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Extra-contractual Damages Stemming from a First-party Insurer's Bad-faith Breach: Will Minnesota Adopt the Tort or Contract Theory of Recovery?

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**EXTRA-CONTRACTUAL DAMAGES STEMMING FROM A
FIRST-PARTY INSURER'S BAD-FAITH BREACH: WILL
MINNESOTA ADOPT THE TORT OR CONTRACT
THEORY OF RECOVERY?**

Jason C. Brown†

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I. INTRODUCTION

An implied-in-law requirement to act in good-faith and deal fairly guides third-party insurers.¹ Moreover, the duty of an insurer to act in good-faith abides in first-party insurance agreements.² A judgment to the contrary violates one of the fundamental principles enunciated in the Restatement (Second) of Contracts,³ as well as the Uniform Commercial Code.⁴ Consequently, the good-faith obligation overshadows an insurer

1. See Theresa Viani Agee, *Breach of an Insurer's Good-faith Duty To Its Insured: Tort or Contract?*, 1988 UTAH L. REV. 135, 136 (1988) (concluding that whether an insurer's breach of its duty to deal in good-faith with an insured in a first-party case constitutes a cause of action in contract or tort has far-reaching consequences for the insurance industry). Agee defines "third party insurance" as "policies which insulate the insured against liability for detriment to the person or property of a third individual." *Id.* at 136; see also 12 GEORGE J. COUCH, COUCH ON INSURANCE § 51:3 (2d ed. rev. 1982) ("That is to say, the exclusive right to defend carries the obligation to act in good-faith, and where the insurer exercises bad-faith by fraudulently or oppressively refusing to settle, and such action results in damage to the insured, the insurer is liable therefor.").

In Minnesota, the recognition of third-party bad-faith stems from the Minnesota Supreme Court decision in *Short v. Dairyland Ins. Co.*, 334 N.W.2d 384, 385 (Minn. 1983). The court, in recognizing such a claim, discussed the fiduciary nature of the relationship existing between insurer and insured in a third party context. See *id.* at 387.

2. See Agee, *supra* note 1, at 137. Agee defines "first-party insurance" as an insurance contract "in which the insurance company agrees to indemnify the insured for personal losses the insured sustains." *Id.*

3. See RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) ("Every contract imposes upon each party a duty of good-faith and fair dealing in its performance and its enforcement.") (emphasis added). The Minnesota Supreme Court has expressly adopted this provision of the Restatement. See *In re Hennepin County 1986 Recycling Bond Litig.*, 540 N.W.2d 494, 502 (Minn. 1995); *Piaisted v. Fuhr* 367 N.W.2d 541, 545 (Minn. Ct. App. 1985).

4. See U.C.C. § 1-203 (1996); MINN. STAT. § 336.1-203 (1998) ("Every contract or duty . . . imposes an obligation of good-faith in its performance or enforcement.") (emphasis added). Although an insurance contract does not involve the sale of goods, the Minnesota Supreme Court has applied the Uniform Commercial

conducting claims evaluations.⁵

Minnesota courts have yet to recognize an insured's right to seek redress against a first-party insurer for bad-faith breach.⁶ If national trends offer any insight into how Minnesota might approach the issue in the future, first-party bad-faith *will* become a recognized cause of action. Whether the cause of action arises through the judicial or legislative branch⁸ is anyone's guess.

Suppose an insured hotel owner's facilities burn to a heaping pile of ash. Subsequently, the insurer denies coverage on the claim, reasoning that the insured intentionally set the hotel ablaze. The insurer, however, cannot characterize the insured as an arsonist through any affirmative proof.⁹ The significance of the insurer deciding not to honor the lan-

Code by analogy where necessary. *See, e.g.,* Holman Erection Co. v. Orville E. Madsen & Sons, Inc., 330 N.W.2d 693, 697 (Minn. 1983) (applying the Uniform Commercial Code in a dispute regarding the construction of a public wastewater treatment facility).

5. *See supra* text accompanying notes 3-4. In essence, this requirement is a part of the performance of the contract, thereby triggering the good-faith obligation. *See also* Agee, *supra* note 1, at 137 (citing Kerry B. Harvey & Thomas A. Wisemen III, *First Party Bad-Faith: Common Law Remedies And A Proposed Legislative Solution*, 72 Ky. L.J. 141, 145 (1983) (providing an overview of bad-faith remedies in insurance litigation)); Alan I. Widiss, *Obligating Insurers to Inform Insureds About the Existence of Rights and Duties Regarding Coverage for Losses*, 1 CONN. INS. L.J. 67, 95 (1995) ("Providing an ounce of information to an insured is far better than a pound of explanations or justifications for the failure to inform an insured.").

6. *See* STEPHEN S. ASHLEY, *BAD-FAITH ACTIONS: LIABILITY AND DAMAGES* § 2-54 (2d. ed. 1997) ("A substantial minority of jurisdictions have rejected a common-law tort cause of action for bad-faith in first-party cases.").

