50 (1970). The general rule is that legal malice can be imputed from proof of illegal or improper motives. See, e.g., *Ledingham v. Blue Cross Plan*, 29 Ill. App. 3d 339, 330 N.E.2d 540 (1975), *rev'd on other grounds*, 64 Ill. 2d 338, 356 N.E.2d 75 (1976).

¹⁵⁷ For a discussion of first-party penalty legislation, see *Holmes, supra* note 100 at ____.

equity.¹⁵⁸ Assuming the absence of first-party penalty legislation, the courts have three theories from which to choose arising out of three different bodies of law: contract, tort, and equity.

Contract seems to be an inappropriate pigeonhole for a rule which grants damages on a nonconsensual basis, as *Gruenberg* indicates.¹⁵⁹ The *Gruenberg* court apparently concluded from this infelicity, by process of elimination, that tort was the appropriate category.¹⁶⁰ This characterization is appealing; relief such as emotional distress damages has the flavor of tort. Unfortunately, there is an equally plausible argument that bad faith does not fit under the tort rubric either. Although tort and contract share a common ancestry,¹⁶¹ the rule that a tort action can only lie for misfeasance of a promise, not nonfeasance, evolved to distinguish the two.¹⁶² The bad faith "tort," however, does not require an injury by affirmative conduct.¹⁶³ Therefore, the misfeasance-nonfeasance distinction, if taken seriously, should disqualify bad faith from classification as a tort.

¹⁵⁸ In fact, a court may use several theories at once. *See, e.g., Larson v. District Court*, 149 Mont. 131, 423 P.2d 598 (1967).

¹⁵⁹ [L]iability is imposed . . . not for a bad faith breach of the contract but for failure to meet the duty to accept reasonable settlements. . . . That responsibility is not the requirement mandated by the terms of the policy itself—to defend, settle, or pay. It is the obligation, deemed to be imposed by the law. . . . 9 Cal. 3d at 573-74, 510 P.2d at 1037, 108 Cal. Rptr. at 485.

¹⁶⁰ 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. *Id.* at 575, 510 P.2d at 1038, 108 Cal. Rptr. 486.

¹⁶¹ Modern tort descends from the trespass action, as does contract (via case and assumption). F. MAITLAND, *THE FORMS OF ACTION AT COMMON LAW*, 65-70 (1958).

¹⁶² 2 F. HARPER & F. JAMES, *LAW OF TORTS* § 18.6 (1956); Prosser, *The Borderland of Tort and Contract*, in *SELECTED TOPICS ON THE LAW OF TORTS* (1953). One New York case summarizes the traditional learning:

It appears well settled that negligent conduct becomes actionable only when it violates some specific duty. The failure to perform a contractual obligation is never a tort unless it is also a violation of a legal duty. "Without duty, there can be no breach of duty, and without breach of duty there can be no liability." "It is the breach of the duty imposed by law and not of the contract obligation which constitutes the tort. While such duty may arise out of contract, it is a separate and distinct undertaking so that a breach of one will not necessarily imply a breach of the other, although the same conduct may at times constitute a tort as well as a breach of contract."

Shubitz v. Consolidated Edison Co., 59 Misc. 2d 732, 734, 301 N.Y.S.2d 926, 930 (1969) (citations omitted). *See, e.g., Findley v. Time Ins. Co.*, 573 S.W.2d 908 (Ark. 1978).

¹⁶³ *See* note 142 and accompanying text *supra*.

The tort and contract categories do not accommodate bad faith comfortably. Moreover, they are not particularly meaningful, since there is no stable dividing line between tort and contract. An obligation to do or forebear from doing an act may be imposed upon an individual only by command of a legitimate government having jurisdiction over him, or by that government's enforcement of his voluntary undertaking of the obligation. The law of torts exemplifies the former circumstance; the law of contracts exemplifies the latter. Thus, theoretically, a tort duty is imposed by law and a contractual duty is voluntarily assumed. But this reasoning is too facile. Tort and contract do not divide neatly along lines of imposed and assumed duties. Some tort duties arise from a voluntary assumption, for example, undertaking to rescue or inviting social guests. Moreover, for some time courts have eroded classical contract theory by implying contract duties and terms which the parties failed to provide.¹⁶⁴

The misfeasance-nonfeasance distinction is no more helpful in dividing tort from contract. The development of promissory estoppel undercuts it. Courts can now award damages for breach of a promise without any affirmative action and without consideration guaranteeing that the promise was made seriously enough to justify judicial enforcement.¹⁶⁵ Promissory estoppel resembles tort as much as contract.¹⁶⁶ It is just one example of the doctri-

¹⁶⁴ The process of implication is pervasive in contract law. Courts imply promises to sidestep problems of indefiniteness and illusory promises, imply terms like notice requirements or constructive conditions, and imply duties like the duty to cooperate to assure contract performance. See generally Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. REV. 666 (1963); notes 182-90 and accompanying text *infra*.

¹⁶⁵ See generally, G. GILMORE, *THE DEATH OF CONTRACT* 69-73 (1974); Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343 (1969).

¹⁶⁶ A little known but excellent study gives a broad-based historical perspective to the development of promissory estoppel and concludes that it has more tort than contract characteristics:

No complete identification of the doctrine of promissory estoppel can be made: in the generalization of the doctrine, some "re-uniting of tort and contract principles" appears and this makes it hard "to categorize the principle of promissory estoppel as one of 'tort' or 'contract.'"

Snyder, *Promissory Estoppel as Tort*, 35 IOWA L. REV. 28, 45 (1949). In this respect promissory estoppel is part of a process with wide-ranging significance whereby "the whole question of contract is integrated in the larger realm of obligations, and this tends to put our issues in the right perspective and to correct the misleading artificial distinctions between breach of contract and other civil wrongs or torts." M. COHEN, *LAW AND THE SOCIAL ORDER* 95-96 (1933).

Modern contract law candidly admits that damages based upon promissory estoppel may be less or more than those awarded by classical contract theory. The second version of the Restatement definition of promissory estoppel added this language which allows for

nal bridges between tort and contract that allow courts to ignore artificial distinctions.

In the absence of any reliable criteria for making a choice between tort and contract, courts often make a result-oriented distinction.¹⁶⁷ The applicable statute of limitations, assignability of the cause of action, and the applicable measure of damages, all depend on the form of action.¹⁶⁸ Where characterizing an action as tort or contract "affects the suit or its procedure, but not the merits of the cause of action"¹⁶⁹ courts may allow a plaintiff to choose the label that favors him most. This is especially likely if, by doing so, the court can avoid a rule that it considers unjust.¹⁷⁰ Moreover, where only one characterization gives rise to the application of rules that seem appropriate to a particular fact situation, a court is likely to adopt it. In the area of products liability, for example, courts tend to label economic losses (loss of bargain) as contract and personal injury or property losses as tort.¹⁷¹ This distinction allocates the former to a contract measure of damages and the latter to a tort measure. It is, however, difficult to understand why a car that fails to operate and a car with a defect that causes personal injury do not both involve a loss of bargain.¹⁷²

less: "The remedy granted for breach may be limited as justice requires." RESTATEMENT (SECOND) OF CONTRACTS § 90 (Tent. Drafts No. 1-7 1973). Cases like *Hoffman v. Red Owl Stores, Inc.*, 26 Wis.2d 683, 133 N.W.2d 267 (1965), provide further support by granting tort-like damages for what might be called a negotiation tort. In discussing *Hoffman*, Professor Henderson opines:

[S]ection 90 should serve as a distinct basis of liability without regard to theories of bargain, contract, or consideration. The criteria which justify and limit the application of promissory estoppel are to be determined exclusively by what Section 90 says about the effects of nonperformance of promises.

Henderson, *Promissory Estoppel and Traditional Contract Doctrine*, 78 YALE L.J. 343, 359 (1969).

