




1983

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Recommended Citation

Harvey, Kerry B. and Wiseman, Thomas A. III (1983) "First Party Bad Faith: Common Law Remedies and a Proposed Legislative Solution," *Kentucky Law Journal*: Vol. 72 : Iss. 1 , Article 4.
Available at: <https://uknowledge.uky.edu/klj/vol72/iss1/4>

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First Party Bad Faith: Common Law Remedies and a Proposed Legislative Solution

BY KERRY B. HARVEY* AND THOMAS A. WISEMAN, III**

INTRODUCTION

Until the recent case of *Feathers v. State Farm Fire & Casualty Co.*,¹ the insurance industry in Kentucky was only accountable to its insureds for the face amount of the insurance contract in the event of a breach by the insurer. The Kentucky Court of Appeals broke with tradition in *Feathers* when it held that an insurance company which unjustifiably withholds the proceeds of an insurance policy may be liable in tort for consequential and punitive damages.²

Traditionally, an insured party seeking recovery for the breach of an insurance contract was limited to damages in the amount of that contract. The courts of Kentucky, at least until *Feathers*, adhered to this view.³ The limitation in Kentucky is largely explained by the absence of any reported Kentucky decision that involved truly egregious conduct by an insurer in settling claims by its insureds. In contrast, other state courts have confronted cases in which an aggressive claims adjuster attempted to exact unreasonable concessions from the insured when attempting to settle

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The authors express their appreciation to the administrative staff of Brown, Todd & Heyburn, and wish to thank Candice F. Loop, Amy B. Martin, Cindy Rayner and Pat Sheets.

¹ No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983), reported in 30 KY. L. SUMM. 9, at 8 (Aug. 5, 1983)[hereinafter cited as KLS].

² *Id.* at 7-8.

³ See, e.g., *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d 685 (Ky. 1966); *Deaton v. Allstate Ins. Co.*, 548 S.W.2d 162 (Ky. Ct. App. 1977). See also text accompanying notes 130-159 *infra*.

a claim.⁴In the context of such cases, a trend has developed that significantly expands the insured's right of recovery against the insurer.⁵ In *Feathers*, the Kentucky Court of Appeals embraced that trend and recognized the tort of first party bad faith.⁶

The case of *Sparks v. Republic National Life Insurance Co.*⁷ illustrates the difficult legal and policy issues inherent in the claims of first party bad faith. In *Sparks*, a family contracted with the defendant insurance company for a health insurance policy. After discussions with the insurance agent, Mr. Sparks applied for the policy through his business and sent the first premium payment with his application.⁸ The court described what happened next:

Exactly one month after purchasing the insurance, Calvin, Suzanne and their three children flew to Safford to visit relatives. On the return flight to Mesa, the small passenger plane in which they were flying crashed. Calvin sustained permanent brain damage. Kevin, the Sparks' five-year-old son, was rendered a paraplegic, as well as suffering a broken jaw and several facial lacerations. Suzanne and another child received minor injuries.⁹

The father's injuries prevented him from maintaining his air conditioning business, and it went bankrupt in December of 1977. The business stopped paying premiums after December, and in March of the following year the insurance company informed Mrs. Sparks that the policy was terminated, denying liability for any medical expenses incurred after December 1, 1977.¹⁰ The Court explained the significant consequences of the termination for the Sparks family:

⁴ See, e.g., *Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d 1127 (Ariz. 1982), cert. denied, 103 S.Ct. 490 (1982); *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973) See also text accompanying notes 30-39 *infra*.

⁵ *Id.* See generally *Graneli, Good Times for Bad Faith*, Nat'l L.J., July 11, 1982 at 1, col. 1.

⁶ No. 83-CA-158-MR, slip op. at 7-8.

⁷ 647 P.2d at 1127.

⁸ *Id.* at 1130-31.

⁹ *Id.* at 1131.

¹⁰ *Id.* The court stated, "Defendants explained that under the provisions of the policy, when insurance coverage was terminated, defendants were no longer obligated to pay for any medical expenses for an injury or illness which occurred while the insurance was in effect." *Id.*

Because of defendant's refusal to pay further medical benefits, Kevin was forced to forego needed muscle release surgery on his left thigh. Although the surgery was later performed at the Arizona Children's Hospital in March 1980, the delay resulted in deformity to Kevin's left leg, leaving the leg two inches shorter than the right. Kevin was also unable to obtain braces or crutches due to defendant's refusal to pay benefits. A recent examination of Kevin revealed that his spine had become badly curved due to his confinement in a wheel chair. The Sparks' also were forced to forego additional medical and psychological care for Calvin. Expert medical testimony established that both Kevin and Calvin would need continuing treatment throughout their lives.¹¹

The insurance company's refusal to pay in *Sparks* was predicated on the insured's failure to maintain premium payments.¹² At the time of purchase, Mr. Sparks examined a brochure explaining the general provisions of the policy. The brochure contained a specific paragraph providing for termination of benefits once the insured failed to make premium payments. It also cautioned the insured to refer to the master policy for more complete details. Mrs. Sparks testified that she expected coverage for injuries incurred while the policy was in force, although she acknowledged that once the premiums went unpaid, injuries sustained in subsequent accidents would not be compensable. The insurer argued that the provisions of the master policy were controlling and that it rightfully terminated benefits. The Arizona Supreme Court ruled that the trial court properly found that the master policy was ambiguous in failing to communicate the limitations urged by the insurer and upheld a directed verdict for the Sparks family.¹³ The court concluded that an insurance company commits a tort when it breaches the contract in bad faith,¹⁴ and upheld the jury verdict against the insurer for \$1,551,000 compensatory damages and \$3,000,000 punitive damages.¹⁵

¹¹ *Id.* at 1131-32.

¹² *Id.*

¹³ *Id.* at 1135.

¹⁴ *Id.* at 1136.

¹⁵ *Id.* at 1143.

The facts of the *Sparks* case present an extreme example of an insured suffering catastrophic consequences as a result of the insurer's determination that it was no longer liable under its policy. Insurance companies make such decisions daily, but they rarely contemplate that the insured will consequently suffer such calamity as the Sparks family. Significantly, the risks of substantial damage awards inherent in decisions by an insurance company concerning its liability on a policy are directly related to whether the action is labelled as one in tort or contract.

A growing number of courts have characterized conduct such as that of the insurance company in *Sparks* as a tort, thereby allowing the insured to recover consequential and punitive damages.¹⁶ Conversely, other courts adhere to the traditional view, characterizing the conduct as a breach of contract and limiting damages to the contract amount.¹⁷ The Kentucky Court of Appeals in *Feathers* adopted the tort theory.¹⁸ The choice of the tort theory, if ultimately established as law in Kentucky, will require the insurance industry in this state to reevaluate its claims settlement practices.

This Article examines the various alternatives available to a court when confronted with facts such as those that occurred in the *Sparks* case. It uses *Sparks* as a backdrop for the discussion because that case illustrates the disastrous consequences which may occur as a result of an insurer's action that could be deemed to be reasonable and in good faith. Part I of the Article analyzes and contrasts the tort and contract theories of recovery in this context.¹⁹ Part II of the Article next considers Kentucky case law and examines the potential impact of the *Feathers* decision on future Kentucky cases.²⁰ Part III examines the legislative remedy recently proposed in the Kentucky General Assembly.²¹ Finally, Part IV explores an alternative legislative approach that may provide a better balance of the competing policy considerations.²²

¹⁶ See notes 30-94 *infra* and accompanying text.

¹⁷ See notes 95-129 *infra* and accompanying text.

¹⁸ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 7.

¹⁹ See text accompanying notes 23-129 *infra*.

²⁰ See text accompanying notes 130-226 *infra*.

²¹ See text accompanying notes 227-282 *infra*.

²² See text accompanying notes 283-285 *infra*.

I. FIRST PARTY BAD FAITH: TORT v. CONTRACT THEORY

Every insurance contract contains an implied covenant of good faith and fair dealing.²³ This implied covenant requires an insurance company to deal in good faith with its insured when evaluating and paying direct, or "first party," claims under the policy,²⁴ as well as when evaluating, defending, and paying indirect, or "third party," claims against the insured by a person not a party to the insurance contract.²⁵

²³ See *Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co.*, 279 N.W.2d 638, 643 (N.D. 1979) ("an insurer is obligated to act in good faith in its relationship with its policyholders"); *Timmons v. Royal Globe Ins. Co.*, 653 P.2d 907, 911 (Okla. 1982) ("there is a single duty to deal fairly with the insured and third parties arising from the relationship established by the contract of insurance"); *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313, 319 (R.I. 1980) ("an insurer is obligated to act in good faith in its relationship with its policyholders").

The Court of Appeals of Kentucky discussed this duty in the third party context in *Manchester Ins. & Indem. Co. v. Grundy*, 531 S.W.2d 493, 498 (Ky.), cert. denied, 492 U.S. 821 (1975). For a discussion of the *Grundy* case see Comment, *Wrongful Refusal to Settle: The Implications of Grundy in Kentucky*, 65 KY. L.J. 220 (1976-77). In *Feathers*, State Farm admitted the existence of this duty in its answer. See *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983). For a general discussion of this duty, see Harman, *An Insurer's Liability for the Tort of Bad Faith*, 42 MONT. L. REV. 67 (1981).

²⁴ "First party bad faith" occurs when the insured alleges that the insurer has failed to honor the terms of the contract in its dealings with the insured. In this type of case, the insured charges that due to an alleged breach by the insurer, the insured is receiving less from a settlement than he was entitled to receive according to the terms of the contract. The insurer and the insured are the only two parties involved. *Feathers* is such a case. Until *Feathers*, no Kentucky court had recognized "first party bad faith" as a tort. Such an action was merely a "breach of contract" case and the insurer was liable only for the amount of the contract. See, e.g., *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d 685, 687 (Ky. 1966).

²⁵ "Third party bad faith," like first party bad faith, contains a claim of injury to the insured. In this context, however, a third party is intimately involved. This type of case occurs when the insurer, under the terms of the contract, is defending the insured against a third party claiming against the insured for some injury covered by the insurance policy. If, as a compromise, the third party offers a settlement which the insurer refuses and the case is then litigated with the amount awarded to the third party exceeding the limits of the policy, causing the insured to be liable for the difference, the insured may have a cause of action against the insurer for a bad faith refusal to settle. If bad faith on the part of the insurer is present, many courts have held that the insurer is guilty of a tort. See, e.g., *Wolfe v. Continental Casualty Co.*, 647 F.2d 705, 709 (6th Cir.) (applying Ohio law), cert. denied, 454 U.S. 1053 (1981); *Larraburu Bros. v. Royal Indem. Co.*, 604 F.2d 1208, 1212 (9th Cir. 1979) (applying California law); *Manchester Ins. & Indem.*

*Sparks*²⁶ presents a fairly typical though unusually moving factual setting for a claim of first party bad faith. The Sparks family contracted with the insurance company for comprehensive health insurance. Simply put, they were primary parties to an unexceptional contract. When the insurance company breached that contract, however, the Sparkses suffered catastrophic consequences. The issue before the courts in these situations is whether the breach of the implied covenant of good faith and fair dealing is a breach of contract or a tort. The remedies available to an insured depend on the resolution of this issue.

Though admittedly extreme, the *Sparks* situation is not unusual. Often, the insured is in a particularly vulnerable position at the very time an insurer refuses to pay. By definition, the insured has felt some loss, possibly of catastrophic proportions, when the insurance claim is made. A denial of the claim, or even a lengthy delay, may result in financial and personal calamity for the insured and his family. On the other hand, insurers, faced with the possibility of large punitive damage awards if the tort theory is applied, may well be deterred from defending questionable claims and asserting valid defenses.

In first party cases, the insurer points loudly and often to its insurance contract, claiming that even if it is liable, damages must be limited to the contract amount. In contrast, the insured claims that the insurer's unreasonableness has caused great and tortious injury, entitling the plaintiff to receive extracontractual and punitive damages. The choice of theory, contract or tort, has far-reaching consequences for insurance companies, insurance consumers (whether claimants or premium payers) and their lawyers.

This complex and multi-faceted problem raises two important, yet simple, public policy objectives: (1) the law should deter insurers from unreasonably delaying or denying benefits due their insureds under the policy, while providing compensation to insureds suffering damages caused by such misconduct; and (2) the law should not discourage insurers from asserting valid defenses

Co. v. Grundy, 531 S.W.2d 493 (Ky.), cert. denied, 492 U.S. 821 (1975). See also Comment, *supra* note 23, at 220.

²⁶ *Sparks v. Republic Nat'l Life Ins. Co.*, 641 P.2d 1127 (Ariz. 1982). See text accompanying notes 7-15 *supra*.

and defending questionable claims. Neither party to the insurance contract should be aided in extorting a favorable settlement through threats of delay or bad faith suits. Tension exists between these two objectives and any solution necessarily involves balancing one against the other. The question is which theory—tort or contract—best promotes the realization of these policy goals.

Until very recently, Kentucky courts have analyzed first party cases under general contract principles, limiting damages to the amount due under the contract.²⁷ The court of appeals signaled a radical departure from this established Kentucky rule in *Feathers* by recognizing the tort of bad faith in first party cases, and with it the allowance of consequential and punitive damages.²⁸ While the rule announced in *Feathers* may not survive review due to the peculiar procedural situation in which the case was decided,²⁹ Kentucky courts will certainly be called upon to consider the issues raised by the case.

This part of the Article reviews the alternatives available to the courts and legislature in fashioning an appropriate rule for first party bad faith cases. It discusses the logical as well as legal foundation for both tort and contract theories and finds ample criticism of both.

A. Tort Theory

The 1973 California case of *Gruenberg v. Aetna Insurance Co.*³⁰ is the landmark decision recognizing a tort for first party bad faith. The decision has provoked great controversy, both in California and elsewhere. It is the authority most often cited by courts adopting the tort of first party bad faith;³¹ yet it is also the

²⁷ See, e.g., *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d at 687 ("The traditional measure of recovery for failure to pay money due under contract is the amount agreed to be paid."); *Deaton v. Allstate Ins. Co.*, 548 S.W.2d at 164 ("the measure of recovery for failure to pay money due under contract is the amount agreed to be paid").

²⁸ *Feathers v. State Farm Fire & Casualty Co.*, slip op. at 8.

²⁹ See note 160 *infra*.

³⁰ 510 P.2d 1032 (Cal. 1973).

³¹ See, e.g., *Noble v. National Am. Life Ins. Co.*, 624 P.2d 874, 875-76 (Ariz. Ct. App. 1979) (Jones, J., concurring); *Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co.*, 375 A.2d 428, 428-30 (Conn. Super. Ct. 1977).

case most severely criticized by courts rejecting its rule.³² Therefore, *Gruenberg* demands careful scrutiny by the Kentucky courts evaluating the tort theory.