7. *See id.* The author notes that every state, except Florida, Georgia, Illinois, Kansas, Louisiana, Maine, Maryland, Michigan, Minnesota, Missouri, New York, Oregon, Pennsylvania and Tennessee recognize first-party bad-faith. *See id.* at § 2-54-55.

8. In recent times, several first-party bad-faith bills have been submitted to the Minnesota Legislature for consideration. *See, e.g.,* 1999 Minn. Sess. Law Serv. 738 (West). This bill states:

An insured under a fire or homeowner's insurance policy issued pursuant to [Minnesota law] may bring an action against the insurer issuing the policy alleging that the insurer refused in bad-faith to pay a claim made by the insured under the provisions of the policy. An insurer has refused to pay a claim in bad-faith if the insurer refused to pay the claim without having a reasonable basis for the refusal, and, at the time of the refusal, the insurer knew there was no reasonable basis for the refusal or acted in reckless disregard of the lack of a reasonable basis for the refusal. An insurer has not acted in bad-faith in refusing to pay an insured's claim if the claim is fairly debatable, in law or in fact. This section does not apply to an action by an insured or a third party against an insurer for wrongful failure to provide a defense or to settle a third-party claim under a liability insurance contract.

guage of its contract with the aforementioned insured involves, arguably, a breach of the non-negotiable¹⁰ duty to act in good-faith.¹¹

An often fiercely contested issue involves whether the insured is entitled not only to compensation for the building loss, but also extra-contractual damages, including punitive and consequential relief, stemming from the insured's breach of the good-faith obligation. After all, there is an inherent incentive for an insurer to delay settlement¹² while the insured's demands swell,¹³ particularly if the insurer's exposure cannot exceed the policy limits.¹⁴

A majority of jurisdictions have answered affirmatively,¹⁵ and allow

Id.

9. This fact situation is common. *See infra* Part II. About a year ago, a rural Minnesota jury returned a verdict of 1.1 million dollars in favor of a mistreated first-party insured. *See Shimer v. United Fire & Cas. Ins. Co.*, No. C5-98-64 (D. Minn. March 5, 1999). In *Shimer*, the insured owned a resort and hotel located in Walker, Minnesota. *See id.* In June 1997, a fire swept through the property, causing extensive structural and cosmetic damage. *See id.* The insured timely submitted its proof of loss, but the insurer denied coverage for several reasons. *See id.* The insurer claimed the insured intentionally set the hotel ablaze and accused the insured of willfully defrauding them. *See id.*

After a million-dollar verdict against the insurer, the insured brought suit to collect punitive damages under the bad-faith doctrine. *See id.* Before opening arguments could take place, the insurer opted to settle for an undisclosed amount. *See id.* Is it possible that the case fell into the statistical reality that most cases settle before trial? Perhaps a more compelling motivation for the insurer to settle involved its lack of interest in a higher court taking on the issue of whether first-party bad-faith becomes a recognized claim. This settlement may have cost the insurer several hundred thousand dollars, but may have also saved it millions in punitive payoffs, at least in the short term. At a minimum, the insurer and insured were, conceivably, both satisfied in some fashion. Still, a case ripe on the issue of first-party bad-faith disintegrated.

10. *See supra* notes 3-4 and accompanying text.

11. *Cf.* 15A COUCH, *supra* note 1, § 58:3 ("Bad faith may also be viewed as interference with contractual relations since the primary interests of the insured were invaded by the defendant insurer's conduct are the rights to receive performance under an existing contract.").

12. For example, an insured may file a one million dollar claim. An insurer's defense costs may run forty to fifty thousand dollars over the course of several years. Concurrently, the insurer may continue investing funds from the unpaid claim and earn twice its attorneys fees. Even if the insured prevails at trial, the insurer ultimately wins.

13. For instance, the fact that a fire destroys an insured's property does not alter the insured's obligation to one's mortgagor.

14. *See Phyllis Savage, The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164, 164-67 (1976) (arguing that it is to nobody's advantage if the insurance industry is weakened by repeated payments of excessive awards).

15. *See supra* text accompanying notes 6-7; *see also* 15A COUCH, *supra* note 1, § 58:3. *See, e.g., Allen Van Etten, Insurer Bad-Faith Comes to Hawaii: The Best Place v. Penn America*, HAW. B.J., Aug. 1996, at 24 (providing an overview of Hawaiian

insureds to pursue damages exceeding their policy limits.¹⁶ These courts have done so, however, under two distinct theories of recovery.¹⁷ It seems that “[t]he scope of what is recognized by common law courts as a tort has grown so that torts and contract are no longer distinct, rather they overlap.”¹⁸ With this in mind, some courts grant relief to the insured under a tort theory.¹⁹ Conversely, other courts grant relief under an extension of the traditional rules associated with a breach of contract claim.²⁰

Predicting which approach Minnesota courts will accept is difficult.²¹ Some appellate decisions seem to sound in contract.²² Others suggest the tort approach is likely.²³