¹⁶⁷ See generally W. PROSSER, *supra* note 148, at 621-22; Fridman, *The Interaction of Tort and Contract*, 93 L.Q. REV. 422, 447 (1977); Note, *The Elastic Concept of Tort and Contract as Applied by the Courts of New York*, 14 BROOKLYN L. REV. 196 (1948).

¹⁶⁸ W. PROSSER, *supra* note 148, at 618-19.

¹⁶⁹ *Id.* at 621.

¹⁷⁰ *Id.* at 621-22.

¹⁷¹ In general, when a plaintiff suffers economic loss together with personal or property damage, recovery for all losses and harms can be attained under any theory. But if only an economic loss occurs, then the contract is supposedly the only theory available. See D. NOEL & J. PHILLIPS, *PRODUCTS LIABILITY IN A NUTSHELL* 105-14 (1974). For an extensive treatment of the rule relating economic losses to contract, see Ribstein, *Guidelines for Deciding Product Economic Loss Cases*, 29 MERCER L. REV. 493 (1978).

¹⁷² It is not possible to assign repair loss to the product and personal injury caused by the product to different types of duties. Both result from breach of the same duty—the product fails to conform to the customer's expectations which were fostered at least in part by the seller's representations, express or implied.

Instead of trying to shoehorn bad faith into categories that are neither suitable nor useful, courts should employ a theory that focuses directly on the issue to be decided and permits formulation of appropriate rules. In the first-party insurance area, the issue involves the proper measure of damages — what damages in addition to the policy benefits should the plaintiff recover? In resolving that issue, a court ought to consider the following factors: (1) how the contract was formed (bargain or adhesion model);¹⁷³ (2) status and relationship of the parties;¹⁷⁴ (3) transactional nature of the contract;¹⁷⁵ (4) quantum of proof of damage; (5) causal connection between the damage and the conduct; and, (6) nature of conduct engaged in by defendant. Findings in a recent study suggest that courts evaluate these six factors, of which the nature of the defendant's conduct is most significant,¹⁷⁶ and award damages accordingly. If the defendant's failure to pay is reasonable or based on probable cause, courts generally follow the classical contract rule by awarding the policy benefit plus interest.¹⁷⁷ But if the insurer acts in bad faith, courts in at least twenty-one states¹⁷⁸ will award extra-contract damages such as economic consequential damages, mental distress damages, and attorney's fees. Moreover, if the court considers the insurer's conduct oppressive, outrageous, malicious, or fraudulent, then it may grant punitive damages.¹⁷⁹

When extra-contract and punitive damages are awarded, the theory of recovery is neither tort nor contract. Either tag only labels the bad faith theory in terms of traditional remedial schemes. The theory underlying extra-contract claims originates in equity. The sources of this theory are the great principles of equity — conscience and good faith — which have made a two-pronged attack upon contractual abuses permitted by the classical

¹⁷³ See notes 51-64 and accompanying text *supra*.

¹⁷⁴ See notes 65-77 and accompanying text *supra*.

¹⁷⁵ See notes 78-95 and accompanying text *supra*.

¹⁷⁶ The real reason why mental suffering and punitive damages were held not recoverable in the contract cases cited . . . is not simply that the cases were in "contract," but that they did not involve sufficiently aggravated conduct. . . . The only factor of consequence is the type of conduct engaged in by the defendant. Where the conduct justifies mental suffering or punitive damages, the court will be able to find a "tort."

Ribstein, *Tort and Contract in Georgia*, 30 MERCER L. REV. 303, 309 (1978).

¹⁷⁷ See note 23 and accompanying text *supra*.

¹⁷⁸ See note 96 and accompanying text *supra*.

¹⁷⁹ See notes 222-59 and accompanying text *infra*.

contract theory. Both are policing devices.¹⁸⁰ The Uniform Commercial Code and the Restatement (Second) of Contracts have elevated them from emotionally satisfying incantations to authentic contract doctrine.¹⁸¹ Courts of equity use unconscionability to prevent oppression and unfair surprise¹⁸² by excising materially offensive terms, such as disclaimers of warranties and limitations on remedies, from written contracts.¹⁸³ Courts have used

¹⁸⁰ For an account of this assault upon the citadel of the classical theory, see Holmes, *supra* note 9 at 384-95, 419-35. The two concepts are equitable in origin. During the reign of Edward III (1327-1337), the English Court of Chancery appeared as a distinct court with prerogative jurisdiction to grant relief which common-law courts would not or could not give. The Chancery Court previously had exercised extraordinary jurisdiction only by permission of the King or the Select Council. See 1 J. POMEROY, A TREATISE ON EQUITY JURISPRUDENCE § 34 (4th ed. 1918). But in 1349, Edward III by a general writ referred all such matters as were "of Grace" to the Chancellor for adjudication. 1 G. SPENCE, THE EQUITABLE JURISDICTION OF THE COURT OF CHANCERY 337 (1846). This general prerogative of grace required the Chancellor to base his decision on principles of "Conscience, Good Faith, Honesty and Equity." *Id.* at 407-08. If a party to a contract committed any unconscientious act or breach of good faith, then the Chancellor would grant relief "under the head of conscience" to the other party. *Id.* at 413.

¹⁸¹ The Uniform Commercial Code defines "good faith" in two sections. The general definition, applicable to all articles, appears in U.C.C. § 1-201(19): "'Good faith' means honesty in fact in the conduct or transaction concerned." The Article Two definition for sales is in § 2-103(b): "'Good faith' in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." The basic statutory good-faith requirement for all U.C.C. transactions is in § 1-203: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement." The importance of good faith is underscored by the fact that it is expressly mentioned in some 50 out of the 400 sections of the Code.

The Restatement provides: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tent. Drafts No. 1-7 1973). The doctrine of unconscionability is enshrined in U.C.C. § 2-302 and in § 234 of the Restatement. The doctrine allows a court to refuse to enforce the entire contract, to excise a paragraph or to limit unconscionable provisions so as to avoid unconscionable results. See U.C.C. § 2-302, Comment 2.

The absorption of unconscionability by modern commercial law is carefully documented in Leff, *Unconscionability and the Code—The Emperor's New Clause*, 115 U. PA. L. REV. 485, 528-41 (1967). For a similar account regarding good faith, see Newman, *The Renaissance of Good Faith in Contracting in Anglo-American Law*, 54 CORNELL L. REV. 553 (1969); Summers, "Good Faith" in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968).

¹⁸² See U.C.C. § 2-302, Comment 1.

¹⁸³ See, e.g., *Henningsen v. Bloomfield Motors*, 32 N.J. 358, 161 A.2d 69 (1960). Other examples include waiver of defense clauses (see, e.g., *Unico v. Owen*, 50 N.J. 101, 232 A.2d 405 (1967)), add-on, dragnet, and cross-collateral clauses (see, e.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965), noted in 79 HARV. L. REV. 1299 (1966)), cognovit (confession of judgment) clauses (see, e.g., *Cutler Corp. v. Latshaw*, 374 Pa. 1, 97 A.2d 234 (1953)), and indemnity and exculpatory clauses (see, e.g., *Weaver v. American Oil Co.*, 257 Ind. 458, 276 N.E.2d 144 (1971)).

the principle of conscionability (although not always by name) in the insurance context for many decades to prevent contractual overreaching by insurers.¹⁸⁴ In his study of insurance, Professor Robert Keeton identified the equitable principle at work: An insurer will not be permitted an unconscionable advantage in an insurance transaction as a result of policy terms even though the insured has manifested fully informed consent.¹⁸⁵

Courts use the good faith principle to imply contractual terms according to the dictates of fair dealing and public policy. Implied warranties of merchantability¹⁸⁶ and habitability,¹⁸⁷ are examples. As Professor Farnsworth observes, the importance of the concept of good faith is in "implying [contract] terms" to assure performance.¹⁸⁸ Good faith also supports implied duties: for example, the duties to cooperate in performance¹⁸⁹ and to mitigate dam-

¹⁸⁴ See generally Holmes, *supra* note 100.