Jerome Gruenberg owned a cocktail lounge known as the Brass Rail, in Los Angeles, California.³³ Aetna Insurance Co., along with two other insurers, carried the fire insurance on Gruenberg's premises. In the early morning hours of November 9, 1969, the Brass Rail was destroyed by fire. After Gruenberg arrived at the scene, he became involved in an argument with an officer of the arson squad, and was arrested. Aetna retained an independent adjusting firm to work the Gruenberg loss. The next day, an adjuster employed by the firm inspected the premises, and while there, told an arson investigator that Gruenberg carried excessive insurance on the building. Later, Gruenberg was formally charged with arson.³⁴

Aetna demanded that Gruenberg appear for examination under oath, pursuant to certain provisions of the insurance policies.³⁵ Gruenberg, heeding advice of counsel, refused to make any statements while the criminal charges were pending.³⁶ At the preliminary hearing on the arson charge, the adjuster appeared as a state's witness and testified that the Brass Rail had been overinsured. Nevertheless, that preliminary hearing was concluded with the dismissal, for lack of probable cause, of all criminal charges against Gruenberg.³⁷

After the dismissal, Gruenberg contacted Aetna and volunteered to give the statement requested by the insurance companies. The insurers, however, denied liability on the basis of his prior refusal to appear for the examination.³⁸ Gruenberg then filed suit, claiming bad faith against the insurer, the insurer's attorneys, the individual adjuster working the claim and his employer and

³² See, e.g., *Vincent v. Blue Cross-Blue Shield, Inc.*, 373 So.2d 1054, 1060-61 (Ala. 1979) (Jones, J., concurring specially); *Spencer v. Aetna Life & Casualty Co.*, 611 P.2d 149, 151-52 (Kan. 1980); *Lawton v. Great Southwest Fire Ins. Co.*, 392 A.2d 576, 580 (N.H. 1978); *Santilli v. State Farm Life Ins. Co.*, 562 P.2d 965, 969 (Or. 1977).

³³ *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1034.

³⁴ *Id.*

³⁵ *Id.*

³⁶ *Id.* at 1034-35.

³⁷ *Id.* at 1035.

³⁸ *Id.*

the independent adjusting firm. Seeking both compensatory and punitive damages, Gruenberg alleged that as a "direct and proximate result of the outrageous conduct and bad faith of the defendants," he had suffered severe economic damage, severe emotional upset and distress, loss of earnings and various other special damages.³⁹

Gruenberg charged that the defendants had breached an implied duty of good faith and fair dealing in its affairs with its insured, and that such conduct was tortious.⁴⁰ Significantly, the *Gruenberg* court cited *third party* bad faith cases as authority for recognizing the same duty in the first party context.⁴¹ The court described the case before it as involving "the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to unreasonably withhold payments due under a policy."⁴² In a crucial and oft-quoted segment, the court stated:

These are merely two different aspects of the same duty. 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, 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.⁴³

³⁹ *Id.*

⁴⁰ *Id.* at 1036.

⁴¹ *Id.* The court cited *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958). The *Comunale* court stated: "There is an implied covenant of good faith and fair dealing in every contract [including insurance policies] that neither party will do anything which will injure the right of the other to receive the benefits of the agreement." 328 P.2d at 200.

⁴² *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1037.

⁴³ *Id.* (emphasis in original). As further support, the court cited *Richardson v. Employer's Liab. Assurance Corp.*, 102 Cal. Rptr. 547 (Cal. Ct. App. 1972), a case involving uninsured motorist's insurance. In *Feathers*, the Kentucky Court of Appeals failed to note that *Gruenberg* had relied upon a case involving uninsured motorist's insurance. This fact makes the court's attempt to distinguish *Feathers* from the controlling authority untenable. See text accompanying notes 169-178 *infra*.

The *Gruenberg* court determined that the implied duty of good faith does not arise merely from the terms of the insurance contract; rather it is a duty imposed by law. Because this duty is non-consensual in origin, the court reasoned that its breach is tortious.⁴⁴ To characterize the insurer's conduct as tortious, the court was compelled to find an *independent* duty imposed by the law, apart from the express or implied terms of the contract.⁴⁵ The elements necessary before *any* tort can be found are fundamental: (1) a *duty* must be owed by the *defendant to the plaintiff*; (2) the defendant must breach the duty; (3) the plaintiff must suffer damages; and (4) the damages must be caused, in fact and proximately, by the breach of the duty.⁴⁶ The difficulty faced by the *Gruenberg* court, and courts adopting its rationale, is in finding a duty that exists independently of the contract between the insurer and its first party insured.⁴⁷

Obviously, an insurer owes its insured a myriad of duties, and these responsibilities are specifically enumerated in the insurance contract. Chief among these is the duty to pay on certain conditions. Generally, however, breach of a contractual duty does not constitute a tort.⁴⁸ If the defendant insurer's conduct does not violate any independent duty to act in a certain way, but is only a failure to perform an obligation under the insurance contract, then damages should be limited to those recoverable in con-

⁴⁴ *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1037. The court further stated:

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

Breach of this duty is a tort

510 P.2d at 1037 (citations omitted) (quoting *Richardson v. Employer's Liab. Assurance Corp.*, 102 Cal. Rptr. at 552). The *Gruenberg* court overruled specific language in *Richardson* requiring that emotional stress must be *severe* in order for the insured to recover for it. *Id.* at 1042 n.10.

⁴⁵ See 510 P.2d at 1037.

⁴⁶ W. PROSSER, HANDBOOK OF THE LAW OF TORTS 143 (4th ed. 1971).

⁴⁷ Courts adopting *Gruenberg* do recognize that a plaintiff must show that the defendant violated a duty arising *independently* of the contract in order to make out a cause of action in tort. See, e.g., *United States Fidelity & Guar. Co. v. Peterson*, 540 P.2d 1070, 1071 (Nev. 1975) ("The duty violated [to deal fairly and in good faith] arises not from the terms of the insurance contract but is a duty imposed by law, the violation of which is a tort."). See also note 69 *infra*.

⁴⁸ D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES 818-21 (1973).

tract.⁴⁹ Normally, punitive damages and damages for emotional distress are unavailable in actions for breach of contract.⁵⁰

Gruenberg found an independent duty based upon the contractual relationship between the insurer and the insured,⁵¹ correctly noting that an insurer is required to act in the insured's interest in handling claims against the insured (a third party situation).⁵² The California court short-circuited the independent duty analysis, however, by proclaiming that the good faith duty in the first party context is merely "another aspect" of the same duty involved in third party cases.⁵³ Analysis of this duty in the third party context reveals that the *Gruenberg* reasoning is flawed.

In the typical third party case, a claim is made against the insured, and the insurance company acts as the attorney-in-fact, responsible for defending the claim.⁵⁴ By the terms of the contract, the insurer has the right to control the defense completely, even though the insured is the defendant. Although the initial relationship between the insurer and insured is created by the contract, the duty of good faith arises without respect to any agreement.⁵⁵ The duty is imposed by law on *all* agency relation-

⁴⁹See Harman, *supra* note 23, at 69 ("It is the violation of the implied covenant of good faith which gives rise to the tort of 'bad faith' and subjects the insurer to liability beyond that for breach of contract." (emphasis added)).

⁵⁰See, e.g., McNutt v. State Farm Mut. Auto. Ins. Co., 369 F. Supp. 381, 385-86 (W.D. Ky. 1973); United States Fidelity & Guar. Co. v. Fyffe, 471 S.W.2d 23, 24 (Ky. 1971). See generally D. DOBBS, *supra* note 48, at 798-821.

⁵¹See *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1040 ("Defendant's duty arises from a contractual relationship existing between the parties.").

⁵²See *id.* at 1037.

⁵³See *id.*

⁵⁴See, e.g., National Farmers Union Property & Casualty Co. v. O'Daniel, 329 F.2d 60, 66 (9th Cir. 1964)("[The insurer] was required by the terms of the policy to defend the action and look after [the insured's] interests as well as its own."); Fowler v. State Farm Mut. Auto. Ins. Co., 454 P.2d 76, 76 (Mont. 1969)("Under the policy [the insurer] was obligated to defend any suit against the insured.").

⁵⁵See e.g., Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1018-19 (Or. 1978). The court stated:

In an action for failure to settle within the policy limits, the insurance company is charged with acting in a fiduciary capacity as an attorney in fact representing the insured's interest in litigation. The company's interest comes into conflict with that of the insured's while representing him; and, arguably, acting in its own interests to the detriment of the insured's interest while acting in such a fiduciary capacity is a tort.

Id. at 1019. See also *City of Wakefield v. Globe Indem. Co.*, 225 N.W. 643, 644 (Mich.

ships of a similar kind, regardless of whether the relationship is created by an insurance contract.⁵⁶ The fact that the insurance company contracts for the exclusive right to act on behalf of the insured creates the duty, rather than the contract itself. The same fiduciary duty is imposed on an attorney the insurance carrier might hire to represent the insured in the third party litigation, even though the attorney is not a party to the insurance contract.⁵⁷ In essence, the third party duty referred to in *Gruenberg* is simply an adjunct of a basic rule of agency: where an agent undertakes to *act* for its principal, it must do so as a fiduciary.⁵⁸

The first party context is strikingly different. In first party cases, the insurer has neither the right nor the duty to act as an agent for the insured. The insured is at all times in control of his own fate, without danger of being bound by a disloyal agent to an unfavorable result. Thus, the agency relationship which creates the independent duty prerequisite for tort liability does not exist. The Oregon Supreme Court recognized this distinction in *Santilli v. State Farm Life Insurance Co.*⁵⁹

In cases involving the insurer's duty to pay under policies for theft, fire, health, disability or life insurance [first party cases], the unique relationship which gives rise to the special duty of liability insurers to attempt to settle within their policy limits does not arise. The insured, or his beneficiary, is not subject to the imposition of excess liability, and his rights and responsibilities are limited to those set forth in his contract.⁶⁰

The *Gruenberg* rationale is incorrect, then, because an essential element of any tort is missing, namely, an *independent* duty run-

1929) ("Prohibition against fraud or bad faith is imposed by law upon every legal relationship and it is *not necessary to contract for it.*" (emphasis added)).

⁵⁶ 3 AM. JUR. 2D *Agency* § 199 (1962) ("the agent is bound to the exercise of the utmost good faith toward [its] principal").

⁵⁷ See, e.g., *In re Gilbert*, 118 S.W.2d 535, 537 (Ky. 1938). The Court stated, "Good faith and fair dealing are expected of a lawyer in his contacts with his adversaries. They are essential elements in his contacts with his clients." *Id.* The attorney owes this duty of good faith and fair dealing to the insured, even though he is compensated by the insurer.

⁵⁸ 3 AM. JUR. 2D *Agency* § 199. "An agent is a fiduciary with respect to the matters within the scope of his agency." *Id.* See generally *Sim v. Edenborn*, 242 U.S. 131 (1916); *Shatz Realty Co. v. King*, 10 S.W.2d 456 (Ky. 1928).

⁵⁹ 562 P.2d at 965.

⁶⁰ *Id.* at 968-69.

ning from defendant to plaintiff. The courts have had difficulty discerning the distinction between the elements of tort and contract in this confusing area; nevertheless, it is a fundamental distinction that must be made.

The shakiness of the reasoning of the *Gruenberg* court is betrayed by its treatment of the claims against the non-insurer defendants. Mr. Gruenberg named the insurance adjusters and lawyers employed by Aetna as defendants and charged them with committing the very acts that resulted in Aetna's tort liability.⁶¹ The court dismissed these defendants, stating that "the non-insurer defendants *were not parties to the agreements* for insurance; therefore, they are not, as such, subject to an implied duty of good faith and fair dealing."⁶² The court, however, had already found an *independent* duty on the part of the insurance company. If the duty is truly independent, then it is irrelevant whether the individuals were parties to the contract or not. Nevertheless, the court absolved the individual defendants of liability *because* they were not parties to the insurance contracts with the plaintiff.⁶³

Another California case, *Egan v. Mutual of Omaha Insurance Co.*,⁶⁴ further illustrates the flaws in the tort analysis. In *Egan*, the plaintiff relied on *Gruenberg* as the basis for his suit for compensatory and punitive damages arising from a claim under a disability insurance policy.⁶⁵ A jury verdict was entered against the insurance carrier for \$45,600 in general damages, \$78,000 for emotional distress, and \$5,000,000 in punitive damages.⁶⁶ Although the punitive damage award was reversed,⁶⁷ the size of the

⁶¹ *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1035.

⁶² *Id.* at 1039. (emphasis added).

⁶³ *Id.* at 1038-39. The Court stated:

However, plaintiff contends that these non-insurer defendants breached only the duty of good faith and fair dealing; therefore, we need not consider the possibility that they may have committed another tort in their respective capacities as total strangers to the contracts of insurance. Obviously, the non-insurer defendants were not parties to the agreements for insurance; therefore, they are not, as such, subject to an implied duty of good faith and fair dealing.

Id.

⁶⁴ 620 P.2d 141 (Cal. 1979).

⁶⁵ *Id.* at 141.

⁶⁶ *Id.* at 144.

⁶⁷ *Id.* at 149. The court held that the punitive damage award was the result of passion and prejudice on the part of the jury. *Id.*

award emphasizes the problems confronting insurers in taking their case before a jury. *Egan* adopted the *Gruenberg* rationale and held the insurer liable in tort for failure to investigate the insured's claim.⁶⁸ The court correctly noted that every contract contains an implied covenant of good faith and fair dealing with other parties to the contract.⁶⁹ Of course, this implied duty arises in every contract, not just insurance policies. In adopting *Gruenberg*, the *Egan* court observed: "[T]he precise nature and extent of the duty imposed by such an implied promise will depend on the contractual purposes."⁷⁰ Yet if, as *Egan* suggests, the duty is imposed by virtue of an implied promise, then it certainly does not arise *independent* of the contract. Further, if the "nature and extent of the duty" depends on the *contractual* purpose, then once again, it cannot be independent, and instead finds life only in the agreement.

The *Egan* court failed to distinguish the separate concepts of tort and contract when it considered the plaintiff's claim for damages. The court stated:

As insurers are well aware, the major motivation for obtaining disability insurance is to provide funds during periods when the ordinary source of the insured's income—his earnings—has stopped. The purchase of such insurance provides peace of mind and security in the event the insured is unable to work.⁷¹

This statement makes a persuasive argument that extra-contractual damages are foreseeable, and therefore recoverable under the rule of *Hadley v. Baxendale*.⁷² Yet this foreseeability analysis really

⁶⁸ *Id.* at 145.