This article examines the contract and tort theory of recovering extra-contractual damages when an insurer breaches its implied duty of good-faith and fair dealing in a first-party insurance claim. In section II, the article provides an overview of the tort and contract theories of recovery in jurisdictions outside of Minnesota.²⁴ Section III demonstrates that Minnesota’s approach to the issue may sound in either tort or contract.²⁵ Section IV balances the tort and contract theories against one another.²⁶ The article concludes that the Minnesota Supreme Court should, when and if it recognizes first-party bad-faith, implement the contract theory.²⁷

II. THE TORT AND CONTRACT THEORY ACROSS THE UNITED STATES

The tort and contract theories of recovery are, naturally, different rules with various elements and consequences. The distinguishing feature of the tort theory of recovery is that first-party insureds may collect punitive damages²⁸ beyond their policy limits with an insurer. Therefore, a

case law related to the tort theory of recovering extra-contractual damages in first-party bad-faith claims).

16. See *infra* Part II.A.

17. See *infra* Parts II.A–B.

18. *Best Place, Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334, 344 (Haw. 1996) (involving an insured who brought suit against fire insurer for breach of contract and tortious breach of implied covenant of good-faith and fair dealing, after insurer denied his fire claim).

19. See *infra* Part II.

20. See *infra* Part II.

21. See *infra* Part III.

22. See *infra* Part III.A.

23. See *infra* Part III.B.

24. See *infra* Part II.

25. See *infra* Part III.

26. See *infra* Part IV.

27. See *infra* Part V.

28. By definition, punitive damages “are not intended as compensation. Rather, they are intended to punish and serve as a deterrence to others.” *Mrozka v. Archdiocese of St. Paul and Minneapolis*, 482 N.W.2d 806, 814 (Minn. Ct. App. 1992) (Randall, J., concurring in part, dissenting in part).

court may impose a penalty, unpredictable in amount, upon the insurer acting in bad-faith.²⁹ To the contrary, a first-party insurer subject to the contract theory may be responsible for consequential damages³⁰ exceeding the insured's maximum payoff. Hence, the insurer's responsibility ends with an amount equal to insured losses that were reasonably foreseeable at the time of contract formation.

A. *The Tort Theory of Recovery*

Before 1973, courts generally endorsed the common-law notion that damages for an insured's bad-faith breach were generally limited to the terms of one's insurance policy.³¹ Many scholars attribute the tort theory

The issue of punitive damages in the insurance arena was a hot topic in the 1990s. In 1991, the United States Supreme Court addressed constitutional limitations on an award of punitive damages. See *Pacific Mut. Life Ins. Co. v. Haslip*, 499 U.S. 1, 23-24 (1991) (holding that punitive damages four times the amount of compensatory damages did "not cross the line into the area of constitutional impropriety."). The court held that "imposing exemplary damages on the corporation when its agent commits intentional fraud creates a strong incentive for vigilance by those in a position 'to guard substantially against the evil to be prevented' . . . [and therefore] we cannot say this is a violation of Fourteenth Amendment due process." *Id.* at 14 (citing *Louis Pizitz Dry Goods Co. v. Yeldell*, 274 U.S. 112 (1927)). *Haslip* received one million dollars in punitive relief. See *Haslip*, 499 U.S. at 7. Justice Stevens authored the Court's majority opinion, holding that the 10 million dollar award was not so "grossly excessive" that it required reversal. See *id.* at 456. In a dissenting opinion, Justice O'Connor, joined by Justices Souter and White, noted that the Court in *Haslip* "held out the promise that punitive damages awards would receive sufficient constitutional scrutiny to restore fairness in what is rapidly becoming an arbitrary and oppressive system . . ." *Id.* at 472-73 (O'Connor, J., dissenting). Cf. *TXO Prod. Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 446-73 (1993) (involving actual damages of \$19,000 and punitive damages 526 times larger in a slander of title case).

29. Many other actions can constitute the tort of bad-faith. See *Allstate Ins. Co. v. Hilly*, 595 So. 2d 873, 875-77 (Ala. 1992) (fraud); *Gourley v. State Farm Mut. Auto. Ins. Co.*, 822 P.2d 374, 377-78 (Cal. 1991) (tortious interference with a property right); *Aranson v. Schroeder*, 671 A. 2d 1023, 1027-28 (N.H. 1995) (malicious defense); John H. Bauman, *Emotional Distress Damages and the Tort of Insurance Bad-Faith*, 46 DRAKE L. REV. 717, 722-28 (1998) (intentional infliction of emotional distress); Robert W. Emerson, *Insurance Claims Fraud Problems and Remedies*, 46 U. MIAMI L. REV. 907, 942-45 (1992) (libel and slander); Jennifer L. Kauth, *Goodbye Good-faith Doctrine: Constitutional Rights Prevail with the Rejection Of the Leon Good-faith Exception*, 30 IDAHO L. REV. 159, 170-71 (1993) (invasion of privacy); Robert J. Newell, *Travelers Ins. Co. v. Smith: Arkansas Employers Are Exposed To Greater Liability*, 52 ARK. L. REV. 503, 515 (1999) (outrageous conduct) (discussing *Liberty Mut. Ins. Co. v. Coleman*, 852 S.W.2d 816 (1993)).