¹⁸⁵ R. KEETON, BASIC TEXT ON INSURANCE LAW 341-69 (1971). For a study of the interrelationship of classical notions of mutual assent and the unconscionability principle, see Holmes, *Interpreting an Insurance Policy in Georgia: The Problem of the Evidentiary Condition*, 12 GA. L. REV. 783 (1978).

¹⁸⁶ U.C.C. § 2-314.

¹⁸⁷ See, e.g., *Javins v. First Nat'l Realty Corp.*, 428 F.2d 1071 (D.C. App. 1970); *Ingalls v. Hobbs*, 156 Mass. 348, 31 N.E. 286 (1892); *Marini v. Ireland*, 56 N.J. 130, 265 A.2d 526 (1970). There are numerous other examples. Gap-filling of missing terms, which changes the classical contract rules of presentation is one. Macneil, *Restatement (Second) of Contracts and Presentation*, 60 VA. L. REV. 589 (1974). Section 2-204(3) of the U.C.C. authorizes gap-filling when material terms are left open. Terms like particulars of performance (U.C.C. § 2-311) or time for performance (U.C.C. § 2-309(1)), can be supplied by the court.

The doctrine of constructive conditions is another example. The idea that good-faith performance is secured through the recognition of constructive conditions was first explained in Corbin's classic article, *Conditions in the Law of Contract*, 28 YALE L.J. 739 (1919). For an update, see Childres, *Conditions in the Law of Contracts*, 45 N.Y.U. L. REV. 33 (1970). Other examples include: (1) good faith denial of an architect's certificate (3 A. CORBIN, CONTRACTS § 651 (1960)); (2) the implication of a good faith requirement in output and requirements contracts to avoid illusory consideration (see U.C.C. § 2-306(1)); (3) good faith limitations on cancellation powers (see, e.g., *Shell Oil Co. v. Marinello*, 63 N.J. 402, 307 A.2d 598 (1973) (court implies a requirement that cancellation be "for cause" into the unilateral right of oil company to cancel dealer's lease); *Monge v. Beebe Rubber Co.*, 114 N.H. 130, 316 A.2d 549 (1974) (court requires good faith firing in at will employment); (4) the requirement that modification be in good faith (U.C.C. § 2-209 and Comment 2)); (5) the rule that a beneficiary's right vests if he relies in good faith (see, e.g., *Copeland v. Beard*, 217 Ala. 216, 115 So. 389 (1928)); (6) an agreement to forbear from suit on an invalid claim is not consideration unless made in good faith (RESTATEMENT (SECOND) OF CONTRACTS § 76B (Tent. Draft No. 2 1965)); and (7) the rule that the holder of a right of first refusal cannot impair the ability to sell (see, e.g., *Wellmore Builders, Inc. v. Wannier*, 49 N.J. Super. 456, 140 A.2d 422 (App. Div. 1958)).

¹⁸⁸ Farnsworth, *supra* note 164, at 670.

¹⁸⁹ A fitting illustration of a duty implied from the principle of good faith and fair dealing is the duty to cooperate to cause a material condition to occur. See 3 A. CORBIN, CONTRACTS § 571 (1960).

ages.¹⁹⁰ Thus, the equitable good-faith principle authorizes courts to impose terms and duties in accord with the parties' expectations and to grant equitable damages for nonperformance.

The bench and bar must recognize this power.¹⁹¹ Too often departures from the principle of freedom of contract have been masked by courts that purport to construe the parties' agreement.¹⁹² Fortunately, as equitable duties and implied terms have begun to emasculate contractual powers, courts have started to ar-

¹⁹⁰ For a discussion of this duty implied from the good-faith principle, see D. DOBBS, *HANDBOOK ON THE LAW OF REMEDIES* 188-91 (1973); F. KESSLER & G. GILMORE, *supra* note 10, at 976-89. Other examples include the duty to attempt to perform as by making reasonable efforts to secure a loan (*see, e.g.*, *Lach v. Cahill*, 138 Conn. 418, 85 A.2d 481 (1951)), or to sell another's product in an exclusive dealing contract (*see, e.g.*, *Underhill v. Schenck*, 238 N.Y. 7, 143 N.E. 773 (1924); *Wood v. Lucy, Lady Duff-Gordon*, 222 N.Y. 88, 118 N.E. 214 (1917); U.C.C. § 2.306(2)). Courts have also implied a duty to give reasonable notice of termination. *See, e.g.*, *Sylvan Crest Sand & Gravel Co. v. United States*, 150 F.2d 642, 644 (2d Cir. 1945). *Cf.* U.C.C. § 2-306(3). *See generally* Gellhorn, *Limitations on Contract Termination Rights—Franchise Cancellations*, 1967 DUKE L.J. 465. Duties to represent an insured by appealing an adverse judgment (*see, e.g.*, *Brassil v. Maryland Cas. Co.*, 210 N.Y. 235, 104 N.E. 622 (1914)) and to take action to rid a cloud on title are also common (*see, e.g.*, *Sitlington v. Fulton*, 281 F.2d 522 (10th Cir. 1960)). The implied duty not to evade the spirit of the deal is a catchall. *See, e.g.*, *Mortgage Corp. v. Manhattan Savings Bank*, 71 N.J. Super. 489, 177 A.2d 326 (Law Div. 1962) (every contract has implied covenant not to render valueless the rights conferred by that contract). It covers the requirements contract cases where a buyer pretends not to have requirements or suddenly expands requirements. *See, e.g.*, *HML Corp. v. General Foods Corp.*, 365 F.2d 77 (3d Cir. 1966); *Massachusetts Gas & Elec. Light Supply Corp. v. V-M Corp.*, 387 F.2d 605 (1st Cir. 1967). Another category of cases follow a scenario according to which A and B agree to exploit some assets for long term mutual profit. B discovers that circumstances will permit him to increase his profits at A's expense. Such conduct evades the spirit of the deal and injures A's right to receive his expectation. The percentage-leasing cases are illustrative. *See, e.g.*, *Stop & Shop, Inc. v. Ganem*, 347 Mass. 697, 200 N.E.2d 248 (1964).

¹⁹¹ This recognition has not come easily. Justice Holmes expressed difficulty in understanding why the law imposes duties in some instances and not others. Holmes, *supra* note 10, at 465-66. Professor Leon Green also seems confused: "How does the stating of the problem in terms of duties enable a judge to pass judgment? Where shall he find the source of duties?" Green, *The Duty Problem in Negligence Cases*, 28 COLUM. L. REV. 1014, 1024 (1928).

¹⁹² In his early study of insurance cases, Professor Kessler brilliantly analyzes this process of using covert tactics to write out substantially oppressive terms and write in good-faith principles:

[C]ourts have made great efforts to protect the weaker contracting party and still keep 'the elementary rules' of the law of contracts intact. As a result, our common law of standardized contracts is highly contradictory and confusing, and the potentialities inherent in the common law system for coping with contracts of adhesion have not been fully developed.

ticulate the real bases for their decisions.¹⁹³ Even Samuel Williston, the grand designer of classical contract theory, accepted the good-faith principle.