⁶⁹ *Id.* This implied duty of good faith and fair dealing is found in every contract. See, e.g., KY. REV. STAT. § 355.1-203 (Bobbs-Merrill 1972) [hereinafter cited as KRS] which states, "Every contract or duty within this chapter imposes an obligation of good faith in its performance or enforcement."

⁷⁰ *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d at 145 (emphasis added).

⁷¹ *Id.*

⁷² 156 Eng. Rep. 145 (1854). For discussion of the *Hadley v. Baxendale* rule, see text accompanying notes 97-128 & 202-22 *infra*. Although separating actions in tort from actions in contract is often difficult, it is essential for determining the available remedies. Chief Justice Struckmeyer of the Arizona Supreme Court made this point in his dissenting opinion in *Noble v. National Am. Life Ins. Co.*, 624 P.2d 866. Responding to the majority opinion that adopted the *Gruenberg* rationale, he stated in dissent:

The existence of a duty to the plaintiff is a prerequisite to tort liability. But the duty, the breach of which gives rise to a tort claim, must be a general

relates only to damages *arising from a breach of contract*, and is out of context when discussing tort damages.⁷³

Finally, the *Egan* court, when dealing with the non-insurer defendants, fell into the same trap of internal inconsistency as *Gruenberg*. The plaintiff in *Egan* also sued two individuals acting as the insurer's agents. The court rejected the claim against these defendants for the very same conduct which resulted in liability of the insurance company, stating that "they are not parties to the insurance contract and not subject to the implied covenant."⁷⁴ The court ignored the fact that if the duty is truly independent, then it is irrelevant whether the defendant is a party to the contract. If the duty is absolute and independent of any contract, then it must also be imposed on an insurer's agents, as well as the company itself.

Certainly, such independent duties exist, and their breach can amount to tortious conduct, even though a contract may be at the heart of a dispute. An example that may be relevant to insurance law is the duty to refrain from the intentional infliction of emotional distress.⁷⁵ An insured might suffer a loss covered by an insurance policy, and report it to the carrier's claim service. Intentional and outrageous conduct by the claim service representatives toward the insured could result in tort liability for intentional infliction of emotional distress in a state recognizing that tort.⁷⁶ While the insurance contract in such a situation initially

duty imposed by law apart from a contract rather than a contractual duty imposed by consent. If the duty is private, created by the terms of a contract, no remedy in tort is available for its breach.

Id. at 868 (Struckmeyer, C.J., dissenting)(quoting Phoenix Professional Hockey Club, Inc. v. Hirmer, 502 P.2d 164, 165 (1972)).

⁷³ See W PROSSER, *supra* note 46, § 92 at 619-20 ("In the tort action, the only limitations are those of 'proximate cause,' whereas *Hadley v. Baxendale* limits breach of contract damages to those foreseeable.").

⁷⁴ 620 P.2d at 149.

⁷⁵ See *Craft v. Rice*, 30 KLS 6, at 2 (May 12, 1983); RESTATEMENT (SECOND) OF TORTS § 46(1) (1965). See generally W PROSSER, *supra* note 46, at 49-62.

⁷⁶ See *Green v. State Farm Fire & Cas. Co.*, 667 F.2d 22, 23-24 (9th Cir. 1982). The Ninth Circuit, applying Oregon law, affirmed the lower court's award of general and punitive damages against an insurance company for its conduct in dealing with the plaintiffs after they had filed a claim for a fire loss. The court held that the insurance adjuster's actions (which included posing as a state policeman when interviewing the plaintiff's neighbors, and threatening to charge the plaintiff with arson if the plaintiff pressed his claim) constituted the tort of outrageous conduct.

created the relationship, the duty to refrain from causing emotional distress is an independent duty imposed on everyone, without respect to the contract.

The courts have failed to enumerate precisely the elements of the tort of bad faith. A Wisconsin court, in *Anderson v. Continental Insurance Co.*,⁷⁷ has given extensive, although ultimately unsatisfactory, consideration to this problem. According to the test developed in *Anderson*, "a plaintiff must show the absence of a reasonable basis for denying benefits of the policy, and the defendant's knowledge or reckless disregard of the lack of reasonable basis for denying the claim."⁷⁸ The court held that the breach of an insurance contract can amount to an intentional tort,⁷⁹ yet undercut that holding when it stated:

[I]mplicit in that test is our conclusion that the knowledge of a lack of a reasonable basis may be inferred and imputed to an insurance company when there is a reckless disregard of a lack of a reasonable basis for denial or a reckless indifference to facts or to proofs submitted by the insured.⁸⁰

Thus, "reckless disregard" is also sufficient to trigger liability. Finally, the standard of culpability is submerged in even greater uncertainty by the frequent references to "objective standard"⁸¹ and "reasonable basis,"⁸² terms usually associated with a negligence standard. The California court in *Egan* also adopted a formula similar to a negligence standard,⁸³ its language to the contrary notwithstanding.⁸⁴ Therefore, if a court adopting this the-

⁷⁷ 271 N.W.2d 368 (Wis. 1978).

⁷⁸ *Id.* at 376.

⁷⁹ *Id.*

⁸⁰ *Id.* at 377.

⁸¹ *Id.*

⁸² *Id.*

⁸³ Under the *Egan* standard, an implied covenant of good faith and fair dealing is said to exist between insurer and insured. This implied promise imposes upon the insurer a duty not to interfere with the insured party's right to receive the benefit of the agreement. If the insurer unreasonably withholds payment, or otherwise fails to protect the insured party's interest, a breach of this duty may have occurred and the insurer may be liable in tort. See *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d at 145.

⁸⁴ The court in *Egan* spoke in contractual terms, referring to a "covenant of good faith and fair dealing." *Id.* The court also noted that there was evidence "that defendant acted maliciously, with an intent to oppress, and in conscious disregard of the rights of its insured." *Id.* at 147.

ory finds that an insurer withholds payment "unreasonably or in bad faith," or fails to exercise ordinary care in investigating plaintiff's claim, then, apparently the insurer will be held liable in tort.⁸⁵ The more skeptical critics of this reasoning have lamented that it imposes strict liability on first party insurers.⁸⁶

The adoption of the tort theory raises the question of its application to other contracts involving business relationships. A recent Montana case has expanded the tort theory to recognize a cause of action in tort for breach of an employment contract. In *Gates v. Life of Montana Insurance Co.*,⁸⁷ the Montana Supreme Court determined: "[A]n employer's breach of the covenant of good faith and fair dealing, which is implicit in the at-will employment contract, gives rise to a tort rather than a contract action, and thus punitive damages may be recovered."⁸⁸ The court indicated that while the duty which was breached arose out of the employment relation, it existed apart from, and in addition to, any terms agreed to by the parties.⁸⁹ The court reasoned that this duty is very similar to the duty to act in good faith in discharging contractual insurance obligations, and concluded that since the duty is imposed by operation of law, its breach should find a remedy in tort.⁹⁰

The prospect of such boundless expansion has significant ramifications in all areas of business. A principal element of contract law has been the economic efficiency inherent in the possession of the option to breach.⁹¹ In some instances, breaching a contract and paying contractual damages makes economic sense if performing the contract will cause substantial losses. If tort

⁸⁵ See *id.*

⁸⁶ See *Neal v. Farmer's Ins. Exch.*, 582 P.2d 980, 999 (Cal. 1978)(Clark, J., dissenting).

⁸⁷ 52 U.S.L.W. 1031 (Mont. Aug. 5, 1983). See also Granelli, *Good Times for Bad Faith*, NATL L.J., July 11, 1982 at 1, col. 1. Another case which seeks tort remedies for a breach of a business contract, *Seamen's Direct Buying Service, Inc. v. Standard Oil of California*, is currently pending in California. *Id.*

⁸⁸ 52 U.S.L.W. at 1031.

⁸⁹ *Id.*

⁹⁰ *Id.*

⁹¹ D. DOBBS, *supra* note 48, at 786 n. 1. See also Birmingham, *Breach of Contract, Damages Measures and Economic Efficiency*, 24 RUT. L. REV. 273 (1969-70).

recovery displaces contract remedies, however, such methods of conducting business will have to be reconsidered.

Despite the conceptual and logical fallacies of the tort theory, it does provide the emotionally appealing result of allowing the insured to recover fully for all conceivable yet ascertainable damages suffered as a result of the insurer's misconduct.⁹² Further, the tort theory allows the jury to punish the insurer for reprehensible conduct, presumably deterring others from engaging in similar conduct.⁹³ While the policy objective of fully compensating the wronged insured is served by the tort theory, the equally important objective of avoiding disincentives to insurers that discourage them from contesting questionable claims is concomitantly sacrificed.⁹⁴ The question remains, then, whether each policy objective may be promoted by utilizing a different theory of recovery.

B. *Contract Theory*

The Arizona Supreme Court applied the tort theory in *Sparks* with the result that the plaintiffs were allowed both consequential *and* punitive damages.⁹⁵ If the court had applied the contract theory, the Sparkses would not have received punitive damages, and might not have recovered any consequential damages.⁹⁶ Thus, for example, Kevin Sparks would not have received compensation for the subsequent physical impairment he sustained because of the lack of funds necessary to obtain medical care. Instead, the Sparkses' recovery would have been limited to that amount due under the terms of the insurance contract: insurable expenses for all medical care necessitated by an occurrence during the life of the policy.

⁹² See *Neal v. Farmer's Ins. Exch.*, 582 P.2d at 985. The court allowed compensatory damages for legal fees incurred in pre-trial arbitration and the finance charges for a second mortgage on the plaintiff's home. *Id.*

⁹³ See *id.* at 991.

⁹⁴ See *id.* at 999 (Clark, J., dissenting).

⁹⁵ See *Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d at 1132. See also text accompanying notes 7-15 *supra*.

⁹⁶ See *id.* But see D. DOBBS, *supra* note 48, at 207 & nn.14-17 ("But it is an overgeneralization to say contract breach never justifies punitive awards." In such cases, courts usually say that defendant has committed a tort as well as a breach, having violated a duty imposed by law).

The basic goal of contract damages is to put the aggrieved party in the position he would have been in had the contract been performed.⁹⁷ This is based on the theory that the non-breaching party should be given the benefit of his bargain. The general measure of damages for breach of an insurance contract is usually the amount of the contract itself, or the extent of insurable damage, whichever is less.⁹⁸ In addition to these general damages, a party may also recover special or consequential damages in a proper case.⁹⁹ Several significant obstacles must be overcome before these damages may be awarded. The damages must have been caused by the breach.¹⁰⁰ The amount of damages must be shown with some accuracy.¹⁰¹ Finally, the plaintiff must prove that such damages were contemplated by the parties at the time of the contract.¹⁰² These requirements increase substantially the difficulty of recovering consequential damages in a contract action.

The latter element, whether the damages were in the contemplation of the parties, is typically defined in terms of "foreseeability."¹⁰³ The standard for this element was first articulated in the classic case of *Hadley v. Baxendale*:¹⁰⁴

Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect of such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or 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. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants,

⁹⁷ See, e.g., D. DOBBS, *supra* note 48, at 786.

⁹⁸ See, e.g., 53 S.W.2d at 969.

⁹⁹ See D. DOBBS, *supra* note 48, at 798-99.

¹⁰⁰ *Id.*

¹⁰¹ *Id.*

¹⁰² *Id.*

¹⁰³ What is "foreseeable" in a contract case differs from what is "foreseeable" in a tort case. The former classification is more narrow. See D. DOBBS, *supra* note 48, at 804 & n.24.

¹⁰⁴ 156 Eng. Rep. at 145.

and thus known to both parties, the damages resulting from the breach of such a contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated. But, on the other hand, if these special circumstances were wholly unknown to the party breaking the contract, he, at the most, could only be supposed to have had in his contemplation the amount of injury which would arise generally, and in the great multitude of cases not affected by any special circumstances, from such a breach of contract. For, had the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages in that case; and of this advantage it would be very unjust to deprive them.¹⁰⁵

The crucial inquiry is whether this standard precludes consequential damages in breach of insurance contract cases.

The Michigan Supreme Court provided a full discussion of each side of this issue in *Kewin v. Massachusetts Mutual Life Insurance Co*¹⁰⁶ which arose from the nonpayment of benefits allegedly due under a disability insurance policy.¹⁰⁷ The court dismissed any contention that the insurer's conduct constituted a tort.¹⁰⁸ Instead, it considered whether, and under what circumstances, mental distress and exemplary damages should be recoverable as a consequence of the breach of an insurance contract.¹⁰⁹ Application of *Hadley v. Baxendale* and its progeny provided the answer.

The court noted that the general rule excluded mental distress damages in contract actions and limited damages to the monetary value of the contract.¹¹⁰ The court described insurance contracts for disability income protection as essentially agreements to pay money upon the occurrence of a specified event;¹¹¹ thus, they are

¹⁰⁵ *Id.* at 151.

¹⁰⁶ 295 N.W.2d 50 (Mich. 1980).

¹⁰⁷ *Id.* at 51.

¹⁰⁸ *Id.* at 56.

¹⁰⁹ *Id.* at 52. The court stated, "Just as with [the rationale] denying damages for mental distress, the theory underlying the denial of exemplary damages in breach of contract cases is that the plaintiff is adequately compensated when damages are awarded by reference only to the terms of the contract." *Id.* at 55.

¹¹⁰ *Id.* at 53.

¹¹¹ *Id.*

commercial in nature and mental distress arising from a breach was not contemplated or foreseeable.

The *Kewin* majority considered an exception to the general rule recognized in *Stewart v. Rudner*.¹¹² In *Stewart* the plaintiff sued a doctor for breach of a contract to deliver the plaintiff's child by Caesarean section. The plaintiff alleged that the breach of the contract caused her child to be stillborn, and she sought damages for the resulting emotional distress.¹¹³ The Michigan Supreme Court framed an exception allowing damages for mental distress when a contract is breached:

When we have a contract concerned not with trade and commerce but with life and death, not with profit but with elements of personality, not with pecuniary aggrandizement but with matters of mental concern and solicitude, then a breach of duty with respect to such contracts will inevitably and necessarily result in mental anguish, pain and suffering. In such cases, the parties may reasonably be said to have contracted with reference to the payment of damages therefore in event of breach. Far from being outside the contemplation of the parties they are an integral and inseparable part of it.¹¹⁴

This commercial/personal distinction articulated in *Stewart* is merely an application of the generally accepted foreseeability analysis.¹¹⁵ The inquiry, focuses on the characterization of the contract: whether it is primarily personal or primarily commercial.¹¹⁶ This distinction is simply a method of expressing a conclusion as to whether emotional distress was a foreseeable result of the contract breach. It simply reflects the conclusion of the *Hadley v. Baxendale* analysis. A majority of the court in *Kewin* held that a disability insurance policy was commercial in nature, and mental anguish damages were therefore barred as too remote.¹¹⁷ Additionally, because the suit was for breach of contract, the court

¹¹² 84 N.W.2d 816 (Mich. 1957).