30. "Consequential damages are the damages which naturally flow from the breach of a contract, or may reasonably be contemplated by the parties as a probable result of a breach of the contract." *Imdieke v. Blenda-Life, Inc.*, 363 N.W.2d 121, 125 (Minn. Ct. App. 1985).

31. See Roger C. Henderson, *The Tort of Bad-Faith in First-Party Insurance Trans-*

of recovery in the first-party insurance arena to a 1973 California Supreme Court decision, *Gruenberg v. Aetna Insurance Co.*³² Despite conflicting views about the origin of the tort theory, it seems the *modern* tort standards grew from the *Gruenberg* decision.³³

Gruenberg, in essence, redefined the common-law by allowing a first-party insured to pursue punitive damages in excess of its policy limitations under a tort liability scheme.³⁴ Since the *Gruenberg* decision, a majority of jurisdictions recognize an insured's ability to recover damages in excess of one's contract terms with the insurer under a tort theory³⁵ of liability.³⁶

actions After Two Decades, 37 ARIZ. L. REV. 1153, 1153 (1995) (advocating for a balancing of rights and responsibilities between an insurer and insured); see also Roger C. Henderson, *The Tort of Bad-Faith in First-Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute*, 26 U. MICH. J.L. REFORM 1, 16-26 (1992) (summarizing the tort of bad-faith). But see *Wetherbee v. United Ins. Co.*, 265 Cal. App. 2d 921, 921 (Cal. Dist. Ct. App. 1968) (awarding plaintiff \$1,050 in contract damages and reversing the court's award of \$500,000 in punitive damages). *Wetherbee* is an early decision perpetuating the development of the tort theory of recovery. See SPENCER L. KIMBALL, CASES AND MATERIALS ON INSURANCE LAW 499 (1992). Although the court reversed the amount of the jury's punitive damage award, Judge Shoemaker upheld the plaintiff's right to collect some punitive damages on remand to the superior court. See *Wetherbee*, 265 Cal. App. 2d at 935. Professor Kimball ponders, "[w]as it sound to make a tort case out of [such a] straightforward breach of contract?" KIMBALL, at 499.

32. 510 P.2d 1032 (Cal. 1973). See generally William H. Gilardy, Jr., *Good-faith and Fair Dealing in Insurance Contracts: Gruenberg v. Aetna Insurance Co.*, 25 HASTINGS L.J. 699 (1974) (providing a deep analysis of the *Gruenberg* decision).

33. But see ROBERT E. KEETON & ALAN I. WIDISS, INSURANCE LAW: A GUIDE TO FUNDAMENTAL PRINCIPLES, LEGAL DOCTRINES AND COMMERCIAL PRACTICES 878 (1988) (indicating that the tort theory of recovery has been around for longer than 1973).

34. Professor Kimball labels this conclusion "unfortunate." See KIMBALL, *supra* note 31, at 499.

35. "To date, use of the tort cause of action for bad-faith performance has been limited primarily to the insurance context . . ." Mark Snyderman, *What's So Good About Good-faith? The Good-faith Performance Obligation in Commercial Lending*, 55 U. CHI. L. REV. 1335, 1362 (1988).

36. See Henderson, *The Tort of Bad-Faith in First-Party Insurance Transactions After Two Decades*, *supra* note 31, at 1153-54. Professor Henderson points out that twenty-four state courts of last resort have adopted the tort theory of recovery, including: Alabama, Alaska, Arizona, Arkansas, Colorado, Connecticut, Idaho, Indiana, Iowa, Kentucky, Mississippi, Montana, Nebraska, Nevada, New Mexico, North Dakota, Ohio, Oklahoma, Rhode Island, South Carolina, South Dakota, Texas, Wisconsin and Wyoming. See *id.* at 1153-54 (citing *Chavers v. National Sec. Fire & Cas. Co.*, 405 So. 2d 1, 6 (Ala. 1981) ("We recognize the intentional tort of bad-faith in first-party insurance actions."); see also *State Farm Fire & Cas. Co. v. Nicholson*, 777 P.2d 1152, 1156-57 (Alaska 1989) ("We hold that, in the first-party context, an insured's cause of action against an insurer for breach of the duty of good-faith and fair dealing sounds in tort."); *Noble v. National Am. Life Ins. Co.*, 624 P.2d 866, 867-68 (Ariz. 1981) ("We are persuaded that there are sound reasons for