The underlying principle is that there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract; in other words, *in every contract* there exists an implied covenant of good faith and fair dealing.¹⁹⁴

In summary, when "extra-contract" damages are awarded for nonperformance of a contract, the wrong that occurred was equitable. Recognition of the equitable nature of this duty precipitates a rethinking of the character of this theory. It is an error to start with the remedy—mental suffering, attorney's fees, or punitive damages—and then infer that defendant committed a tort wrong. No doubt much of the confusion is caused by the diverse forms of relief available. When an *ex delicto* award is made, for instance, it is natural to conclude that it was tort-based. It is the breach of a duty that leads to an appropriate remedy and one should start with the duty rather than the remedy. In every contract there is an implied covenant that one will not harm another's contractual expectation by bad-faith nonperformance. The equitable principle of good faith and fair dealing supplies the law with a standard to measure conduct in contract nonperformance. If

Kessler, *Contracts of Adhesion—Some Thoughts about Freedom of Contract*, 43 COLUM. L. REV. 629, 633 (1943). Professor Murray also notes the problem and suggests the solution:

[I]t is to be observed that courts, even today, frequently hesitate to admit that conditions are being read into the contract, when that is in fact what is being done. The tendency is to conceal the true nature of the process under the cloak of a spurious interpretation. . . . As an original matter it would probably have been wiser had the courts, instead of dealing with the problem through the medium of so-called implied condition, frankly admitted that we have here a situation calling for an equitable adjustment of the rights and duties of the parties under circumstances not provided by them.

J. MURRAY, *MURRAY ON CONTRACTS* 305-06 (2d rev. ed. 1974).

¹⁹³ Thus during the last generation, the courts of New Jersey have engaged in the explicit "development of those principles of equity, fair dealing, good faith . . . which breathed new life-giving honesty into the bare contractual relationship." In a number of cases, the naked terms of a contract, however explicit, were held not to constitute the final balance of decision. New Jersey Courts instead judged contractual provisions against the demands of fair dealing and public policy . . . [and] implied terms . . . [and] created an obligation of good faith and fair dealing [in contracts].

Schultze v. Chevron Oil Co., 579 F.2d 776, 782 (3d Cir. 1978) (citations omitted). For a discussion of the process of leavening contractual rights with equitable duties in the insurance context, see *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 65 N.J. 474, 323 A.2d 495 (1974).

¹⁹⁴ 5 S. WILLISTON, *WILLISTON ON CONTRACTS* § 670, at 159 (3d ed. 1961) (Emphasis added).

nonperformance is in good faith, courts award traditional contract remedies. If nonperformance is in bad faith or is accompanied by outrageous, malicious or fraudulent conduct, then they may grant tort-like damages. Notwithstanding the nature of the damage award, the relief is based on an independent substantive theory springing from equity.

Attempts to name this theory of liability more precisely than equity or "good faith" have contributed to misunderstanding. Most suggested labels, at least in the first-party insurance area, either are not adequately descriptive or retain inapt references to traditional legal pigeonholes; examples are "tort of bad faith,"¹⁹⁵ "tort of outrage,"¹⁹⁶ "tortious breach of contract,"¹⁹⁷ "tortious interference with a protected property interest,"¹⁹⁸ "bad faith breach,"¹⁹⁹ "Gruenberg-ian tort,"²⁰⁰ and "insurer's mistaken judgment."²⁰¹ "Bad faith wrong"²⁰² may be the most accurate and least deceptive. This buzzing confusion suggests an analogy to the law of restitution. From the equitable principle of restitution for unjust enrichment, courts have fashioned wide-ranging forms of relief including constructive trust, replevin, ejectment, rescission, and implied-in-law contract (*quasi ex contractu*). The word "restitution" was chosen by the authors of the Restatement of the Law of Restitution over forty years ago to represent the commonality of these diverse forms of relief.²⁰³ But, as Professor Seeburger explains, many in the legal profession do not see restitution as a distinct theory of relief but only as a means of describing alternate remedies.²⁰⁴

From the equitable principle of good faith and fair dealing in contract performance and enforcement, courts have fashioned various forms of relief to apply when the defendant fails to per-

¹⁹⁵ Parks & Heil, *Insurers Beware: "Bad Faith" is in Full Bloom*, 9 FORUM 63, 71 (1973).

¹⁹⁶ Volz, *The New Tort of Outrage*, 36 ALA. LAW. 568 (1975).

¹⁹⁷ Richardson v. Employers Liab. Assur. Corp., 25 Cal. App. 3d 232, 236, 102 Cal. Rptr. 547, 552 (1972).

¹⁹⁸ Keenan & Gillespie, *The Insurer and the Tort of the Intentional Infliction of Mental Distress*: Fletcher v. Western National Life Insurance Co., 39 INS. COUNSEL J. 335, 339 (1972).

¹⁹⁹ 13 TULSA L.J. 606, 625 (1978).

²⁰⁰ 11 SAN DIEGO L. REV. 492, 503 (1974).

²⁰¹ Kircher, *Insurer's Mistaken Judgment — A New Tort?*, 59 MARQ. L. REV. 775 (1976).

²⁰² Summers, *supra* note 181, at 258.

²⁰³ RESTATEMENT OF THE LAW OF RESTITUTION (1937). The restaters were Professors A. W. Scott and W. A. Seavey.

²⁰⁴ They see it [restitution] as only a remedy. It is used by them as no more than alternative measure of damages in a conversion case, as only an election to be made in the event of a material breach of contract, or as a device for taking the profit from errant fiduciaries. The plain fact is that Restitution is a substantive, and independent, theory of liability.

Seeburger, Book Review, 40 U. PITT. L. REV. 121, 122 (1978).

form in good faith. But unlike the word "restitution," good faith or even good faith performance does not describe adequately the basis for the award of extra-contract damages. Since the duty originates in equity, pertains to contract performance, and upon breach awards tort-like damages, an appropriate name for this overlapping of traditional categories might be "conequitort." The word "restitution" was invented to underscore its separate significance. The focus that a name gives²⁰⁵ encourages the legal professional to put a sharp analytical eye on the substantive law of restitution. The use of a novel name like conequitort might cause this substantive, independent theory of liability to come into clearer focus for judicial development.

2. *The Standard of Conduct*

The implied covenant of good faith and fair dealing in commercial contracts reflects the ethical tenor of our society and requires that the contractual powers society sanctions be reasonably exercised. The key to understanding good faith lies in the word "reasonableness." The requirement of good faith invokes notions of unselfishness and impartiality — an insurer must weigh the competing interests and give the insured's interest at least as much weight as his own. "Bad faith" refers to unreasonable conduct wrongfully depriving the other party of the benefits of the agreement.²⁰⁶ When an insurer unreasonably denies an insured the benefit of having a stated sum of money available upon the occurrence of a contingent risk, a breach of the good-faith duty occurs. The insurer's conduct is unreasonable when it shows a deliberate preference for its interests over those of the insured. The good-faith standard requires a party to seek a fair mean, to try to strike an equitable balance when a conflict of interests appears.²⁰⁷ This standard is at odds with the traditional conception of contracting parties as atomistic entities, bound only by arid

²⁰⁵ I am familiar with Dean Prosser's famous statement that a tort does not need a name. W. PROSSER, *supra* note 235, at 3. But again, this new "extra-contract" claim is not a tort, and Prosser just may have been wrong anyway.

²⁰⁶ See note 135 and accompanying text *supra*. The ultimate duty arising from the covenant of good faith is "that neither party will do anything to deprive the other of the *benefits of the agreement*." *Austero v. National Cas. Co.*, 84 Cal. App. 3rd 1, 27, 148 Cal. Rptr. 653, 670 (1978) (emphasis in original).

²⁰⁷ To act in good faith is to exercise one's formal entitlements in the spirit of solidarity. The good faith standard requires one to find in each case the mean between the principle that one party may disregard the interests of the other in the exercise of his own rights and the counterprinciples that he must treat those interests exactly as if they were his own.

formalities which reflect the prevailing individualistic attitudes of the nineteenth century.

Under the good faith standard, a carrier need only act honestly upon reasonable grounds in denying or delaying payment. A good-faith refusal to pay means that the insurer has reasonable grounds or probable cause in law or in fact to reject the claim.²⁰⁸ At first glance, this reasonableness standard looks like the ordinary tort standard. It is not. Since the good-faith duty originates in equity, a contracting party is held to a higher standard of conduct than the ordinary negligence standard: The carrier must accord the insured's interests consideration at least equal to that he gives his own.