¹¹³ *Id.* at 821.

¹¹⁴ *Id.* at 824.

¹¹⁵ See text accompanying notes 97-105 *supra*.

¹¹⁶ See *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d at 53. See also 295 N.W.2d at 57 (Williams, J., concurring in part and dissenting in part).

¹¹⁷ See 295 N.W.2d at 53-55.

did not allow punitive or exemplary damages.¹¹⁸ This holding is representative of the analysis accorded in first party cases by courts adhering to the traditional contract theory.

One justice stated in a separate opinion that the court should have allowed emotional distress as consequential damages in *Kewin*.¹¹⁹ Justice Williams noted several examples of contracts which were deemed to be "personal": "[C]ontracts to marry, contracts between carriers and passengers, contracts of innkeepers and guests, contracts for the disposition of dead bodies, contracts for the delivery of death messages, contracts for public entertainment or amusement, and contracts to provide care, room, and board."¹²⁰ Justice Williams concluded that disability insurance contracts are personal in nature, and therefore mental anguish was a proper item of recovery upon breach.¹²¹ After citing several cases in which various types of first party insurance contracts are labelled as personal, Justice Williams determined that contracts for disability insurance are personal in nature because the insurer is selling and the insured is buying peace of mind.¹²² He stated: "[I]t is elemental that an insured is basically contracting for both financial and emotional security in the event of loss."¹²³ The Justice presumed that disability insurers contemplate

¹¹⁸ *Id.* at 55.

¹¹⁹ 295 N.W.2d at 57 (Williams, J., concurring in part and dissenting in part).

¹²⁰ *Id.* at 62 (Williams, J., concurring in part and dissenting in part)(citations omitted). Justice Williams quoted from the RESTATEMENT (SECOND) OF CONTRACTS § 367 comment a (Tentative Draft No. 14, 1979):

In the second exceptional situation [to the general rule that recovery for emotional disturbance is not available in breach of contract actions], the contract or the breach is of such a kind that serious emotional disturbance was a particularly likely result. Common examples are contracts of carriers and innkeepers with passengers and guests, contracts for the carriage or proper disposition of dead bodies, and contracts for the delivery of messages concerning death. Breach of such a contract is particularly likely to cause serious emotional disturbance. *Breach of other types of contracts, resulting for example in sudden impoverishment or bankruptcy, may by chance cause even more severe emotional disturbance, but, if the contract is not one where this was a particularly likely risk, there is no recovery for such disturbance.*

Id. at 61-62 n.6 (emphasis in original)(This language was adopted in the final version of the Restatement. See RESTATEMENT (SECOND) OF CONTRACTS § 353 comment a (1979)).

¹²¹ *Id.* at 69.

¹²² *Id.*

¹²³ *Id.*

emotional distress as a consequence of breach at the time a policy is issued.¹²⁴ Under this theory, once a breach of the insurance contract has been established, and the contract is characterized as personal, damages for mental anguish will flow if there is proof of the distress.¹²⁵ Given the nature of insurance, this view is not unreasonable since the assumption that people desire to procure peace of mind by purchasing insurance seems to be accurate.

Significantly, the quality of the breach is not relevant under this reasoning. In other words, distinctions of good faith and bad faith have no meaning since the emotional distress and other consequential damages are merely contract damages. Contract law, being amoral,¹²⁶ does not inquire into the defendant's state of mind at the time of the breach. An unintentional breach of contract causes the same damages as an intentional or bad faith breach.¹²⁷ While punitive damages are unavailable under this theory, a wide array of consequential damages could be awarded. The consequential damages would not be limited to emotional distress; indeed, emotional distress might be among the more difficult consequential damages to prove.¹²⁸ If a credit life insurer were to breach its contract, however, the insured might well claim and recover damages from an ensuing foreclosure. Liability would be predicated on a determination that such damages were reasonably foreseeable or, at the time of the contract, in the contemplation of the parties. The breach of a health insurance contract, as in *Sparks*, may result in foreseeable consequences such as medical complications arising from the lack of funds for necessary treatment.¹²⁹ Thus, the contract theory, applied in the manner suggested by Justice Williams, provides adequate compensation to the insured.

¹²⁴ *Id.*

¹²⁵ *See id.*

¹²⁶ *Cf.* Birmingham, *supra* note 90, at 292 ("protection of the [aggrieved party's] expectation interest is [adequately] dictated by considerations of economic efficiency [without the necessity of considering morality]").

¹²⁷ *See* 295 N.W.2d at 55.

¹²⁸ *See* J.A. STEIN, DAMAGES AND RECOVERY, at § 31 (1972)(observing the "difficulty of assessing the proof [because it] is largely in the exclusive control of the plaintiff").

¹²⁹ *See Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d at 1131-32.

II. KENTUCKY CASE LAW

First party bad faith is becoming a fertile area for litigation in jurisdictions throughout the country. Although the tort theory is gaining widespread acceptance,¹³⁰ many courts nonetheless continue to adhere to the traditional contract analysis when confronted with a first party bad faith claim by an insured.¹³¹ Prior to *Feathers v. State Farm Fire & Casualty Co.*,¹³² the Kentucky courts seemed firmly settled in the contract camp. The Sparkses would probably have been limited to recovery solely under the terms of the contract under traditional Kentucky law. If *Feathers* becomes the established law of the jurisdiction, however, the Sparkses of Kentucky may seek virtually unlimited damages.

A. *Pre-Feathers Case Law*

Until *Feathers*, Kentucky courts uniformly held that damages for breach of a first party insurance policy were limited to the amount due under the contract.¹³³ This limitation was accomplished under the familiar rubric of contract law *Clark v. Life and Casualty Insurance Co.*¹³⁴ provides a good example of the application of this rule and illustrates its longevity. In *Clark*, the plaintiff had procured a life insurance policy for his wife. Upon her death, the insurer refused to pay \$162, the amount due under the policy, claiming that no premiums had been paid. The plaintiff alleged that he had purchased the policy to defray the expenses of his wife's burial, and that, after learning of the insurer's refusal to pay, the undertaker refused to extend credit.¹³⁵ As a result, plaintiff claimed that he "was compelled to beg and borrow from friends and acquaintances whatever amounts he could in order to produce the required fund to properly bury his wife, and that

¹³⁰ See notes 4-5 *supra* for cases accepting the tort theory.

¹³¹ See note 3 *supra* for cases accepting the contract analysis.

¹³² No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983).

¹³³ See, e.g., *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d 685, 687 (Ky. 1966); *Clark v. Life & Casualty Ins. Co.*, 53 S.W.2d 968, 969 (Ky. 1932); *Deaton v. Allstate Ins. Co.*, 548 S.W.2d 162, 164-65 (Ky. Ct. App. 1977).

¹³⁴ 53 S.W.2d at 968.

¹³⁵ *Id.* at 969.

he was thereby caused great humiliation and suffering, both mentally and physically," and he sought \$5,000 in damages.¹³⁶ *Clark* presents the classic first party situation in which the insured, presenting very sympathetic facts, claims that the insurer's unreasonable acts have caused damages far in excess of the amount provided for in the insurance contract. These apparently unanticipated damages in *Clark* are analogous to those in *Sparks*.¹³⁷

In *Clark*, the Court of Appeals of Kentucky treated the insurance policy as merely a commercial contract,¹³⁸ noting: "[T]he measure of recovery for the failure to pay money [on a life insurance policy] is the amount agreed to be paid with legal interest."¹³⁹ Utilizing this general measure of damages, the Court rejected plaintiff's claim for damages for mental distress.¹⁴⁰ Although decided in 1932, the *Clark* approach has been the beginning and end of the analysis for Kentucky courts until *Feathers*. After labeling a case as one in contract, the courts have simply applied the general measure of damages and rather mechanically disallowed consequential damages.¹⁴¹

¹³⁶ *Id.*

¹³⁷ *Id.*. The Court noted in its preliminary discussion: "There are many classes of cases where consequential damages may be recovered for the violation of a contract, when such recovery may be considered as fairly within the contemplation of the parties as proximately flowing from the breach." *Id.* This passage merely restates the *Hadley v. Baxendale* rule limiting recovery of consequential damages for breach of contract. See note 105 *supra* and accompanying text.

¹³⁸ 53 S.W.2d at 969.

¹³⁹ *Id.*

¹⁴⁰ *Id.* at 970. The Court did not reach the question whether the carrier's failure to pay was justified. Once the claim for consequential damages was eliminated, the amount in controversy fell below the Court's jurisdictional requirement, and the case was dismissed on that ground. *Id.*

¹⁴¹ See, e.g., *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d at 685. *But see* *Motors Insurance Corp. v. Jackson*, 340 S.W.2d 610 (Ky. 1960). In *Jackson*, the Court of Appeals intimated that a more thorough analysis might be in order. The plaintiff had purchased a truck for use in his business. The truck was damaged in an accident, and, after investigation, the insurer notified the plaintiff that it considered the policy cancelled *ab initio*, citing alleged false representations made by the insured. The complaint alleged that the cancellation was wrongful, and resulted in the repossession of the vehicle. The plaintiff sought damages for the loss of the use of the truck and lost profits resulting from the repossession. Curiously, the Court labelled the case as "[a]n action on a contract sounding in tort." *Id.* at 611. The Court did not expand on this characterization since it found the evidence of consequential damages too indefinite to support the claim. *Id.* at 612.

While *Jackson* seemed to leave the door open for a hybrid action merging tort and contract, *Judd* rejected any notion that such an action could be maintained. Recognizing

*General Accident Fire & Life Assurance Corp. v. Judd*¹⁴² is a more recent example of this line of reasoning in Kentucky. *Judd* concerned a claim by an automobile owner under the collision coverage of her automobile insurance policy. After the insured automobile was badly damaged in an accident, the insured and the carrier could not agree on an estimate of the cost necessary to repair the car. The insured sued, demanding not only recovery for the reduction in value caused by the damage, but also storage costs and damages for lost use of the automobile. In an argument that presaged *Feathers*, plaintiff claimed that her action "sound[ed]" in both tort and contract.¹⁴³ Thus, only the amount due under the policy was recoverable. The Court, however, characterized the suit as nothing more than one for breach of a contract to pay money.¹⁴⁴ Citing *Clark*, the Court noted that the traditional measure of damages for a breach of such a contract is the amount due under the policy,¹⁴⁵ and concluded with a reminder that punitive damages are not allowed for a breach of contract.

The more recent case of *Deaton v. Allstate Insurance Co.*¹⁴⁶ acknowledged the continued validity of this rule. Because *Deaton* was decided after other jurisdictions¹⁴⁷ had begun to adopt the tort theory in cases of first party bad faith, the issues are more sharply focused. *Deaton* involved an automobile accident in which one of the plaintiffs' children was killed, and the other seriously injured.¹⁴⁸ The plaintiffs asserted a claim against the insurance company under their uninsured motorist coverage. They stated their action in tort, claiming that the insurer was guilty of bad faith in failing to pay promptly under the policy, and that the bad faith constituted a tort. Citing *Judd*, the court characterized

the uncertainty created by *Jackson*, the *Judd* Court construed *Jackson* to be in accord with the general rule, thereby foreclosing recovery beyond the contract amount. See *General Accident Fire & Life Assurance Corp. v. Judd*, 400 S.W.2d at 687-88.

¹⁴² 400 S.W.2d at 685.

¹⁴³ *Id.* at 687.

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* The Court concluded with a reminder that punitive damages are not allowed for a breach of contract. *Id.* at 688.

¹⁴⁶ 548 S.W.2d 162 (Ky. Ct. App. 1977).

¹⁴⁷ See, e.g., *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973).

¹⁴⁸ 548 S.W.2d at 163.

the case as a simple breach of contract action.¹⁴⁹ The court then applied the general measure of damages, limiting recovery to the amount due according to the terms of the contract.¹⁵⁰ The court clearly indicated that it considered first party cases to give rise to a breach of contract action only, and, significantly, left little doubt that it considered a claim under an uninsured motorist policy as a first party action.¹⁵¹

Before evaluating the traditional Kentucky rule, the factual contexts in which these first party cases have arisen should be noted. In particular, *Judd* and *Deaton* contained no evidence of any egregious behavior on the part of the insurer.¹⁵² Furthermore, the kind of tragic circumstances which are compounded by the termination of coverage, as so poignantly illustrated by *Sparks*,¹⁵³ cannot be found in the reported decisions of Kentucky. The failure of these two factors to appear in concert is the most compelling explanation of the longevity of the strict Kentucky rule.

A mechanical application of this traditional rule has several advantages. Awards are limited to the maximum amount stated by the contract, with the apparent consequences that insurance underwriting will be more accurate.¹⁵⁴ Obviously, recoveries will generally be lower, and, theoretically at least, the savings are passed on to consumers.¹⁵⁵ In addition, insurance carriers are encouraged to defend questionable cases and to raise all valid defenses, without fear of excessive jury verdicts. Again, lower premiums should be the result. The traditional rule also has the

¹⁴⁹ *Id.* at 164. The court stated: "A first party claim [as in the present case] gives rise to a contract action. Although appellants allege that this is a tort action, this court is of the opinion that this is a breach of contract action." *Id.*

¹⁵⁰ *Id.*

¹⁵¹ *Id.* Cf. *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983)(distinguishing uninsured motorist policy actions and first party actions). See text accompanying notes 170-78 *infra*.

¹⁵² Cf. *Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d 1127, 1131 (Ariz. 1982) (insurer's refusal to pay for timely medical treatment resulted in five-year old child becoming a paraplegic).

¹⁵³ See *id.*

¹⁵⁴ The insurer is able to predict his potential maximum liability by simple reference to the policy limits.