sons for recognizing the rule announced in *Gruenberg*.”); *Aetna Cas. & Sur. Co. v. Broadway Arms Corp.*, 664 S.W.2d 463, 465 (Ark. 1984) (“Bad-faith may give rise to either first or third party claims.”); *Travelers Ins. Co. v. Savio*, 706 P.2d 1258, 1271 (Colo. 1985) (“[T]he Workmen’s Compensation Act does not bar Savio from bringing a tort action in state court for damages arising from bad-faith in the processing of his request for rehabilitation.”); *Buckman v. People Express, Inc.*, 530 A.2d 596, 599 (Conn. 1987) (“[T]his court recognizes an independent cause of action in tort arising from an insurer’s common law duty of good-faith.”); *White v. Unigard Mut. Ins. Co.*, 730 P.2d 1014, 1019 (Idaho 1986) (“The imposition of liability in tort for bad-faith breach of an insurance contract is warranted”); *Erie Ins. Co. v. Hickman*, 622 N.E.2d 515, 518-19 (Ind. 1993) (“[R]ecognition of a cause of action for the tortious breach of an insurer’s duty to deal with its insured in good-faith is appropriate.”); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 349 N.E.2d 173, 180 (Ind. 1976) (“Exceptions have developed where the conduct of the breaching party not only amounts to a breach of the contract, but also *independently* establishes the elements of a common-law tort) (emphasis added); *Dolan v. Aid Ins. Co.*, 431 N.W.2d 790, 794 (Iowa 1988) (“[W]e are convinced traditional damages for breach of contract will not always adequately compensate an insured for an insurer’s bad-faith conduct.”); *Curry v. Fireman’s Fund Ins. Co.*, 784 S.W.2d 176, 178 (Ky. 1989) (“The facts of this case well illustrate the desirability of permitting recovery in tort when an insurance company acts in bad-faith in dealing with its own insured.”); *State Farm Fire & Cas. Co. v. Simpson*, 477 So. 2d 242, 249 (Miss. 1985) (“The punitive award was approved because the intentional wrong was so gross that it merited redress”); *Lipinski v. Title Ins. Co.*, 655 P.2d 970, 977 (Mont. 1982) (“[T]he court could as easily have held that the damages flowed from the commission of the prima facie tort of bad-faith”); *Braesch v. Union Ins. Co.*, 464 N.W.2d 769, 773 (Neb. 1991) (“Accordingly, when the insurer unreasonably and in bad-faith withholds payment of the claim of its insured, it is subject to liability in tort.”); *United Fire Ins. Co. v. McClelland*, 780 P.2d 193, 197 (Nev. 1989) (“[T]he district court did not err in admitting Leverty’s testimony that United Fire breached its duty and was liable for bad-faith and punitive damages.”); *State Farm Gen. Ins. Co. v. Clifton*, 527 P.2d 798, 800 (N.M. 1974) (“In order to recover damages in a tort action under the facts in this case, there must be evidence of bad-faith”); *Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co.*, 279 N.W.2d 638, 643 (N.D. 1979) (“Where . . . [the insurer] 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.”) (emphasis added); *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983) (“The key issue presented is whether appellees have sufficiently pleaded a cause of action in tort, stemming from the refusal of their insurer to pay their claim, to allow them to proceed on a punitive damages claim against their insurer.”); *Christian v. American Home Assurance Co.*, 577 P.2d 899, 904 (Okla. 1978) (“We approve and adopt the rule that an insurer has an implied duty to deal fairly and act in good-faith with its insured and that the violation of this duty gives rise to an action in tort for which consequential and, in a proper case, punitive, damages may be sought.”); *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313, 319 (R.I. 1980) (“[T]his duty sounds in contract as well as in tort”); *Nichols v. State Farm Mut. Auto. Ins. Co.*, 306 S.E.2d 616, 618-19 (S.C. 1983) (“[U]nreasonable refusal on the insurer’s part to accept an offer of compromise[d] settlement will render it liable in tort to the insured”); *In re Certification of a Question of Law*, 399 N.W.2d 320, 324 (S.D. 1987) (“[A]n insurer’s violation of its duty of

1. *The Gruenberg Decision*

The facts of *Gruenberg* are, perhaps, the most shocking and evident of an insurer's bad-faith breach reported to date.³⁷ The insured owned a Los Angeles cocktail lounge insured by the respondent.³⁸ After a fire occurred, a member of the Los Angeles Fire Department confronted the insured and arrested him for arson.³⁹ Subsequently, the insurer's claims adjuster visited the site and reported the insured had excessive policy coverage.⁴⁰ Consequently, the state charged the insured with arson and defrauding his insurer.⁴¹

One month later, the insurer's attorney demanded that the insured submit to an examination under oath and produce documents relating to the fire.⁴² The insured's lawyer responded, explaining that the insured would not make statements concerning the fire while criminal charges were pending.⁴³ In response, the insurer advised that they were denying liability for the insured's failure to submit to the examination.⁴⁴

Eventually, the state dropped all charges for lack of probable cause.⁴⁵ The insured ultimately volunteered for the examination.⁴⁶ However, the insurer reaffirmed its assertion that it was denying coverage for failure to appear.⁴⁷

The insured brought suit, claiming that "[a]s a direct and proximate result of the outrageous conduct and bad-faith of the [insurer] . . . I have suffered severe economic damage, severe emotional upset and distress, loss of earnings and various special damages."⁴⁸ The insured sought both compensatory and punitive damages,⁴⁹ contending he plead a sufficient cause of action *in tort* for the breach of the implied duty of good-faith and

good-faith and fair dealing constitutes a tort, even though it is also a breach of contract."); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 856-60 (Wyo. 1990) ("To deny an action in tort would deny such recovery and consequently encourage insurers to delay settlement."). However, "the tort created by *Nichols* is expressly preempted when the bad-faith claim arises under an employee benefit plan." *Duncan v. Provident Mut. Life. Ins. Co.*, 427 S.E.2d 657, 658 (S.C. 1993) (involving a bad-faith ERISA claim).