Good faith and negligence are similar in that both ordinarily pose questions of fact to be decided by the jury. The standard for judging conduct, however, differs. Negligence is based upon an objective standard of due care; good faith conduct is irrelevant to the issue of negligence. If a defendant fails to comply with the objective negligence standard, then the fact that he was acting in good faith will not reduce his responsibility for the consequences of his negligent act. Well-intentioned bungling is actionable under the negligence standard. Although good faith is irrelevant to the negligence issue, the converse is not necessarily true; negligent conduct can be used as circumstantial evidence of bad faith. In determining whether an insured had a reasonable basis to deny benefits, negligent handling or processing of the claim is relevant. For example, a court might investigate whether the insurer undertook a proper investigation of the claim before it denied benefits, and, if so, whether it subjected the results of the investigation to fair, professional review and evaluation.²⁰⁹ Only negligent acts that permit an inference of disregard for the insured's interests bear on bad faith. Notwithstanding the interrelationship of the two concepts, the good-faith standard has a sphere of authority quite distinct from the negligence standard; under *Silberg's* inquiry into both the objective and subjective reasonableness of the

²⁰⁸ An insurance company which fails to deal fairly and in good faith with its insured by refusing *unreasonably* to pay the insured for a valid claim covered by the policy is subject to liability for all damages proximately resulting from such conduct.

California Jury Instructions, CAL. CIV. CODE § 12.92 (1977) (emphasis added).

²⁰⁹ Comment, *Extra-Contractual Damages in Suits on Insurance Policies*, 46 CIN. L. REV. 170, 185 (1977). Recently, the California Supreme Court held that failure to investigate properly is a breach of the good-faith covenant as a matter of law. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal.3d 809, 598 P.2d 452, 456-57, 157 Cal. Rptr. 482 (1979).

insurer's conduct,²¹⁰ it holds him accountable to a higher standard than ordinary negligence.

Some commentators fear that there is a movement away from this good-faith standard toward strict liability.²¹¹ Much of the concern centers around a 1975 first-party insurance opinion which mixed first-party and third-party cases and held that "insurance companies that *erroneously* withhold payments from their insureds, and deprive them of the security they bargained for, must be held to account for the consequences of their conduct."²¹² If courts replace bad faith or wrongful refusal with erroneous refusal, strict liability will result. A year later, in *Egan v. Mutual of Omaha*,²¹³ the California Court of Appeals was more explicit: "When an insurer decides to withhold payment on a policy of insurance, it proceeds at its own risk."²¹⁴ Surprisingly, the long-awaited California Supreme Court opinion in *Egan* failed to clarify the standard.²¹⁵ The law remains unclear.

²¹⁰ See note 144 and accompanying text *supra*.

²¹¹ See, e.g., Kircher, *supra* note 201, at 779.

²¹² *McDowell v. Union Mut. Life Ins. Co.*, 404 F. Supp. 136, 141 (C.D. Cal. 1975) (emphasis added). In *Johansen v. California State Auto Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 123 Cal. Rptr. 288, 538 P.2d 744 (1975), a third-party excess case, Judge Tobriner held that if a policy-limits demand is made and reasonable time for consideration is given, and the insurer rejects the demand, then it does so at its peril. The insurer was held liable although it had promptly filed a declaratory action in an attempt to resolve the coverage dispute. Although the court held that it was not deciding whether an insurer is strictly liable for failure to accept the demand, it did just that:

[A]n insurer who fails to accept a reasonable settlement offer within policy limits because it believes the policy does not provide coverage *assumes the risk* that it will be held liable for all damages resulting from such refusal . . .

Id. at 12, 538 P.2d at 746, 123 Cal. Rptr. at 290 (emphasis added). The court, citing *Communale*, held that assumption of the risk occurred even if the insurer had a good faith belief that the policy did not provide coverage. It stated that:

an insurer's "good faith," though erroneous, belief in noncoverage affords no defense to liability flowing from the insurer's refusal to accept a reasonable settlement offer.

Id. at 16, 538 P.2d at 748, 123 Cal. Rptr. at 292 (footnote omitted). *McDowell* applied *Johansen's* strict liability standard to a first-party case. 404 F. Supp. at 140-41.

²¹³ 133 Cal. Rptr. 899 (Cal. App. 1976), *hearing granted*, Cal Sup. Ct., No. 30747 (Mar. 9, 1977) (opinion withdrawn from official publication).

²¹⁴ *Id.* at 909.

²¹⁵ The California Court of Appeals directed a verdict on the issue of breach of the good faith covenant based on Mutual's failure to investigate plaintiff's claim properly. On appeal, Mutual argued that the ruling subjected it to strict liability in tort and that the covenant could be breached only by a wrongful denial when the insurer knew it had no reasonable basis for its refusal to pay. The California Supreme Court disagreed, and in these pithy words explained:

Although we recognize that distinguishing fraudulent from legitimate claims may occasionally be difficult for insurers, especially in the context of disability policies, an insurer cannot reasonably and in good faith deny payments to its insured without thoroughly investigating the foundation for its denial.

Despite these cases, it is doubtful that a strict liability standard will ever generally apply in the first-party context. Several factors suggest that the good faith standard will continue to govern first-party cases. First, the duty of good faith conduct provides adequate protection for all competing interests. An insurer who makes an honest mistake in failing to pay should not be held strictly liable for all the insured's consequential losses. Insurance companies should be encouraged to contest what they honestly consider to be illegitimate claims and avoid dissipating their reserves. The only safe course of action under a withhold-at-your-own-risk rule is to "[p]lay all claims and investigate afterwards, assuming, of course, payment doesn't waive that right."²¹⁶ Second, although strict liability is gaining some momentum in third-party cases,²¹⁷ the policy underpinning the insurer's duty to use reasonable care in settling third-party claims is inapposite to first-party claims. When a third-party insurer denies coverage and refuses to defend, it may be appropriate to impose the risk of an erroneous decision on it. The coverage denial implicitly rejects all future settlement offers exposing the insured to a potentially disastrous excess judgment. Moreover, the company stands in a special relationship to the insured; it has agreed to undertake his defense, and he has placed himself in its hands. Thus, most courts which have considered the issue hold that a distinction between first and third-party cases is warranted²¹⁸ and that an insurer who denies a

Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 598 P.2d 452, 456-57, 157 Cal. Rptr. 482 (1979). Since Mutual failed to investigate properly by having the disabled insured examined by a doctor of its choice or by consulting with the insured's doctors and surgeon, the court held that the trial court properly instructed the jury that the good-faith covenant had been breached.

Thus, the most that can be deduced on the strict liability issue in California is the following: An insurer's failure to pay a first-party benefit is a breach of the covenant of good faith and fair dealing as a *matter of law* in at least two instances: (1) when the insurer fails to investigate properly the insured's claim (*see id.*); (2) when the insurer drafts an ambiguous policy provision and then interprets it against the insured in denying payment. *See* Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 982, 79 Cal. Rptr. 326 (1969); notes I49-52 and accompanying text *supra*. At least one writer concludes that a holding on the issue of good faith as a matter of law "extends the doctrine of strict liability in tort to insurance policies." J. McCARTHY, *supra* note 36, at 68. To be charitable, that conclusion is somewhat infelicitous.

²¹⁶ Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 592, 510 P.2d 1032, 1049, 108 Cal. Rptr. 480, 497 (1973) (dissenting opinion, Roth, J.).

²¹⁷ *See, e.g.*, Rova Farms Resort, Inc. v. Investors Ins. Co. of America, 65 N.J. 474, 323 A.2d 495 (1974); Alt v. American Family Mut. Ins. Co., 71 Wis. 2d 340, 237 N.W.2d 706 (1976). *See also* Comment, *In California Excess Liability Cases, Does "Bad Faith" in Law Equal Strict Liability in Practice?*, 4 PEPPERDINE L. REV. 115, 121 (1977).