¹⁵⁵ See *Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 999 (Cal. 1978)(Clark, J., dissenting).

commendable characteristic of being consistent with the fundamental principles of tort and contract.¹⁵⁶

The traditional rule has significant disadvantages, however. The rule provides no disincentive to deter insurance companies from unreasonably denying or delaying the payment of valid claims. Indeed, the rule seems to have the opposite effect. In addition, recovery that is always limited to the contract amount may provide inadequate compensation for damages suffered by the victim as a consequence of "bad faith." An example helps to illustrate the abuses permitted by the traditional rule. Assume that an insured's house burns down, with a proven loss of \$50,000, and that the homeowner has insurance for such a loss. Even though no substantial defenses are available, the insurer has little to lose in denying or delaying payment. The only added costs to the carrier are its own legal fees, and interest at the legal rate, assuming the insured sues.¹⁵⁷ On the other hand, the company might prevail on an apparently unmeritorious defense. More likely, the insured will probably accept a settlement for much less than the true value of his claim, simply because he needs the money *now*, in order to provide housing for his family. In effect, the insurance carrier can hold the insured's recovery hostage, demanding as ransom a favorable settlement, with little or no attendant risk. The strength of this leverage is obviously significant.¹⁵⁸

As this scenario illustrates, bad faith is not deterred, extorted settlements are allowed, and perhaps encouraged, and the insured,

¹⁵⁶ See text accompanying notes 30-129 *supra*.

¹⁵⁷ 400 S.W.2d at 687. The current legal rate of interest in Kentucky is 8%, and it seems certain that an insurance company will invest at a substantially higher rate. KRS § 360.010 (Bobbs-Merrill Cum. Supp. 1980).

¹⁵⁸ See *Neal v. Farmers Ins. Exch.*, 582 P.2d at 999 (Clark, J., dissenting). The relative power of the insurers' position has been recognized by some insurance carriers. In *Neal*, the court quoted the following section of the defendant's manual for claims representatives:

It is important for the claims representative to learn how to sense opportune times for settlement. This will apply whether or not the claimant is represented by an attorney. Such things as a marriage or death in the family, the purchase of a home or automobile will present the ordinary claimant with a financial situation which will suggest to him the admissability of getting his money out of his claim. If the injury is such that settlement may be tactfully approached, the claims representative should follow through with appropriate discussion.

582 P.2d at 987 n.8.

as a matter of reality, does not get the benefit of his bargain. The effect on the insured may be disastrous.¹⁵⁹ If the insurer is not deterred from lengthy delays, the compensation may reach the insured too late to avoid the unfortunate consequences which prompted him to purchase insurance in the first place. Thus, the prevailing rule is marred with substantial defects, and a move to a more effective approach has seemed inevitable for some time. Whether *Feathers* is in fact a more effective approach is debatable.

B. *The Tort Theory and Feathers v State Farm Insurance*

The Kentucky Court of Appeals recently brushed *Judd* and *Deaton* aside, holding that when an insurer wrongfully withholds payment of first party proceeds, its conduct is tortious and entitles the insured to recover consequential and punitive damages.¹⁶⁰ With this ruling, the court of appeals has attempted to align Kentucky with a growing number of jurisdictions which recognize a cause of action in tort against an insurance company which wrongfully refuses to pay claims under first party policies.¹⁶¹ The ultimate effect of *Feathers* as precedent is not clear, however, due to the peculiar procedural circumstances surrounding the case.¹⁶²

¹⁵⁹ See, e.g., text accompanying notes 7-15 *supra*.

¹⁶⁰ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983) reported in 30 KY. L. SUMM. 9, at 7-8. [hereinafter cited as KLS].

¹⁶¹ See notes 30-93 and accompanying text *supra*. See also Granelli, *supra* note 5, at 1.

¹⁶² After the trial court dismissed the case, the plaintiffs appealed to the Kentucky Court of Appeals, setting in motion a bizarre sequence of events. The parties presented oral arguments to a panel composed of Judges McDonald, Hayes, and Cooper. After oral argument, the parties agreed to settle the dispute, and entered into a formal agreement resolving all issues on July 8, 1983. Motion for Reconsideration at 1, *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR (Ky. Ct. App. Aug. 5, 1983)[hereinafter cited as Motion]. The parties filed an agreed order of dismissal with prejudice in the trial court, *Id.* at 1, and a joint motion to dismiss the appeal with prejudice and to strike it from the docket of the court of appeals. *Id.* at 2. The court clerk received the joint motion on July 18, 1983. *Id.* The next day, the trial court entered the agreed order and dismissed with prejudice all claims raised by the complaint. *Id.* Thus, under usual standards of practice, the issue before the Kentucky Court of Appeals had become moot.

One week after the notice of settlement had been received, the court of appeals, through Judge McDonald, rendered an opinion reversing the trial court's dismissal of the tort claim. No. 83-CA-158-MR, slip op. at 8. Five days later, the court denied the parties' joint motion to dismiss, stating that the court had rendered its opinion. Motion at 2. The

The case began when the home of Arthur and Mary Jane Feathers was destroyed by fire. State Farm Fire and Casualty Co. insured the home against fire, but declined payment alleging that the proof of loss filed by the insured contained misrepresentations.¹⁶³ The Feathers claimed that State Farm's refusal to pay constituted a breach of the duty to act in good faith, and sought damages for "acute anxiety and mental suffering, and loss of consortium," in addition to the amount due under the contract.¹⁶⁴ In answer, State Farm denied bad faith, citing its reasonable belief that the home was destroyed as the result of the Feathers' arson. The trial court granted State Farm's motion for judgment on the

decision has been published in *Kentucky Law Summary* (30 KLS 9, at 8) and is designated to be published in the official reporter unless further action is taken. See KY. R. CIV. P. 76.28(4)(a)[hereinafter cited as CR]. State Farm has filed a petition for rehearing seeking only to have the opinion withdrawn and an order of dismissal entered. If the petition is not granted, the possibility of an appeal to the Kentucky Supreme Court remains, but the issue may not be appealable because the underlying case is moot. Meanwhile, the panel of the court of appeals has issued an opinion of uncertain authority that threatens to alter drastically previous practices of the insurance industry and bar of Kentucky. Regardless of the ultimate status of *Feathers*, its inevitable offspring must force consideration of the issue by the Kentucky Supreme Court in the near future.

Interestingly, Judge McDonald also authored *Craft v. Rice*, No. 82-CA-1346-MR (Ky. Ct. App. Apr. 22, 1983), reported in 30 KLS 6, at 2, which recognized the intentional tort of outrage. In *Craft*, Judge McDonald, citing *Reed v. Maley*, 74 S.W. 1079 (Ky. 1903) and *Browning v. Browning*, 584 S.W.2d 406 (Ky. Ct. App. 1979), stated that in light of the new tort of outrage "the conduct described as non-actionable in *Reed* and *Browning*, one a sexual intercourse solicitation and the latter an intentional infliction of emotional injury, is now subject to re-examination." *Craft v. Rice*, No. 82-CA-1346-MR, slip op. at 8-9. Both *Reed* and *Browning* require a finding of "impact" before a plaintiff may recover damages for emotional distress. *Reed v. Maley*, 74 S.W. at 1080; *Browning v. Browning*, 584 S.W.2d at 408.

In light of the *Feathers* and *Craft* opinions, both authored by Judge McDonald, it seems that the court of appeals has embarked on a re-examination of Kentucky tort law. Perhaps the impact rule will be the next issue chosen for re-examination.

¹⁶³ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 1-3. State Farm's answer admitted a duty to act in good faith, but argued that:

[T]he fire gives rise to the reasonable belief that said fire was the result of arson and that [the plaintiffs] or one of them with the knowledge of the other, burned or procured the burning of the dwelling house referred to in Plaintiffs' complaint. Said intentional burning of said dwelling house constituted fraud and voided the above-mentioned policy of insurance.

Id. at 2.

¹⁶⁴ *Id.*

pleadings and dismissed the case,¹⁶⁵ but the court of appeals reversed.¹⁶⁶

The Court of Appeals of Kentucky attempted to distinguish the prior Kentucky first party cases that would otherwise have controlled the result in *Feathers*,¹⁶⁷ and adopted the tort theory, citing *Gruenberg*.¹⁶⁸ Unfortunately, the court's attempted distinctions of *Judd* and *Deaton* are not persuasive. Indeed, the *Feathers* holding implicitly overrules those cases.

Although both plaintiffs and defendant agreed at oral argument that the case was controlled by *Deaton*,¹⁶⁹ with the plaintiffs asking the court to overrule that case, the *Feathers* court distinguished *Deaton* on the ground that it involved uninsured motorist coverage.¹⁷⁰ The court stated: "[I]n *Deaton*, we have no pure first party action because it was an action on contract founded in tort. The uninsured motorist coverage provided that the company would pay to the insured legal damages that the uninsured motorist was obligated to pay."¹⁷¹ This distinction in types of insurance coverage, however, does not justify different treatment with respect to the duties owed by the insurer to the insured. In both instances, the insurance company is obligated to make payment in good faith directly to the insured under the terms of the contract.

Other courts have had no difficulty in applying the same rule to both first party cases and uninsured motorist cases. For example, the California Supreme Court applied the *Gruenberg* rule to an uninsured motorist claim, when the situation was presented in *Neal v. Farmers Insurance Exchange*.¹⁷² *Neal* did not suggest that uninsured motorist claims are to be treated differently than any other first party claim. Instead, the court held that an insurer commits the tort of first party bad faith when it breaches the du-

¹⁶⁵ *Id.* at 3.

¹⁶⁶ *Id.*

¹⁶⁷ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 5-7.

¹⁶⁸ *See id.* at 7-8. *See also* text accompanying notes 30-46 *supra*.

¹⁶⁹ *Id.* at 5.

¹⁷⁰ *Id.* at 5-6.

¹⁷¹ *Id.* at 6.

¹⁷² 582 P.2d at 980, 985-86.

ty¹⁷³ to deal fairly with its insured. Moreover, *Gruenberg* itself relied on *Richardson v. Employers' Liability Assurance Corp.*,¹⁷⁴ another uninsured motorist case.¹⁷⁵

The United States Court of Appeals for the Seventh Circuit, in *Craft v. Economy Fire & Casualty Co.*,¹⁷⁶ has also considered whether uninsured motorist insurance claims are distinguishable from other first party coverage cases. Although Indiana law had implied the existence of the duty of good faith with regard to fire and life insurance, *Economy*, being sued for breach of this duty, argued that uninsured motorist coverage was materially different and therefore the duty did not apply.¹⁷⁷ The Seventh Circuit rejected this contention, and held that uninsured motorist coverage should be treated just as other first party insurance.¹⁷⁸

The Kentucky Court of Appeals distinguished *Feathers* from the cases of *Deaton* and *Judd* on an additional ground.¹⁷⁹ The court in *Deaton* had stated: "[A]lthough appellants allege that this is a tort action, this court is of the opinion that this is a breach of contract action."¹⁸⁰ Likewise, the *Judd* Court labeled the action before it as one for breach of contract.¹⁸¹ The court in *Feathers* summarily distinguished *Judd* and *Deaton*: "[W]e conclude the converse: we have a tort action."¹⁸²

¹⁷³ *Id.* Although the facts of *Neal* concerned an uninsured motorist's policy, the court held:

In the so-called "third party" situation, of which *Comunale* and *Crisci* are representative, the breach of duty may have as its proximate result the entry of a judgment in excess of policy limits against the insured. In a situation such as that before us, which the parties hereto are pleased to term a "first party" situation, the injuries of the plaintiff, being sustained prior to the alleged breach, cannot be a proximate result of that breach, and therefore cannot serve as a proper measure of damages.

Id. at 988. Thus, the court accepted the parties' characterization of this action as first party bad faith.

¹⁷⁴ 102 Cal. Rptr. 547 (Cal. Ct. App. 1972).

¹⁷⁵ *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1037

¹⁷⁶ 572 F.2d 565 (7th Cir. 1978)(applying Indiana law).

¹⁷⁷ *Id.* at 567.

¹⁷⁸ *Id.* at 570.

¹⁷⁹ See *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 7.

¹⁸⁰ *Deaton v. Allstate Ins. Co.*, 548 S.W.2d at 164.

¹⁸¹ 400 S.W.2d at 687.

¹⁸² No. 83-CA-158-MR, slip op. at 7.

This conclusory reasoning begs the question. The issue for decision is whether the action is one in tort or contract. *Judd* and *Deaton* implicitly found that no independent duty owed to the insured was violated, and thus limited the remedies to those available in contract. Despite the assertions of the court of appeals, these holdings are inconsistent with the new rule announced in *Feathers*.¹⁸³

Unfortunately, *Feathers* fails to articulate satisfactorily the independent duty necessary to find a tort. In fact, the court scarcely referred to this critical issue, relegating it to the last page of the opinion, where it stated:

Nevertheless, once the policyholder has substantially complied with and performed the terms and conditions required by the policy, then at that point the insurance company becomes akin to a fiduciary as to the sums owed under the policy. The proceeds of the policy may not be withheld unless there is a substantial breach of the contract by the policyholder. We simply say that if State Farm was not justified in its actions, then its conduct was tortious against the policyholder for which consequential and punitive damages may be presented to the fact finder.¹⁸⁴

The court dealt with the requisite of an independent duty in cursory fashion with the conclusory statement that the company becomes "akin to a fiduciary."¹⁸⁵ Apparently, the court held that this transformation occurs whenever the policyholder has complied with the terms and conditions of the policy. Of course, when an insurance company denies payment it is alleging that the policyholder has *not* complied with the terms and conditions necessary for payment. Under this rationale if the company is ultimately judged to have been incorrect, it is not simply in breach of contract; rather, it has committed a tort. The literal language of the opinion does not require intent or subjective bad faith as

¹⁸³ The court of appeals was compelled to find some method to distinguish *Judd*, even an artificial one, since *Judd* was issued from Kentucky's highest court. See *id.* at 6-7. *Deaton*, a case that seems identical to *Feathers*, may have been distinguished, rather than overruled, because a member of the *Feathers* panel, Chief Judge Hayes, authored *Deaton*.

¹⁸⁴ *Id.* at 8,

¹⁸⁵ *Id.*

an element of the tort. This brief passage may ultimately prove to be judicial quicksand, for if the quality of conduct has no relevance to the issue of liability, the court has created something akin to strict liability.¹⁸⁶ Surely the court did not intend this result, but it is the only reasonable construction of the language employed.

The court in *Feathers* stated that if State Farm was not justified in declining payment then its conduct was tortious.¹⁸⁷ In essence, the court held that to determine if a tort has been committed, one must look to the contract; if the contract did not justify State Farm's actions, it committed a tort. This reasoning cannot be reconciled with fundamental principles of tort law. If the actions truly constitute a tort, reference to the contract should be unnecessary. To have a tort, a duty that arises independently of the contract must be breached.¹⁸⁸ If the duty breached is independent of the contract, one need not refer to the contract to measure the actions. If State Farm was not justified in its actions, then its conduct was in breach of contract, but it cannot correctly be considered tortious simply because it was not justified under the policy.