37. See generally *Gruenberg*, 510 P.2d at 1034-1035.

38. See *id.* at 1034.

39. See *id.*

40. See *id.*

41. See *id.*

42. See *id.*

43. See *id.* at 1035.

44. See *id.*

45. See *id.*

46. See *id.*

47. See *id.*

48. *Id.*

49. See *id.*

fair dealing.⁵⁰ The insured's claim, therefore, sounded in tort and contract.⁵¹

The court held the insurer's conduct toward the insured was "unconscionable and constituted a tortious breach of contract."⁵² The court explained that the duty violated by the insured, namely good-faith and fair dealing, is imposed by law, and nonconsensual in origin.⁵³ The court found that the insurer willfully and maliciously constructed a scheme to deprive the insured of the benefits of this policy by encouraging criminal charges through surreptitiously suggesting that the insurer was motivated to commit arson.⁵⁴ Further, the court noted that the existence of a contractual relationship did not insulate the insurer from liability placed upon tortfeasors intervening with a property interest of the insured in receiving the benefits of his bargain.⁵⁵ Even though the insurer's duty arose from a contractual relationship with the insured, the court stated that such a duty is *independent* of performance of [an insurer's] contractual obligations.⁵⁶ Hence, the court concluded, the duty sounds in tort, notwithstanding the fact that the insurer breached the contract.⁵⁷

2. *The Anderson Decision*

Scholars have implied that *Gruenberg*, while reaching a worthy conclusion, is vague and unguiding.⁵⁸ One author believes the Supreme Court of Wisconsin, in *Anderson v. Continental Insurance Co.*,⁵⁹ decided five years after *Gruenberg*, "took the lead . . . by articulating a more detailed . . . standard."⁶⁰

Like *Gruenberg*, *Anderson* involved an insurer's refusal to pay an insured for losses suffered because of a fire.⁶¹ In deciding the case, the *An-*

50. *See id.* at 1036.

51. *See id.* at 1037.

52. *Id.*

53. *See id.*; *see also supra* text accompanying notes 3-4.

54. *See Gruenberg*, 510 P.2d at 1038.

55. *See id.* at 1040.

56. *See id.*

57. *See id.* at 1037.

58. *See infra* note 60 and accompanying text.

59. 271 N.W.2d 368 (Wis. 1978).

60. *See Henderson, The Tort of Bad-Faith in First-Party Insurance Transactions After Two Decades, supra* note 31, at 1157; *see also* Johnny C. Parker, *Does Lack of an Insurable Interest Preclude an Insurance Agent from Taking an Absolute Assignment of His Client's Life Policy?*, 31 U. RICH. L. REV. 71, 104 n.111 (1997) ("The *Anderson* standard is more stringent than that articulated by the California Supreme Court in *Gruenberg*.").

61. *See Anderson*, 271 N.W.2d at 371. In *Anderson*, the insureds owned a home in Milwaukee. *See id.* They obtained an insurance policy from the defendant, providing coverage for loss occasioned by "fire, lightning, explosion, or smoke." *See id.* While the policy was in effect, the insureds discovered that the "walls, carpet-

Anderson court first disposed of the “tortious breach of contract” label placed on the cause of action by the *Gruenberg* court.⁶² The *Anderson* court noted that such a label is “confusing” and “inappropriate” because it might lead practitioners to believe that the wrongful act sounds in contract, thereby denying a claimant punitive damages.⁶³

Second, the *Anderson* court explored the rationale for the separate tortious act relating to the breach of an insurance contract.⁶⁴ The court adopted the findings of the Wisconsin Supreme Court in *Hilker v. Western Automobile Insurance Co.*,⁶⁵ decided nearly fifty years prior.⁶⁶ In *Hilker*, the court found the duty of an insurance company comparable to that of a fiduciary.⁶⁷

Finally, the court redefined the elements⁶⁸ required for a bad-faith claim based in tort law.⁶⁹ In demonstrating a claim for bad-faith, an insured must show “[1] the absence of a *reasonable* basis for denying [the] benefits of the policy and [2] the [insurer’s] knowledge or reckless disregard for the lack of a reasonable basis for denying the claim.”⁷⁰

Apparently, courts in the aforementioned jurisdictions have adopted the tort approach as a matter of public policy.⁷¹ Central to their decision, courts furnish what they discern as an adequate remedy for an insured

ing, furniture, draperies, and clothing in the house were covered with an oil and smoke residue, which, allegedly, resulted from a fire or an explosion in the furnace.” *Id.* The following day, the insureds notified their insurer. *See id.* The insureds alleged that the insurer, and its agents, “refused to negotiate in good-faith concerning the amount of payment, and that each of them submitted offers in settlement which were completely unrealistic.” *Id.* at 372. The insureds alleged that the consistent refusal of the insurer to negotiate in good-faith was “done with the knowledge and design of avoiding the obligations under the insurance contract.” *Id.* Specifically, they claimed that the conduct of both the insurer and its agent was “fraudulent, intentional, and in bad-faith and for the purpose of discouraging, avoiding, or reducing the payment due under the terms of the policy.” *See id.*

62. *See id.* at 374.