²¹⁸ *See, e.g.*, Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 392 A.2d 576, 580-81 (1978). *See also* Scottish Union & Nat'l Ins. Co. v. Bejcy, 201 F.2d 163, 166 (6th Cir.

first-party claim based on an honest but mistaken belief of non-coverage ought to be protected.²¹⁹ The California Court of Appeals in the recent case of *Austero v. National Casualty Co.*²²⁰ settled on the rule that will probably prevail in first-party cases. The court looked to *Silberg* and *Gruenberg* and held unequivocally "that the ultimate test of liability in the first party cases is whether the refusal to pay policy benefits was *unreasonable*."²²¹

In summary, the good-faith standard is not tort-based. Although bad faith may involve negligence or negligence may be indicative of bad faith, negligence alone is insufficient to render an insurer liable for extra-contract damages. Since the carrier must give at least equal weight to the insured's interest, the insurer is held to a higher standard than that of the tort standard of due care. Second, the equal-consideration test requires a two-tier inquiry. The first is objective: Was there a reasonable basis in law or fact for denying benefits? The second is subjective: Did the insurer deny benefits while it knew or should have known there was no reasonable basis for doing so? Such knowledge can be implied as a matter of law in proper cases. Third, with the widespread use of the good-faith standard which measures the reasonableness of the insurer's conduct, strict liability is unlikely to get a grip on this area of the law. Finally, intent to harm is not a requisite of bad faith conduct. Proof of fraud, malice, oppression or outrageous conduct is not required. The standard of conduct for determining whether an insurer has breached the covenant of good faith, therefore, differs from the standard for judging whether that same party is liable for punitive damages.

III

FRAUDULENT OR OPPRESSIVE BREACH OF CONTRACT

Courts limit recovery for simple breach of contract to classical contract remedies, and for bad-faith breach of an equitable cov-

1953); *Merrin Jewelry v. St. Paul F. & M. Ins. Co.*, 301 F. Supp. 479, 481 (S.D.N.Y. 1969); *Leonard v. Firemen's Ins. Co.*, 100 Ga. App. 434, 436-37, 111 S.E.2d 773, 775-76 (1959).

²¹⁹ See, e.g., *Ledingham v. Blue Cross Plan for Hospital Care*, 29 Ill. App.3d 339, 330 N.E.2d 540 (1975) *rev'd on other grounds*, 64 Ill. 2d 338, 356 N.E.2d 75 (1976).

²²⁰ *Austero v. National Cas. Co.*, 84 Cal. App. 3d 1, 148 Cal. Rptr. 653 (1978), *discussed in* 19 DEFENSE RESEARCH INSTITUTE, FOR THE DEFENSE 215 (1978).

²²¹ *Id.* at 32, 148 Cal. Rptr. at 673. The petition for rehearing in *Austero* was not only denied but the court resolutely reaffirmed the original opinion, flatly rejecting the deny-at-your-own-risk rule as precedent for first-party cases. The California Supreme Court has sanctioned this point of view. See *Neal v. Farmers Ins. Exchange*, 21 Cal.3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

enant to extra-contract damages, such as attorney's fees,²²² litigation costs,²²³ collateral economic losses,²²⁴ and mental suffering.²²⁵ They focus on the nature of the insurer's conduct — whether the insurer was unreasonably serving its own interests, or was fairly but incorrectly withholding payments — and draw upon contract or tort for damages that fit the crime. This focus, however, has led some courts to recognize yet a third independent category: a breach where the insurer intended to harm its insured. In *Beck v. State Farm Mutual Automobile Insurance Co.*²²⁶ the court crystallized this distinction:

[P]roof of a violation of the duty of good faith and fair dealing does not establish that the defendant acted with the requisite intent to injure the plaintiff. Thus it does not follow that, because State Farm took an unreasonable [bad faith] position on the validity of a defense to coverage under Beck's policy, State Farm acted with intent to harm Beck.²²⁷

If State Farm intentionally harmed its insured, he could recover punitive damages. Since courts infer intention from objective conduct, they must revert to evaluating the nature of the insurer's conduct. One can appreciate this process only through case-by-case analysis.

The cases show gradations in the character of the conduct surrounding the breach. Disability and health insurers sometimes engage in malicious and outrageous conduct just to avoid legiti-

²²² *Mustachio v. Ohio Farmers Ins. Co.* 44 Cal. App.3d 358, 118 Cal. Rptr. 581 (1975); *Kirk v. Safeco Ins. Co.*, 28 Ohio Misc. 44, 273 N.E. 2d 919 (1970).

²²³ *Eckenrode v. Life of America Ins. Co.*, 470 F.2d 1 (10th Cir. 1972); *Escambia Treating Co. v. Aetna Cas. & Sur. Co.*, 421 F. Supp. 1367 (N.D. Fla. 1976); *McDowell v. Union Mut. Life Ins. Co.*, 404 F. Supp. 136 (D.C. Cal. 1975); *Gruenberg v. Aetna Ins. Co.*, 9 Cal.3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Christian v. American Home Assur. Co.*, 577 P.2d 899 (Okla. 1977).

²²⁴ Consequential damages have been allowed where the insurer's conduct caused business or credit losses as well as loss of homes through mortgage foreclosures. *See, e.g.*, *Allyance Ins. Co. v. Alper-Salvage Co.*, 19 F.2d 828 (6th Cir. 1927) (Tennessee law); *Campbell v. Government Emp. Ins. Co.*, 306 So. 2d 525 (Fla. 1974); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 264 Ind. 599, 349 N.E.2d 173 (1976); *United States Fidelity & Guar. Co. v. Peterson*, 91 Nev. 617, 540 P.2d 1070 (1975).

²²⁵ Many of the courts which have recognized the right to recover consequential damages from an insurer for bad-faith failure or delay in making payments under a policy have included the mental suffering caused by the failure or delay within the damages recoverable. *See* note 96 *supra*.

²²⁶ 54 Cal. App.3d 347, 126 Cal. Rptr. 602 (1976).

²²⁷ *Id.* at 355-56, 126 Cal. Rptr. at 607 (citing *Silberg v. Cal. Life Ins. Co.*, 11 Cal. 3d 452, 462-63, 521 P.2d 1103, 113 Cal. Rptr. 711, 718 (1974)).

mate claims.²²⁸ They intentionally leave insureds and their families destitute,²²⁹ fraudulently attempt to induce insureds into waiving their policy rights,²³⁰ and harass them by requiring burdensome, unnecessary medical examinations²³¹ and by slandering them.²³² Fire insurers allegedly initiate unfounded prosecutions for arson and fraud,²³³ force insureds into expensive and time-consuming examinations solely to delay payment,²³⁴ and propel insureds into bankruptcy by delaying desperately needed policy benefits.²³⁵ A life insurance company may invent a nonexistent defense to force an unfair settlement on a poor widow.²³⁶ In short, insurers do use fraudulent, oppressive, and abusive tactics to coerce insureds into unfair settlements. One commentator warned that "unless prevented by the courts, it is to the interest of a disability insurer to engage in protracted and unwarranted litigation creating undue stress which may well precipitate the insured's death."²³⁷

What do courts do about such tactics? Many duck the issue by keeping their heads buried in the firm but shallow soil of classical contract law. These courts proclaim that the matter is contract and punitive damages are not awarded for breach of contract regardless of how malicious, oppressive or fraudulent the breach.²³⁸ Even while resting on this ghostly conceptual illusion

²²⁸ See, e.g., *Felder v. Great Amer. Ins. Co.*, 260 F. Supp. 575 (D.S.C. 1966); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); *State ex rel. Larson v. District Ct. of 8th Jud. Dist.*, 149 Mont. 131, 423 P.2d 598 (1967).

²²⁹ See, e.g., *Silberg v. California Life Ins. Co.*, 11 Cal.3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

²³⁰ Cases listed in Note, *Punitive Damages for Breach of Contract in South Carolina*, 10 S.C.L.Q. 444, 468 (1958). See also cases cited in note 228 *supra*.