Despite the conceptual infirmities of the *Gruenberg/Feathers* rule, it does promote desirable public policy objectives. Certainly, this rule maximizes the deterrence of bad faith. Moreover, this rule fully compensates the mistreated insured for all injuries. However, the disadvantages greatly outweigh the advantages of the tort theory of recovery. The theory is simply conceptually unsound. When the courts convert contract actions into tort actions simply by describing the transaction as a breach of a "fiduciary duty," the certainty of the law is sacrificed. Separating insurance contracts from other consensual relationships will be increasingly difficult, and tort recoveries for breach of contract will have undesirable policy ramifications.¹⁸⁹

Furthermore, the tort theory of recovery does little to protect insurers from the natural prejudice of juries. First party bad faith

¹⁸⁶ See *Neal v. Farmer's Ins. Exch.*, 582 P.2d 980, 999 (Cal. 1978)(Clark, J., dissenting).

¹⁸⁷ No. 83-CA-158-MR, slip op. at 8.

¹⁸⁸ W PROSSER, *supra* note 45, at 143. RESTATEMENT (SECOND) OF TORTS § 281a (1965). See also text accompanying notes 45-53 *supra*.

¹⁸⁹ See text accompanying notes 76-94 *supra*.

cases have resulted in extremely high punitive damage awards.¹⁹⁰ The *Sparks* case resulted in three million dollars in punitive damages.¹⁹¹ Although the award may not seem excessive in view of the suffering of the Sparks family, it must be recalled that punitive damages are in no way compensatory and should only be awarded to punish and deter egregious conduct.¹⁹² In *Sparks*, the insurer did not directly cause the injuries, but only refused to pay for their treatment because it felt it had a reasonable and valid defense.¹⁹³

*Egan v. Mutual of Omaha Insurance Co.*¹⁹⁴ provides another example of an excessive punitive damage award. In that case, the jury returned a verdict for \$45,600 in general damages and \$78,000 for emotional distress.¹⁹⁵ The jury also awarded the plaintiff five million dollars in punitive damages.¹⁹⁶ The fact that the court vacated this award as excessive is unlikely to comfort insurers facing similar allegations. In *Neal*, the dissent noted that these huge punitive damage awards are simply passed on to the premium paying public.¹⁹⁷ They are, in effect, a publicly subsidized windfall to the plaintiff.¹⁹⁸

The spectre of seven figure punitive damage awards will no doubt lead insurance carriers to avoid the risk of an adverse verdict, and to forego defense of at least some possibly meritorious claims. Again, the added cost will be passed on to the public.¹⁹⁹ These shortcomings of the tort theory of recovery counsel closer examination of the alternatives, as matters of both law and policy

C. *A Proposed Common Law Theory*

According to the prevailing rule in Kentucky prior to *Feathers*, a first party bad faith case is no more than a breach of contract

¹⁹⁰ See Granelli, *Good Times For Bad Faith*, Nat'l L.J., July 11, 1982, at 11, col. 2.

¹⁹¹ *Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d at 1132.

¹⁹² See, e.g., RESTATEMENT (SECOND) OF TORTS § 908 (1965). See also D. DOBBS, note 48 *supra* at 204-05.

¹⁹³ 647 P.2d at 1132.

¹⁹⁴ 620 P.2d 141 (Cal. 1979).

¹⁹⁵ *Id.*

¹⁹⁶ *Id.* at 144.

¹⁹⁷ *Neal v. Farmer's Ins. Exch.*, 582 P.2d at 999 (Clark, J., dissenting).

¹⁹⁸ See *id.*

¹⁹⁹ See *id.*

claim.²⁰⁰ After determining that the action is one for breach of contract, Kentucky courts have applied the traditional measure of damages: the money owed under the contract plus interest.²⁰¹ However, limiting damages to this amount is not preordained by general principles of damages. While the courts have failed to consider what, if any, consequential damages should be allowed in addition to the money owed under the contract, extra-contractual damages may be allowed for breach of a first party insurance contract in a manner consistent with existing Kentucky case law. These damages would include, in a proper case, awards for mental anguish as well as damages for injury to pecuniary interests. Not only could the allowance of such damages be rationalized under existing Kentucky common law, but the theory is consistent with fundamental principles of contract law

Kentucky adheres to the universal rule of foreseeability descended from *Hadley v. Baxendale*,²⁰² that, on proof of breach, the plaintiff in a contract action is entitled to "all such damages as arise naturally from the breach of the rights which that contract was contemplated to assure."²⁰³ Proper analysis must consider whether the *Hadley v. Baxendale* rule precludes consequential damages in breach of insurance contract cases.

Interestingly, *Feathers* gives strong hint of adopting a personal/commercial contract distinction that would facilitate foreseeability analysis. Unfortunately, the court failed to continue this line of reasoning and instead adopted the *Gruenberg* cause of action in tort.²⁰⁴ In discussing the nature of the homeowner's insurance contract before it, the *Feathers* court stated:

In our opinion, the homeowner's fire policy is unique. We are not dealing with the purchase and sale of a box of shoe laces. The purchaser of a fire insurance policy is *buying peace of mind* and a cushion to help himself in the event his home is damaged or destroyed. He is usually economically devastated after a fire

²⁰⁰ See, e.g., *Clark v. Life & Casualty Ins. Co.*, 53 S.W.2d at 969.

²⁰¹ See *id.*

²⁰² 156 Eng. Rep. 145 (1854).

²⁰³ *Graves v. Winer*, 351 S.W.2d 193, 196 (Ky. 1961)(quoting OLECK, DAMAGES TO PERSONS AND PROPERTY § 85, at 73-74 (Rev. ed. 1957)).

²⁰⁴ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 7-8.

and may have no source of money to replace what he has lost other than the proceeds of the insurance policy he has purchased and relied upon.²⁰⁵

Apparently, the *Feathers* court was tempted to distinguish first party insurance contracts from everyday commercial agreements. The court noted that the policyholder is purchasing peace of mind, and describes what the *Kewin* dissent would characterize as a personal contract.²⁰⁶ The court could have easily continued in that vein, and found that the homeowner's policy was personal in nature. Under the *Hadley* rule the damages claimed for mental anguish were foreseeable, and thus recoverable. From a conceptual standpoint, an award of damages on this basis would have been much more palatable than the alchemy involved in transforming the breach of contract into a tort action.

Kentucky case law provides support for utilizing the personal/commercial contract distinction as a basis for the award of consequential damages. For example, in *Postal Telegraph Cable Co. v. Terrell*,²⁰⁷ the plaintiff, Mrs. Lou Terrell, was traveling by train from Louisville to visit her father in Memphis, Tennessee. The train was to arrive in Memphis late at night. That evening, Mrs. Terrell's husband sent her father a telegram to advise him of his daughter's impending arrival, intending that he meet her at the station. The telegram reached Memphis in due course but for some unexplained reason was not delivered to Mrs. Terrell's father.²⁰⁸ As a result, upon her arrival in the Memphis station at 2:00 a.m., she had no means of transportation to her father's home, about three miles away. Traveling with her were her two children, ages three and one.²⁰⁹ Mrs. Terrell testified that "there were men dressed very rough in overalls with trousers tucked in their boots, lying on the floor of the depot, and that she was worried and frightened, and suffered mental anguish by having to remain there

²⁰⁵ *Id.* at 7 (emphasis added).

²⁰⁶ Compare No. 83-CA-158-MR, slip op. at 7 with *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d at 69-70 (Williams, J., concurring in part, dissenting in part). See also text accompanying notes 106-29 *supra*.

²⁰⁷ 100 S.W. 292 (Ky. 1907).

²⁰⁸ *Id.*

²⁰⁹ *Id.* at 292-93.

until morning.”²¹⁰ Plaintiff sued for breach of the contract to deliver the telegram, and the jury returned a verdict for plaintiff in the sum of \$500, which included damages for emotional distress. The Kentucky Court of Appeals upheld this award, explaining:

Delay in the announcement of a death, an arrival, the straying or recovery of a child, and the like, may often be productive of an injury to the feelings, which cannot easily be estimated in money, but for which a jury should be at liberty to award fair damages. Yet in such cases the damages ought not to be enhanced by evidence of any circumstances which could not reasonably have been anticipated as probable from the language of the written message.²¹¹

The Court thus adopted the same line of reasoning advocated by the *Kewin* dissent, namely, that mental distress damages can be awarded for breach of contract if the contract is personal, indicating that the damages are foreseeable.²¹² The *Terrell* Court elaborated on its holding when it stated: “[I]f, as argued, the law does not deal generally with the feelings and emotions, it may be answered that here the parties themselves have contracted with respect to those things, or, at least, have contracted with respect to those things which naturally affect the feelings and emotions.”²¹³ Finding that the telegram itself apprised the defendant that breach of its contract of delivery would result in emotional distress, the Court upheld the award of damages.²¹⁴ Essentially, this ruling was nothing more than finding that plaintiff had fulfilled the *Hadley v. Baxendale* requirement for the award of this particular type of damage. The requirement was fulfilled because by the very nature of the contract emotional distress could reasonably have been foreseen as a consequence of the breach by the defendant at the time of the making of the contract.

²¹⁰ *Id.* at 293.

²¹¹ *Id.* at 294 (quoting T. SHEARMAN AND A. REDFIELD, SHEARMAN & REDFIELD ON NEGLIGENCE § 605, at 694 (3d ed. 1974)).

²¹² *Cf. Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d at 60 (Williams, J., concurring in part, dissenting in part).

²¹³ *Postal Tel. Cable Co. v. Terrell*, 100 S.W. at 294 (quoting *Western Union Tel. Co. v. Van Cleave*, 54 S.W. 827, 828 (Ky. 1900)).

²¹⁴ *Id.* at 295.

The *Terrell* rationale should also be applied in analyzing claims of first party bad faith. Of course, as noted in the *Kewin* dissent, bad faith becomes a misnomer because the quality of breach is unimportant; a good faith breach will produce the same damages as a malicious or bad faith refusal to pay policy proceeds.²¹⁵ The inquiry under *Terrell* is whether the insurance policy itself apprised the defendant that mental suffering might reasonably be anticipated from the failure to pay the policy proceeds upon the fulfillment of all conditions precedent. If mental suffering should have been anticipated, then it is a foreseeable consequence of the breach, and damages are recoverable.²¹⁶ This approach is not a radical departure from existing law, but is rather an application of it. Employing the ancient test of foreseeability is a sounder approach than is applying a mechanical damage formula with little or no consideration of the underlying legal principles and policy objectives.

The personal/commercial contract analysis does not mandate automatic victory for insureds, and the question as to which side of the line a particular policy falls will often be close. Indeed, insurers might plausibly assert that all first party insurance contracts are commercial in nature. Such an argument might run as follows: As noted by the *Kewin* dissent, certain types of contracts, such as for the delivery of death messages or to marry, have been traditionally categorized as personal contracts. In each such instance, it appears that the very *act* of performance by the potential defendant is bound up with the personal feelings. For example, in a contract to marry, the act of performance is marrying the promisee. This very act, all could agree, involves the personal feelings of the promisee. The act of performing an insurance contract in the payment of money is not tied to the emotions, and, arguably, is therefore not a personal contract. Should the personal/commercial distinction be drawn by analyzing only the *act* of the promisor's performance, insurance contracts would invariably be labelled commercial. The analysis, however, should not be so limited. The focus of the personal/commercial analysis should be

²¹⁵ See *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d at 71 (Williams, J., concurring in part, dissenting in part).

²¹⁶ Cf. *Postal Tel. Cable Co. v. Terrell*, 100 S.W. at 295.

on the substance of the contract, and the nature of the interests protected. Even when so viewed, reasonable people may differ as to which side of the line a particular insurance policy belongs.

Further, a determination that a particular insurance policy is commercial in nature does not automatically foreclose recovery of consequential damages. The rule of *Hadley v. Baxendale* has two aspects. Recovery of consequential damages is allowed if the evidence shows that the damages *either* (1) result naturally from the breach, *or* (2) were, at the time the contract was made, in the contemplation of the parties as a likely result of breach.²¹⁷ A court then might examine homeowners coverage and determine that the contract is commercial in nature. Thus, damages for mental anguish would not result naturally from the breach. Recovery of consequential damages might not be foreclosed, however, if the plaintiff can prove that due to circumstances peculiar to that transaction, the claimed damages were within the contemplation of the parties when the contract was made.

Before leaving *Terrell*, it is important to note that the Court emphasized that its allowance of consequential damages in this kind of case is "not confined to telegrams announcing the sickness or death of a near relative, but extends to all those cases where mental suffering may be reasonably anticipated as a natural result of the breach of the contract, and this can be shown by the face of the telegram."²¹⁸ The *Terrell* analysis should be applied in all cases, including contracts for insurance, where the consequential damages might be foreseeable. Subsequent cases have unfortunately described the *Terrell* holding as an exception to the general rule that emotional distress is not an element of damage for breach of contract.²¹⁹ The *Terrell* rule is not an exception but rather the proper application of the general rule which states that special damages arising from a breach of contract are recoverable if they were reasonably in the contemplation of the parties when the con-

²¹⁷ See quotation accompanying note 105 *supra*. See also D. DOBBS, *supra* note 48, at 804.

²¹⁸ 100 S.W. at 295.

²¹⁹ See e.g., *Archer v. Continental Assurance Co.*, 107 F. Supp. 145, 147 (W.D. Ky. 1952) ("The exception to this rule [disallowing emotional distress damages in contract cases] is damages arising out of a failure to transmit a death message by a public communication agency.").

tract was made.²²⁰ In most situations, mental anguish is not an element of damages that can be said to have been reasonably in the contemplation of the parties at the time of contracting. *Terrell*, and arguably *Kewin*, presented situations in which the parties did contemplate such damages. In those cases, mental anguish was a foreseeable consequence of the breach and therefore recoverable.²²¹ The fact that mental anguish damages are not foreseeable in *most* cases does not make the award of such damages in an appropriate case an exception to the general rule, but rather the natural result of its proper application. In addition to erroneously characterizing such cases as *Terrell* as an exception to the general rule, some courts, applying Kentucky law, have apparently overlooked *Terrell* altogether.²²² This potentially important case unfortunately seems to have been lost in the backwaters of Kentucky decisional law.

The contract approach to first party bad faith cases carries with it certain advantages. It is supported both by general legal principles,²²³ and by existing case law in Kentucky.²²⁴ From the insurer's perspective, the contract theory provides insulation from "runaway juries." Punitive damages would not be recoverable since the case would still be in contract, not tort. While emotional distress recoveries are not amenable to precise measurement, at least some proof of causation and evidence sufficient to make other types of consequential damages reasonably ascertainable would be required. Without such proof, the trial judge would be called upon to take the case from the jury.