63. *See id.*

64. *See id.* at 374-75.

65. 235 N.W. 413, 415 (Wis. 1931).

66. *See Anderson*, 271 N.W.2d at 374.

67. *See Hilker*, 235 N.W. at 415.

68. *See Daniel S. Bopp, Tort and Contract in Bad-Faith Cases: Is the Honeymoon Over?*, 59 DEF. COUNS. J. 524, 527 (1992) (discussing the limited defenses available for a first-party bad-faith claim).

69. *See Anderson*, 271 N.W.2d at 376-77.

70. *Id.* at 376 (emphasis added).

71. *See supra* notes 58-70; *see also* James M. Fischer, *Why are Insurance Contracts Subject To Special Rules of Interpretation?: Text Versus Context*, 24 ARIZ. ST. L.J. 995, 1013-15 (1992) (discussing the consequences and judicial reaction to insurance contracts as “adhesion” contracts). Fischer characterizes the “tort” approach as a “public policy approach.” *Id.* at 1015; *see also* Beck v. Farmers Ins. Exch., 701 P.2d 795, 798 (Utah 1985) (discussing cases which adopt the tort theory as a matter of public policy).

wronged by an insurer's defiance.⁷² These courts fear that absent such a standard, first-party insurers acting in bad-faith may be liable only for damages equal to the maximum payout provided by the relevant policy.⁷³

B. *The Contract Theory of Recovery*

Judicial remedies serve to protect the expectation interest of a promisee,⁷⁴ meaning his or her interest in having the benefit of the bargain by being placed in as good a position as he or she would have been had the contract been fully performed.⁷⁵ The measure of damages for breach of an insurance contract has typically been limited to the lesser of the policy amount or the extent of the insurable loss.⁷⁶ In recent times, however, courts have applied the rule of *Hadley v. Baxendale*⁷⁷ in the insurance arena, and acknowledged an insured's right to recover consequential

72. See Fischer, *supra* note 71, at 1013. Fischer cautions, however, that "the pro-insured bias may amount to excessive correction." *Id.* at 1014.

73. See *Beck*, 701 P.2d at 798-99 (discussing cases which discuss courts' fears); see also Harvey & Wiseman, *supra* note 5, at 158 (citing the limitation of recovery to the insurance policy under contract theory); Savage, *supra* note 14, at 168 (showing differences in recovery between the contract and tort theories).

74. See RESTATEMENT (SECOND) OF CONTRACTS § 344(a) (1981); CHARLES L. KNAPP & NATHAN M. CRYSTAL, PROBLEMS IN CONTRACT LAW 893 (3d ed. 1993). The authors note that the drafters of the Restatement (Second) adopted the principles proposed by Professor Lon Fuller and his associate William Perdue in section 344. See *id.* at 893. In 1936, Fuller and Perdue advanced the thesis that there are three basic interests the law should seek to protect in fashioning remedies for breach of contract. See *id.* at 892.

75. See KNAPP & CRYSTAL, *supra* note 75, at 892.

76. See Agee, *supra* note 1, at 145 (citing *Clark v. Life & Cas. Co.*, 53 S.W.2d 968, 969 (Ky. 1932)). The Minnesota Supreme Court recently applied this standard to innocent insureds. See *Hogs Unlimited v. Farm Bureau Mut. Ins. Co.*, 401 N.W.2d 381, 387 (Minn. 1987) ("[I]nnocent insured partners may recover their proportionate interest under the insurance policy for intentional destruction of their partnership property interest.").

77. 156 Eng. Rep. 145, 145 (1854). The rule of *Hadley v. Baxendale* has been nearly universally accepted. See, e.g., James Ulicny, Note, *Corl v. Huron Castings, Inc.: Wrongful Discharge and the Collateral Source Rule*, 1997 DET. C.L. REV. 273, 301 (1997) (discussing the widespread acceptance of the rule expressed in *Hadley v. Baxendale*). Actually, there are two "rules" of *Hadley*. See *Hadley*, 156 Eng. Rep. at 145. A plaintiff suing for breach of contract may recover only damages which either: (1) arise naturally from the breach of contract itself, or (2) arise from the special circumstances under which the contract was actually made, if communicated by the plaintiff to the defendant. See *id.* But see Thomas A. Diamond & Howard Foss, *Consequential Damages for Commercial Loss: An Alternative to Hadley v. Baxendale*, 63 FORDHAM L. REV. 665, 665 (1994) (concluding that the application of a single, inflexible standard for contract liability, irrespective of the surrounding circumstances, is a fundamentally flawed approach); Melvin Aron Eisenberg, *The Principle of Hadley v. Baxendale*, 80 CAL. L. REV. 563, 563 (1992) (arguing that contract law is now ready to substitute for the regime of *Hadley*).