²³¹ See, e.g., *Haas v. Pacific Mut. Life Ins. Co.*, 70 Ohio App. 332, 334, 41 N.E.2d 263, 265 (1941).

²³² See, e.g., *Miller v. Mutual of Omaha Ins. Co.*, 235 So. 2d 33 (Fla. App. 1970).

²³³ See, e.g., *Mustachio v. Ohio Farmers Ins. Co.*, 44 Cal. App. 3d 358, 118 Cal. Rptr. 581 (1975); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 571, 510 P.2d 1032, 1035, 108 Cal. Rptr. 480, 483 (1973).

²³⁴ See, e.g., *Merrin Jewelry Co. v. St. Paul Fire & Marine Ins. Co.*, 301 F. Supp. 479, 482 (S.D.N.Y. 1969); *Ind. Grocery Co. v. Sun Ins. Co.*, 146 Minn. 214, 178 N.W. 582 (1920).

²³⁵ See, e.g., *Reichert v. General Ins. Co. of America*, 68 Cal.2d 822, 827, 442 P.2d 377, 379, 69 Cal. Rptr. 321, 323 (1968) (en banc).

²³⁶ See, e.g., *Eckenrode v. Life of America Ins. Co.*, 470 F.2d 1 (7th Cir. 1972).

²³⁷ 16 J.A. APPLEMAN & J. APPLEMAN, *supra* note 23 § 8881, at 636 (citation omitted).

²³⁸ In *Ketcham v. Miller*, 104 Ohio St. 372, 136 N.E. 145 (1922), the court held that even where the petitioner averred that the defendant breached the contract "unlawfully, forcibly, willfully, wantonly, [and] maliciously," the action *ex contractu* did not become an action *ex delicto*. *Id.* at 376-77, 136 N.E. at 146.

of fixed islands of tort and contract, some courts are troubled by denying all extra-contract recovery. When the voice of conscience gets the better of them, they assert that extra damages may be recovered if the claim is founded on an imposed duty rather than upon a contractual duty.²³⁹ Ignoring imposed duties from equity, these courts turn solely to the imposed duty of tort. Their final position is aptly summed up by the Restatement (Second) of Contracts: "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."²⁴⁰ In first-party disputes, many courts have accordingly granted punitive damages when the breach of the policy was accompanied by an independent tort.²⁴¹

These cases fall into two categories based on when the tort-wrong occurred: at the sales (contract formation) stage or at the claims presentation and processing stage. At the sales stage, the sales agent may intentionally misrepresent the scope of coverage²⁴² or the carrier may issue the policy with no intention of ever performing the contractual obligations fairly.²⁴³ These cases require proof of what might be called "promissory fraud." The

²³⁹ See cases collected in 1 C.J.S., ACTIONS § 47 (1936).

²⁴⁰ RESTATEMENT (SECOND) OF CONTRACTS § 369 (Tent. Draft No. 14, 1979).

²⁴¹ *Escambia Treating Co. v. Aetna Cas. & Sur. Co.*, 421 F. Supp. 1367 (N.D. Fla. 1976); *Helton v. Reserve Life Ins. Co.*, 399 F. Supp. 1322 (D. Mont. 1975) (violation of statute); *Cassady v. United Ins. Co. of America*, 370 F. Supp. 388 (W.D. Ark. 1974); *Asher v. Reliance Ins. Co.*, 308 F. Supp. 847 (N.D. Cal. 1970); *Short v. Grange Mut. Cas. Co.*, 307 F. Supp. 768 (S.D. W. Va. 1969); *Old Southern Life Ins. Co. v. Woodal*, 326 So. 2d 726 (Ala. 1976); *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *MacDonald v. Penn Mut. Life Ins. Co.*, 276 So. 2d 232 (Fla. Dist. Ct. App. 1973); *Ledingham v. Blue Cross Plan*, 29 Ill. App. 3d 369, 330 N.E.2d 540 (1975); *Gibson v. National Ben Franklin Ins. Co.*, 387 A.2d 220 (Me. 1978); *United States Fidelity & Guar. Co. v. Peterson*, 91 Nev. 617, 540 P.2d 1070 (Nev. 1975); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 111-12, 229 S.E.2d 297, 301 (1976); *Christian v. American Home Assur. Corp.*, 577 P.2d 299 (Okla. 1977); *Drake v. Milwaukee Mut. Ins. Co.*, 70 Wis. 2d 977, 236 N.W.2d 204 (1974).

South Carolina has its own special rules. Before one is entitled to punitive damages, he must prove not only that the breach of contract was effected with fraudulent intent but also that the breach was accompanied by a fraudulent act. For a discussion of the South Carolina cases see Sullivan, *Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change*, 61 MINN. L. REV. 207, 231-36 (1977).

²⁴² See, e.g., *Sharp v. Automobile Club*, 225 Cal. App. 2d 648, 37 Cal. Rptr. 585 (1964); *Craver v. Union Fidelity Life Ins. Co.*, 37 Ohio App. 2d 100, 307 N.E. 2d 265 (1973).

²⁴³ See, e.g., *Wetherbee v. United Ins. Co.*, 265 Cal. App.2d 921, 71 Cal. Rptr. 764 (1968); *Miller v. National Am. Life Ins. Co.*, 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1976); *International Security Life Ins. Co.*, 475 S.W.2d 363 (Tex. Civ. App. 1971), *rev'd in part*, 496 S.W.2d 544 (Tex. 1973).

requisite pre-contract intent to defraud may be proven by inference from the insurer's subsequent post-claim conduct.²⁴⁴ At the claims presentation and processing stage, the wrong that occurs is the use of oppressive or fraudulent conduct (or some combination of both) to extort an unfair settlement. The wrong may be pure economic coercion accomplished by delaying tactics which play on the insured's poor financial condition or fraudulent coercion such as pretended defenses, false accusations, mental harassment and other tricks. One can extract from these cases a standard for awarding punitive damages based on notions of fraud and oppression. The standard is intentional, aggravated misconduct which consists of some form of fraud or oppression or both. Therefore, the rule for recovering punitive damages requires proof of: Breach of contract + Independent tort + Intentional, aggravated misconduct.

The independent torts that are typically relevant in this area are described above.²⁴⁵ They consist of either fraud, intentional infliction of mental distress, intentional interference with a protected property interest, or the tort of bad faith. To speak of a tort of bad faith, however, is to indulge in a legal fiction²⁴⁶ so that courts may award punitive damages.

Two other theories that may be more analytically sound can support these punitive awards. The first pays lip service to the independent tort requirement by asserting that the breach of the contract itself is a tortious act for which punitive damages are recoverable.²⁴⁷ An Ohio court concluded, for example, "that the actions of the defendant were such as to be a breach of contract amounting to a wilful, wanton and malicious tort. . . ." ²⁴⁸ Perhaps

²⁴⁴ See *Miller v. National Am. Life Ins. Co.*, 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1976); notes 106-10 and accompanying text *supra*.

²⁴⁵ See notes 106-56 and accompanying text *supra*.

²⁴⁶ Legal fictions are subject to many meanings. See L. FULLER, *LEGAL FICTIONS* (1967). Their use incurred the wrath of Bentham: "Fiction of use to justice? Exactly as swindling is to trade. . . . The most pernicious and basest sort lying. It affords presumptive and conclusive evidence of moral turpitude. *Id.* at 3.

²⁴⁷ At least three jurisdictions adopt this approach. *Vernon Fire & Cas. Ins. Co. v. Sharp*, 161 Ind. App. 413, 316 N.E.2d 381 (1974), *modified on other grounds*, 264 Ind. 599, 349 N.E.2d 173 (1976); *Kirk v. Safeco Ins. Co. of America*, 28 Ohio Misc. 44, 273 N.E.2d 919 (C.P. 1970); *State Farm Gen. Ins. Co. v. Clifton*, 86 N.M. 757, 527 P.2d 798 (1974). *Cf. Helton v. Reserve Life Ins. Co.*, 399 F. Supp. 1322 (D. Mont. 1975) (punitive damages allowed when breach of the insurance policy is also violation of insurance code).