From the insured's viewpoint, the contract theory provides compensation for all provable injuries. The insured would not be called upon to prove "bad faith" of the insurer, removing this troubling element from the case. All plaintiffs who could prove damages from a breach of a first party insurance contract would

²²⁰ See 100 S.W. at 295. See also *Hadley v. Baxendale*, 156 Eng. Rep. at 145.

²²¹ See 100 S.W. at 290; 295 N.W.2d at 50.

²²² See, e.g., 107 F. Supp. at 147 (stating that the exception to the general rule is a "failure to transmit a *death message* by a public communication agency") (emphasis added). *Terrell* makes it clear that death message cases are not the only ones for which emotional distress damages may be recovered. 100 S.W. at 295.

²²³ See text accompanying notes 95-128 *supra*.

²²⁴ See text accompanying notes 207-222 *supra*.

be compensated for their injuries, not just those who can prove the further element of bad faith. The injuries are just as real, whether produced in good or bad faith.²²⁵

As with the other alternatives, certain disadvantages are present in the contract theory. Although jury prejudice is reduced, it will still be a factor in cases where mental anguish is claimed. Because damages for mental anguish are not susceptible to precise measurement, juries might attempt to use such awards as a substitute for punitive damages. In addition, this theory removes the insurer's defense of good faith. Because the quality of conduct is not a relevant inquiry, the insurer is liable for consequential damages regardless of its reasonableness in contesting a fairly debatable claim.

Although conceptually sound, application of the contract theory would also have the unfortunate effect of leaving the law of first party bad faith unsettled. Each particular type of insurance, and each type of injury produced by its breach, would have to be analyzed on a case by case basis in terms of foreseeability. For example, a court could quite consistently hold a disability insurance policy to be "personal," and therefore award damages for mental anguish from its breach, while finding property insurance to be "commercial," limiting damages to the amount due under the contract. It could be quite some time before the wide range of insurance policies are considered by the courts. In the interim, insurers and insureds would have no certainty. Additional problems would be raised by the status of the insured. For example, the owner of a sole proprietorship suffering a fire loss to his business might convince the courts to award consequential damages, including emotional distress. This would not be possible if the sole proprietorship were incorporated, for a corporation cannot sustain emotional distress. Such artificial distinctions seem unfair, but are inherent in the contract theory.

In summary, as with any accommodation of competing interests, the contract theory has its shortcomings. On balance, however, it is the most desirable of the available common law solutions to the problem of first party bad faith. It is conceptually

²²⁵ See *Kewin v. Massachusetts Mut. Life Ins. Co.*, 295 N.W.2d at 57 (Williams, J., concurring in part, dissenting in part).

sound, and provides a balance between two competing policy goals.²²⁶ Absent legislative action in the field, the contract theory should be seriously considered by Kentucky courts.

III. TOWARDS A LEGISLATIVE RESOLUTION

The problems created by first party bad faith are complex, and the common law has failed to provide an adequate solution.²²⁷ The situation begs for legislative action to weigh the competing policies and establish an appropriate balance.

On January 29, 1982, Rep. Jim LeMaster introduced House Bill No. 360 in the Kentucky House of Representatives.²²⁸ This bill proposed a new section to the Kentucky Insurance Code.²²⁹ The proposed bill attempted to establish a statutory framework to govern the claims settlement practices of insurers.²³⁰ The bill passed the House of Representatives unanimously, but failed to emerge from the Senate Committee on Insurance.

Because *Feathers* will undoubtedly revive interest in a legislative alternative, an examination of this proposed bill and a consideration of its possible effect on claims of first party bad faith is important. Additionally, *Feathers* has generated great concern in the insurance industry, which may encourage the legislature to adopt a similar act in the hope of avoiding the unpredictable consequences that may flow from *Feathers*.

A. *Kentucky's Insurance Code*

The Kentucky Insurance Code creates an insurance department headed by an insurance commissioner, who is appointed by the governor for a four year term.²³¹ The Department of Insurance has jurisdiction over "every person engaged as principal and as indemnitor, surety, or contractor in the business of entering into contracts of insurance."²³² The Code empowers the com-

²²⁶ See text accompanying notes 26-27 *supra*.

²²⁷ See text accompanying notes 23-129 *supra*.

²²⁸ H.R. 360, 1982 Reg. Sess.

²²⁹ KRS ch. 304 (Cum. Supp. 1982).

²³⁰ See H.R. 360, *supra* note 228, at 1.

²³¹ See KRS § 304.2-020 (1982).

²³² KRS § 304.2-100 (1982).

missioner to enforce its provisions and to investigate violations.²³³ Further, the commissioner may promulgate rules and regulations establishing standards for compliance with the provisions of the Code.²³⁴

The existing Code prohibits undesirable business practices such as the use of false financial statements, defamation, boycott, coercion and intimidation, unfair discrimination, discriminatory denial of insurance, and rebates.²³⁵ Although the Code does not expressly prohibit an insurer from denying a first party claim in bad faith, it does contain a general admonition against unfair or deceptive practices: "No person shall engage in this state in any practice which is prohibited in this subtitle, or which is defined therein as, or determined pursuant thereto to be, an unfair method of competition or any unfair or deceptive act or practice in the business of insurance."²³⁶ Thus, the existing code implicitly authorizes the commissioner to charge an insurer with first party bad faith.²³⁷ This provision could at least be utilized to deter bad faith conduct. However, the Code does not expressly provide a private right of action through which an *insured* may seek compensation for damages suffered due to bad faith.

B. *Kentucky's Proposed Unfair Claims Settlement Practices Act*

As originally introduced by Representative LeMaster, House Bill No. 360 was an attempt to fill the void in the Code by providing an enumeration of unfair claims settlement practices and

²³³ See KRS § 304.1-040 (1982).

²³⁴ See KRS § 304.2-110 (1982).

²³⁵ See KRS §§ 304.12-040—100 (1982).

²³⁶ KRS § 304.12-010 (1982).

²³⁷ The existing code does not contain an express provision that affirmatively prohibits an insurer from denying a first party claim in bad faith. Instead, the Code prohibits certain enumerated conduct. See text accompanying notes 241-250 *infra*. The Code allows the commissioner, however, to punish certain conduct not specifically enumerated. KRS § 304.12-130 (1982) provides:

(1) If the commissioner believes that any person engaged in the insurance business is engaging in this state in any method of competition or in any act or practice in the conduct of such business which is not defined in this subtitle but such act or practice is unfair or deceptive and that a proceeding by him in respect thereto would be in the public interest, he shall, after a

expanding the available remedies.²³⁸ The Lemaster bill was designed to address both first party and third party claims.²³⁹ A "first party claimant" as defined by the bill includes "an individual, corporation, association, partnership or other legal entity asserting a right to payment under an insurance policy or insurance contract arising out of the occurrence of the contingency or loss covered by such policy or contract."²⁴⁰

Significantly, the bill attempted to define unfair claims settlement practices by listing thirteen specific instances of such conduct. Specific practices designated as unfair included: misrepresentation of policy provisions;²⁴¹ failure to provide for prompt investigation of claims under insurance policies;²⁴² failure to negotiate in good faith to settle disputes over claims;²⁴³ unjustified offers of inadequate amounts, forcing insureds to institute litigation;²⁴⁴ and failure to provide a prompt and reasonable explanation for denial of a claim, or for the offer of a compromise settlement.²⁴⁵ The provision also contains a residual clause that prohibits "any other act or practice in connection with claims settlement which is unfair or deceptive."²⁴⁶

The proposed bill also expressly created a private right of action by the first party claimant if he has been "aggrieved by the use of or employment by another person of an unfair claims settlement practice."²⁴⁷ The bill provided: "(b) Such an action may be brought to enjoin and to restrain any violation of this chapter and, in addition thereto, for the recovery of damages. The court may in its discretion, award actual damages and may provide for

hearing of which notice of the hearing and of the charges against him are given such person, make a written report of his findings of fact relative to such charges and serve a copy thereof upon such person and any intervenor at the hearing.

²³⁸ H.R. 360, *supra* note 228, at § 3.

²³⁹ *Id.* at § 1(a)-(b).

²⁴⁰ *Id.* at § 1(a).

²⁴¹ *Id.* at § 3(a).

²⁴² *Id.* at § 3(c),(d).

²⁴³ *Id.* at § 3(f).

²⁴⁴ *Id.* at § 3(g).

²⁴⁵ *Id.* at § 3(m).

²⁴⁶ *Id.* at § 3(n).

²⁴⁷ *Id.* at § 5.

such equitable relief as it deems necessary or proper."²⁴⁸ The bill departed from existing law in that it requires the *court* to award damages,²⁴⁹ rather than the jury.²⁵⁰

The LeMaster bill stated: "[N]othing in this subsection shall be construed to limit a person's right to seek punitive damages where appropriate."²⁵¹ The bill also allows a court to assess "reasonable attorney's fees and costs" against the insurer when the first party claimant prevails.²⁵² These two provisions encourage plaintiffs to bring first party claims, and they will undoubtedly generate additional litigation. Unfortunately, in effectuating the policy objectives of compensation and deterrence of bad conduct, the statute sacrifices the competing policy of avoiding disincentives that discourage insurers from defending questionable claims.

The proposed bill does not purport to provide any standards for a court to employ when determining what quality of conduct constitutes an unfair claims settlement practice other than the enumerated circumstances and the general prohibition against "unfair or deceptive" practices. Interestingly, a general provision of the Code prohibits the assessment of an administrative penalty when the insurer acts in good faith.²⁵³ Through his regulatory power, the commissioner may be in a position to direct the courts in determining whether the practices of an insured constitute first party bad faith. Without such guidance, however, the Kentucky courts will be left to examine how other state courts interpret similar acts in their jurisdictions.

²⁴⁸ *Id.*

²⁴⁹ *Id.*

²⁵⁰ *Id.*

²⁵¹ *Id.*

²⁵² *Id.* at § 5(d).

²⁵³ The commissioner may punish the insurer under the existing code as follows:

Any person who willfully violates any rule, regulations, or order of the commissioner, shall, except where other penalty is expressly provided, be subject to such suspension or revocation of certificate of authority or license, or administrative fine in lieu of such suspension or revocation as may be applicable under this Code for violation of the provision to which such rule, regulation or order relates.

C. *Unfair Claims Settlement Practices Act Applied*

Several jurisdictions have adopted statutes defining and proscribing unfair claims settlement practices.²⁵⁴ Some courts have held that the statute preempts common law remedies,²⁵⁵ while others have adopted the tort theory, despite the presence of the statute.²⁵⁶

Courts finding a tort have reasoned that the statute creates the independent duty of the insurer to act in good faith and deal fairly with its insured. Violation of this duty established the tort. Before a tort can be recognized, however, the court must determine whether the legislature intended to preempt the field and thereby foreclose the availability of common law tort remedies. For example, the court in the *Sparks* case was required to interpret an Arizona statute prohibiting misrepresentation and false advertising of insurance policies.²⁵⁷ That provision of the Arizona Insurance Code did not expressly mandate a private right of action.²⁵⁸ Nevertheless, the court reasoned that a right of action was implied by the Code. The court relied on the language of the statute which stated that neither the insurance director nor the court "may in any manner relieve or absolve any person...from any other liability, penalty or forfeiture under law."²⁵⁹ The court acknowledged that the Arizona Insurance Code allowed the state's director of insurance to issue cease and desist orders to enjoin acts or practices in violation of the department's regulations.²⁶⁰ Notwithstanding this power, the court found that the private right of action was preserved "irrespective of governmental action against the insurer."²⁶¹ *Sparks* also relied on *Sellinger v. Freeway Mobile Home Sales, Inc.*,²⁶² a case which followed a similar rationale in interpreting the state's Consumer Fraud Act.

²⁵⁴ See, e.g., *Sparks v. Republic Nat'l Life Ins. Co.*, 647 P.2d 1127, 1138-39 (Ariz. 1982); *Lynch v. Mid-America Fire & Marine Ins. Co.*, 418 N.E.2d 421, 424-26 (Ill. App. Ct. 1981); *Coleman v. American Universal Ins. Co.*, 273 N.W.2d 220, 221-22 (Wis. 1979).

²⁵⁵ See text accompanying notes 263-69 *infra*.

²⁵⁶ See text accompanying notes 257-62 & 270-74 *infra*.

²⁵⁷ 647 P.2d at 1138.

²⁵⁸ *Id.*

²⁵⁹ *Id.* at 1139 (quoting ARIZ. REV. STAT. ANN. § 20-456(c) (1975)).

²⁶⁰ *Id.*

²⁶¹ *Id.*

²⁶² 521 P.2d 1119 (ARIZ. 1974). In *Sallinger*, the buyer sued the seller of a mobile

In Oregon, the statutory scheme provides for the imposition of civil penalties for the commission of unfair trade practices.²⁶³ If found guilty of an unfair practice, the insurer is required to pay the state treasury a civil penalty ranging from \$2,000 - \$10,000.²⁶⁴ The Supreme Court of Oregon considered the effect of this statute on a common law contract action in *Farris v. United States Fidelity & Guaranty Co.*²⁶⁵ Although the facts of the case occurred in a third party context, the court found the tort theory did not apply since, in refusing to defend the insured at the outset of litigation, the insurer never assumed the fiduciary duty necessary to give rise to a tort.²⁶⁶ Because the court characterized the action as one for breach of contract, the case has direct precedential value for the first party context.

Farris considered whether the statutory provision providing for civil penalties prevents the insured from recovering consequential damages in a breach of contract action.²⁶⁷ The court first noted that the statute sought to "prohibit insurance companies from intentionally breaching their contract to settle their insureds' claims as defendants did here and to inflict certain consequences for so doing."²⁶⁸ The court then interpreted the scope of the statute:

Because the statutes did provide for the payment of damages not usually recoverable in such a situation, it would appear that had the legislature intended to enlarge the damages further, it would have so provided. It was certainly not intended by the legislature that additional pressure to perform the contract be exerted by allowing the recovery of damages for emotional distress, since the statute provides for civil damages recoverable by the state for that purpose. There is nothing to indicate that the legislature intended, when it prohibited certain claims settlement practices in ORS 746.230, that actions for breach of insurance contracts

home, complaining of numerous defects and shoddy workmanship. Although the Arizona Consumer Fraud Act does not contain language expressly authorizing a private right of action for violations of the Act, the Arizona Supreme Court held that such a right of action was "inferentially" created by the statute.

²⁶³ OR. REV. STAT. § 731.988 (1981).

²⁶⁴ *Id.*

²⁶⁵ 587 P.2d 1015 (Or. 1978).

²⁶⁶ *Id.* at 1019.

²⁶⁷ *Id.* at 1017-18.

²⁶⁸ *Id.* at 1018.

would be transformed, in all of the covered instances, into tort actions with a resulting change in the measure of damages. The statutes express no public policy which would promote damages for emotional distress. Concern about the insured's peace of mind does not appear to be the gravamen of the statutory policy²⁶⁹

Thus, the Oregon court concluded that consequential damages were precluded by the existence of the statute, and that the legislature did not intend to enlarge remedies available at common law.

The existence of a civil penalty statute or an exclusivity provision has not prevented other courts from recognizing the tort theory. For example, in *Lynch v. Mid-America Fire and Marine Insurance Co.*,²⁷⁰ the Illinois court rejected the preemption argument and recognized a common law tort of first party bad faith, despite the existence of a statute permitting the court to award to an insured suing on a policy certain costs and attorney's fees if the insurer's conduct has been "vexatious" and "unreasonable."²⁷¹ The court reasoned: "[T]he tenor of the section gives no indication that it was intended to cover the field of awarding compensation for bad faith or vexatious dealing by insurers."²⁷² Similarly, in *Coleman v. American Universal Insurance Co.*,²⁷³ the Wisconsin Supreme Court was confronted with the preemption issue in the context of a worker's compensation insurance claim. The court held: "[W]here a worker's compensation insurer acts in bad faith in the settlement or payment of compensation benefits, a separate tort is committed that is not within the purview of the exclusivity provisions of the worker's compensation law."²⁷⁴ Thus, this court found the existence of a comprehensive statutory scheme did not preclude plaintiff from bringing a common law tort claim for an injury not directly addressed by the act.

The LeMaster bill makes significant progress by its attempt to define unfair claims practices. Nevertheless, it does not address

²⁶⁹ *Id.*

²⁷⁰ 418 N.E.2d at 421.

²⁷¹ *Id.* at 424.

²⁷² *Id.* at 425.

²⁷³ 273 N.W.2d at 220.

²⁷⁴ *Id.* at 221.

certain serious problems. As the bill is drafted, it apparently contemplates remedies not unlike those available under common law tort theory, for insureds that are alleged to be victims of first party bad faith. It does not, however, provide clear guidance on the quality of conduct that constitutes an unfair claim settlement practice, nor is it precise as to when, if ever, punitive damages should be awarded. Therefore, it is reasonable to assume that a Kentucky court interpreting the LeMaster bill would conclude that the tort theory is the law of this state. While it is certainly within the legislative prerogative to create such a right of action, another legislative approach should be considered that serves public policy from the perspective of both the insured and the insurer.

IV. AN ALTERNATIVE LEGISLATIVE SOLUTION

This Article has frequently discussed the issues of first party bad faith in the context of *Sparks v. Republic National Life Insurance Co.*,²⁷⁵ a case that emphasizes the shocking consequences that may result from an erroneous termination of coverage by an insurer. *Sparks* also provides perspective for the dilemma posed by the two competing policy objectives inherent in claims of first party bad faith. The first objective recognizes that an insured's cause of action for first party bad faith should entitle him to damages promised under the policy, and consequential damages "within the contemplation of the parties."²⁷⁶ The second public policy implicated by first party bad faith is that the risks of excessive judgments should not be so unreasonable that they discourage insurers from challenging claims that are at least fairly debatable.²⁷⁷ Any effective resolution of the problem must address these two policy goals.

The difficult questions raised by first party bad faith require a careful balancing of the competing interests. Unfortunately, the courts, restrained by principles of common law formulated to solve different problems, have found it difficult, and sometimes impossible, to achieve a workable balance. The Kentucky Court of Ap-

²⁷⁵ 647 P.2d 1127 (Ariz. 1982). See text accompanying notes 7-15 *supra*.

²⁷⁶ See text accompanying notes 95-129 *supra*.

²⁷⁷ See text accompanying notes 26-27 *supra*.

peals in *Feathers* tipped the balance in favor of the first objective, recognizing a new tort and allowing recovery of extensive consequential and punitive damages.²⁷⁸ The court abandoned any accommodation of the second policy interest. Because of the failure of the common law to provide an effective resolution, a legislative solution is appropriate. The legislative forum can provide for the consideration and debate of all viewpoints, resulting in a proper balance.

The authors propose a statute that provides for a monetary penalty to be imposed on the insurer when the factfinder determines that it acted in bad faith.²⁷⁹ Such a penalty will deter acts of bad faith. Legislation incorporating a penalty provision for bad faith need not be complicated. A penalty would only be imposed after finding that the insurer acted in bad faith. The standard for bad faith would be defined by the statute and should be similar to a negligence or perhaps gross negligence standard. The statute, like the LeMaster bill, should label certain conduct as unfair claims settlement practices. It should also include a residual power allowing the courts to reach cases of bad faith falling outside the specific enumeration.

In essence, the legislation should provide that a first party insurer who, with negligence or recklessness, fails to pay or delays payment of a claim that is not otherwise fairly debatable, has acted in bad faith toward its insured. Such a finding would automatically trigger the penalty provision, forcing the insurer to pay a percentage of the judgment to the insured as a penalty. The penalty is designed to deter insurers from challenging claims other than those that are at least fairly debatable. The authors suggest 20% as an appropriate measure. This statute must contain two provisions to ensure its effectiveness. First, the prevailing insured should be allowed to recover reasonable attorney's fees for successful prosecution of a first party claim, regardless of the insurer's bad faith. This provision accomplishes several objectives. By recovering those fees, the insured is guaranteed the benefit of his bargain, rather than having his award substantially reduced by the cost of

²⁷⁸ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR, slip op. at 8 (Ky. Ct. App. Aug. 5, 1982).

²⁷⁹ See Appendix *infra*.

establishing his right to payment under the policy. Further, the insurer is prevented from using the prospect of protracted and costly litigation as leverage for exacting a settlement of the claim below the amount due under the policy. The insurer is encouraged to exercise caution before denying a claim in light of the prospect that he may eventually subsidize the insured's litigation as well.

The statute must also contain an exclusivity provision to ensure that it provides the sole remedy in first party cases. This provision protects insurers from unrestricted tort recoveries by making clear that the legislation is intended to preempt the field. This provision is necessary because some courts have used unfair claims legislation as a springboard for allowing tort damages, thereby eviscerating the intent and effectiveness of the legislation.²⁸⁰

Once litigation is commenced by the insured to recover under the contract, the statute should contain a mechanism to facilitate prompt settlement of the claim. For example, the dispute may concern a difference of opinion with respect to the amount to which the insured is entitled rather than whether coverage is afforded for the loss. The authors propose a mechanism that allows the insurer to mitigate his potential loss by allowing it to submit a written offer of settlement to the insured for an amount it believes the insured is entitled to recover. If the insured rejects that offer and the insurer is ultimately adjudged and entitled to recover an amount equal to or less than the offer of settlement, the insured should not be allowed to recover attorney fees incurred from the time the offer of settlement was first communicated to him.

Finally, this solution requires special findings from the factfinder. Initially, the factfinder must determine if the insurer is liable under the policy. If so, a determination of the bad faith issue would follow. If an insured succeeds on both issues, judgment must be entered for the amount due under the policy as contract damages, 20% of this amount as penalty, and a reasonable attorney's fee. Of course, interest and costs would be awarded as in any contract case.

Additional avenues of common law recovery may be available to insureds injured by truly egregious conduct. Particularly reprehensible practices may violate a duty independent from the

²⁸⁰ See notes 257-62 & 270-74 and accompanying text *supra*.

contract, giving rise to a separate action in tort. For example, under appropriate circumstances, an insurer and its agent might be guilty of common law fraud for actions taken during the course of a claim. If so, the statute would not preclude recovery. The recent case of *Craft v. Rice*²⁸¹ provides an additional theory of recovery in tort that may prove useful in cases of flagrant misconduct. In *Craft*, the Kentucky Court of Appeals recognized the tort of outrage as defined by the Restatement (Second) of Torts which describes the tort as follows: "(1) 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."²⁸² The court recognized that a duty exists to refrain from recklessly or intentionally causing severe emotional distress to another.²⁸³ This duty exists in the bad faith context independent of the contract.

The tort of outrage provides a safety net for those suffering severe but intangible injury by the outrageous conduct of insurance companies or their representatives. The Kentucky courts should adhere, without deviation, to the rigorous Restatement standard of culpability because the tort of outrage can be a slippery slope. Deviation from the strict standard threatens to impose a type of strict liability on insurers, a result that should be avoided. However, if the Restatement position is followed, the tort of outrage can be a useful tool in deterring bad faith.

Of the available common law and legislative alternatives, the statutory penalty scheme yields the best balance of the competing policy objectives. The penalty and award of attorney's fees forces insurers to evaluate claims early in the settlement process and deters them from unreasonably withholding payment of valid claims. At the same time, insurers will not be discouraged from questioning claims which are fairly debatable, because no penalty results for defense in good faith. Although insurance companies are always subject to some degree of jury prejudice, the risks of multi-million dollar punitive damage awards are eliminated. The remedial

²⁸¹ 30 KLS 6, at 2 (slip op. Aug. 22, 1983).

²⁸² RESTATEMENT (SECOND) OF TORTS § 46(1) (1965).

²⁸³ 30 KLS 6, at 2-3.

legislation avoids the conceptual problems inherent in the common law solutions. Most importantly, the legislature can shape the statute to achieve the most socially and economically desirable accommodation of competing public policies. While the penalty provision might provide excessive or inadequate compensation, according to the particular case, it must be remembered that deterrence, rather than compensation, is its primary goal. The insured is compensated by recovery under the contract, and receipt of attorney's fees. Although the inherent tension between the policy objectives may make a perfect solution impossible, this statutory approach presents a workable solution that should be considered by the General Assembly.

CONCLUSION

A timeworn maxim states that bad facts often make bad law. Many courts have adopted the tort theory in the context of gross overreaching by the insurer and catastrophic injury to the insured. This Article has discussed the problems caused by the conclusion that an insurer commits a tort when it breaches an insurance contract. The compelling facts of an insured's plight do not warrant an abandonment of fundamental principles of contract and tort law. The *Feathers*²⁸⁴ court usurped the prerogative of the General Assembly to make the difficult choices inherent in this issue and ignored the admonishment of Chief Justice Struckmeyer of the Arizona Supreme Court when that body recognized the tort theory:

Plainly, the Legislature is not unaware of bad faith motives in breaching a contract and has provided a remedy by which a party may recover his expenses if compelled to litigate. A change in the law which the majority impatiently press forward to make should more properly emanate from the Legislature, where a thorough assessment of necessity and the social and economic implications may be considered.²⁸⁵

²⁸⁴ *Feathers v. State Farm Fire & Casualty Co.*, No. 83-CA-158-MR slip op. at 7-8 (Ky. Ct. App. Aug. 5, 1983).

²⁸⁵ *Noble v National Am. Life Ins. Co.*, 624 P.2d 866, 871 (Ariz. 1981)(Struckmeyer, C.J., dissenting).

Prior to *Feathers*, the insurance industry in this state had been relatively unchecked by statutory or common law constraints on the quality of its conduct in settling claims with insureds. Clearly, the court of appeals in *Feathers* sought to change this situation. Because the various common law solutions are not adequately equipped to resolve the competing policy objectives presented by this issue, the legislature should adopt a statute designed to address the concerns of both the insurer and the insured.

APPENDIX

AN ACT relating to first party insurance claims.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

SECTION 1. A NEW SECTION OF SUBTITLE ____ OF KRS CHAPTER 304 IS CREATED TO READ AS FOLLOWS:

(1) The desire to provide a fair and equitable means of resolving disputes that arise between insurers and insureds requires that the statutory mechanism herein be adopted to effect the following purposes:

(a) To encourage insurers to conduct reasonable investigations of claims by its insureds;

(b) To promote prompt, fair and equitable settlements of claims in which liability has become reasonably clear;

(c) To deter insurers from unreasonably delaying or denying benefits due their insureds under contracts of insurance;

(d) To provide the insured the benefit of his bargain when he is compelled to bring a cause of action against his insurer to enforce the terms of a valid insurance contract;

(e) To provide a reasonable remedy for common law causes of action by first party claimants; and

(f) To allow insurers to assert valid defenses and to defend fairly debatable claims without exposure to liability grossly disproportionate to the claims and amounts involved.

(2) Under no circumstances is it the intent nor shall this subtitle be construed to provide the basis for an independent duty, which the breach thereof would give rise to an independent tort.

(3) As used in this subtitle the following definitions shall apply:

(a) "First party claimant" means an individual, corporation, association, partnership or other legal entity asserting a right to payment under an insurance policy or insurance contract arising out of the occurrence of the contingency or loss covered by such policy or contract. A "first party claimant" includes, but is not limited to, the intended beneficiary of an uninsured motorist insurance policy.

(b) An "insurance policy or contract" means a policy or contract entered into by an insurer as defined in this Chapter or a substitute therefore entered into by a self-insured entity or employer.

(c) "Bad faith" means there must be an absence of a reasonable basis of denial of the insurance policy or contract benefits. The insurer's refusal to pay a fairly debatable claim does not constitute bad faith for purposes of this subtitle.

(4) If a first party claimant is adjudged to have been entitled to recovery according to the terms of the insurance contract under which a right of recovery is claimed in an amount in excess of that amount offered by the issuer of the insurance policy or contract, the court shall award the first party claimant a reasonable attorney fee.

(5) Should the issuer of the insurance policy or contract make a written offer of settlement to the first party claimant in an amount that is equal to or more than that which the first party claimant is ultimately adjudged to be entitled to recover, the first party claimant shall not recover attorneys fees incurred from the time the offer of settlement was communicated to the first party claimant. After litigation has commenced, the settlement offer shall be in the form contemplated and governed by the terms of Kentucky Rules of Civil Procedure.

(6) Upon being adjudged liable to the first party claimant, the issuer of the insurance policy or contract shall pay an additional penalty not to exceed twenty percent (20%) of the recovery to the extent it exceeds any amount offered in accordance with sub-section five (5) hereof if the court or jury finds that such defendant's refusal to pay the first party claimant according to the terms of the insurance policy or contract was in bad faith. But in no case shall such penalty be less than five hundred dollars (\$500).

(7) The penalty imposed under this subtitle shall be the ex-

clusive remedy for the refusal of the issuer of the insurance policy or contract to pay a first party claimant in the absence of good faith and such failure shall not give rise to an independent action in tort.

ADDENDUM

At the time of printing, the legislative proposal by the authors had been introduced before the 1984 Kentucky General Assembly as House Bills 761 and 794 and Senate Bill 334.