²⁴⁸ *Kirk v. Safeco Ins. Co. of Am.*, 28 Ohio Misc. 44, 46, 273 N.E.2d 919, 921 (C.P. 1970).

the most important example of this school of thought is the Indiana case of *Vernon Fire and Casualty Insurance Co. v. Sharp*.²⁴⁹ The Indiana Supreme Court concluded that the lines between tort and contract are often so blurred that any effort to segregate tortious activity accompanying the breach from the breach itself is futile. Moreover, the court found the reasons²⁵⁰ for the independent tort requirement insubstantial, especially when serious harm occurs from tortious activity that cannot be conveniently pigeonholed as an existing tort. Rather than recognizing the tort of bad faith, the court held that when conduct with tortious overtones mingles with the contract breach, an independent tort is not a prerequisite to the recovery of punitive damages.²⁵¹ The breach per se is tortious in nature.

The Indiana Court of Appeals' opinion in *Vernon*, which the Indiana Supreme Court upheld, is even more direct. Citing cases that awarded punitive damages but in which no contracts were at issue,²⁵² the appeals court held that "the evidence was sufficient to allow the jury to find that the insurer's conduct amounted to heedless disregard of the consequences, malice, gross fraud or oppressive conduct."²⁵³ In effect, the court indicated that punitive damages should be awarded in contract actions according to the standard applied in tort. *Vernon* is not an isolated opinion; courts are awarding punitive damages in contract actions outside the insurance context on similar grounds.²⁵⁴ But punitive damages are not recoverable for every contract breach. As in tort ac-

²⁴⁹ 264 Ind. 599, 349 N.E.2d 173 (1976).

²⁵⁰ According to the court, the functions of the independent tort requirement are twofold:

First, it maintains the symmetry of the general rule of not allowing punitive damages in contract actions, because the punitive damages are awarded for the tort, not the contract. Secondly, the independent tort requirement facilitates judicial review of the evidence by limiting the scope of review to a search for the elements of the tort.

Id. at 608, 349 N.E.2d at 180 (emphasis in original).

²⁵¹ *Id.* at 609, 349 N.E.2d at 181.

²⁵² 161 Ind. App. 413, 417, 316 N.E.2d 381, 384 (1974).

²⁵³ *Id.*

²⁵⁴ See, e.g., *Whitfield Constr. Co. v. Commercial Dev. Corp.*, 392 F. Supp. 982 (D.V.I. 1975); *Rex Ins. Co. v. Baldwin*, 163 Ind. App. 308, 323 N.E.2d 270 (1975); *Eakman v. Robb*, 237 N.W.2d 423 (N.D. 1975). See also *Dold v. Outrigger Hotel*, 54 Hawaii 18, 501 P.2d 368 (1972).

tions, punitive damages should be recoverable only upon proof of aggravated or reckless conduct.²⁵⁵ Thus, the first alternative analysis is to declare that the breach of the contract itself is tortious in nature and may allow for punitive damages. The formula for this approach would require a plaintiff to prove: Breach of contract + intentional, aggravated misconduct.

The second alternative approach also eliminates the requirement of proving an independent tort. Recognizing that a plaintiff's complaint is often an inextricable mix of contract and tort elements, these courts do not categorize cases of oppressive or fraudulent breach as either.²⁵⁶ They recognize that analysis should not be driven underground, that courts ought to explain the real bases for decisionmaking, and that covert manipulation of rules to achieve a just result is a judicial prevarication.²⁵⁷ *Boise Dodge, Inc. v. Clark*²⁵⁸ is an example. There the Idaho Supreme Court acknowledged not only that tort is difficult to distinguish from contract, but also that such a distinction is unnecessary to the imposition of punitive damages. When plaintiff's "new" automobile turned out to be second-hand, he sued for breach of contract and received an award of punitive damages. Rather than struggling with an obdurate conceptual illusion, the court struck to the heart of the issue:

In any event, from the legal point of view of the imposition of punitive damages in this case, it does not matter whether respondent's counterclaim technically sounded in contract or tort. The rule . . . is that punitive damages may be assessed in contract actions where there is fraud, malice, oppression or other sufficient reason for doing so. This rule recognizes that in certain cases elements of tort, for which punitive damages have always been recoverable upon a showing of malice, may be

²⁵⁵ W. PROSSER, *supra* note 64, at 9-10.

²⁵⁶ For a thoughtful development and analysis of these cases, see Sullivan, *supra* note 2, at 236-40.

²⁵⁷ The distinctions between tort and contract are so protean and opaque that oftentimes decisions using these distinctions are difficult to reconcile. Compare *Associated Heavy Equip. Schools, Inc. v. Masiello*, 219 So.2d 465 (Fla. Dist. Ct. App. 1969) with *Henry Morrison Flager Museum v. Lee*, 268 So.2d 434 (Fla. Dist. Ct. App. 1972). Compare *Scheps v. Giles*, 222 S.W. 348 (Tex. Civ. App. 1920) with *Orgain v. Butler*, 478 S.W.2d 610 (Tex. Civ. App. 1972).

²⁵⁸ 92 Idaho 902, 453 P.2d 551 (1969).

inextricably mixed with elements of contract, in which punitive damages generally are not recoverable.²⁵⁹

The problem with such cases, however, is that they fail to give any theoretical justification for their decision except to reject the tort-contract distinction as meaningless. The opinions, however, bristle with notions of good faith and fair dealing. Arguably, their justification lies in a conscious recognition that when an aggravated breach of the equitable covenant of good faith and fair dealing in contract performance occurs, punitive damages are authorized. This approach also eliminates the requirement of an independent tort and necessitates proof of: Breach of covenant of good faith and fair dealing + intentional aggravated misconduct.

Whether courts will look beyond artificial distinctions between tort and contract as well as requirements of independent torts for the imposition of punitive damages remains to be seen. One can safely say that the cutting edge of the law is already forged. But the question of whether *Vernon*, *Boise Dodge*, *Gruenberg*, and *Silberg* are harbingers of fundamental legal change or only isolated examples of judicial candor is open to discussion.

CONCLUSION

Classical contract theory grew out of a single model of contract formation: the bargained-for exchange. In its heyday, it treated all contracts as if they conformed to that model. When courts began to abandon this rigid assumption, Professor Gilmore concluded that contract was dead. This report may have been greatly exaggerated. Where the facts underlying a contract action fit the traditional model—the simple breach situation—traditional rules are appropriate and most courts continue to apply them. Consensual theory survives where consensus is, in fact, the basis of a contract.

A court may, however, conclude that a contract does not fit the traditional model and that the application of classical rules would be unjust—the bad-faith and the oppressive breach situations. This study of first-party insurance contracts, which exemplify the adhesive agreement, shows that judges are likely to look beyond classical theory in such cases and fashion duties and

²⁵⁹ *Id.* at 907, 453 P.2d at 556. A more recent example involves a case in Fairfax County, Virginia, where the court ordered Koons Ford, an auto dealer, to pay \$25,000 in punitive damages to an Arlington buyer who was told she was buying a "new" car. It was second-hand. See *Washington Post*, May 19, 1979, at I, Col. 4. The case is on appeal.

remedies necessary to do justice between the parties. This process draws on the tort principle of fault to justify departing from traditional contract rules. Moreover, relief such as punitive and mental distress damages is similar to that awarded in tort actions. But the source of the theory that justifies extra-contract relief in a suit for breach of contract is the law of equity, specifically the concepts of conscience and good faith. Thus modern courts are synthesizing a new set of principles that supplement traditional contract theory and confine it to its proper sphere of operation.