damages beyond general damages.⁷⁸

Several jurisdictions outside of Minnesota accept the “foreseeability” standard in supporting awards of consequential, as opposed to punitive, damages in first-party bad-faith cases.⁷⁹ For example, the highest courts of Delaware,⁸⁰ Maine,⁸¹ New Hampshire,⁸² Utah,⁸³ and West Virginia⁸⁴ have expressly recognized the right to recover extra-contractual damages under some expanded version of the rules proscribing damages for breach of contract. At the federal level, the First⁸⁵ and Sixth⁸⁶ Circuits have adopted the contract theory of recovery.

1. *The Lawton Decision*

The New Hampshire Supreme Court, the first to invoke such logic, broke away from the *Gruenberg* mode of thinking in 1978. The court crafted a contract theory of recovery in response to a first-party insurer’s bad-faith breach of first-party insurance contract in *Lawton v. Great Southwestern Fire Insurance Co.*⁸⁷ The basic facts of *Lawton* mirror closely those in California’s *Gruenberg* decision,⁸⁸ sounding in tort,⁸⁹ as well as the *Shimer*

78. See *infra* text accompanying notes 82-88.

79. See *infra* text accompanying notes 89-137.

80. See *Tackett v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 254, 254 (Del. 1995) (involving insureds who brought action against insurer for bad-faith delay in paying underinsured motorist benefits).

81. See *Marquis v. Farm Family Mut. Ins. Co.*, 628 A.2d 644, 644 (Me. 1993) (“Insureds brought action against fire insurer for breach of contract, statutory interest and attorneys fees, breach of fiduciary duty and bad-faith.”).

82. See *Lawton v. Great S.W. Fire Ins. Co.*, 392 A.2d 576, 581-82 (N.H. 1978) (holding that mental distress damages are not typically recoverable in a contract action); see also *Drop Anchor Realty Trust v. Hartford Fire Ins. Co.*, 496 A.2d 339, 344 (N.H. 1985) (involving an insured motel owner who brought action against his property insurer for alleged bad-faith by failing to settle the insured’s claim for property damage following a blizzard); *Jarvis v. Prudential Ins. Co. of Am.*, 448 A.2d 407, 409 (N.H. 1982) (reaffirming the rule expressed in *Lawton*).

83. See *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 802 (Utah 1985).

84. See *Hayseeds, Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73, 80 (W. Va. 1986).

85. See *deVries v. St. Paul Fire & Marine Ins. Co.*, 716 F.2d 939, 942 (1st Cir. 1983) (citing *Lawton*, 392 A.2d at 576).

86. See *Salamay v. Aetna Ins. Co.*, 741 F.2d 874, 876 (6th Cir. 1984). Like the court in *Lawton*, the Sixth Circuit did not restrict the damages owed an insured to the terms of the insured’s policy. See *id.*; see also *Bob G. Freeman, Reasonable and Foreseeable Damages for Breach of an Insurance Contract*, 21 TORT & INS. L.J. 108, 108 (1985) (describing and identifying the “battle” as insurers seeking ways to protect themselves from potentially limitless liability as insureds pursue financial punishment they feel insurers deserve).

87. 392 A.2d 576 (N.H. 1978).

88. See *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1034 (Cal. 1973).

89. See *supra* text accompanying notes 38-58.

decision of the Ninth Judicial District of Minnesota.⁹⁰

In *Lawton*, the plaintiff sought damages against his insurance company for its failure to make payment of a fire loss pursuant to a fire insurance policy.⁹¹ In the three counts raised against his insurer, the plaintiff sought consequential damages totaling \$500,000 because of the “irreparable damage to the plaintiff’s business . . . loss of use of his property, loss of business opportunity, [and] additional damage to the property occasioned by the [insurer’s] delay.”⁹²

The trial court dismissed the insured’s claim to the extent he sought damages exceeding his policy limits, holding the policy limits cap an insured’s remedies.⁹³ However, in a well-reasoned opinion by Justice Brock, the New Hampshire Supreme Court reversed.⁹⁴

Beyond the damages analysis, the court considered the insured’s counts sounding in tort.⁹⁵ It noted that the insured sought to “plead a tort claim for what [was] essentially a breach of contract.”⁹⁶ The court was attentive to the majority trend towards awards of tort damages.⁹⁷ Still, it rejected the tort theory in favor of consequential relief.⁹⁸

Among the many reasons the *Lawton* court gave for allowing an insured to collect consequential damages in excess of his policy limits, three particular pieces of reasoning stand out. First, the *Lawton* court noted that the policy limits contained in the parties’ contract restricted the amount the insurer was obligated to pay in the *performance* of the contract, as opposed to the damages recoverable should the insurer *breach*.⁹⁹ Next, the court pointed out that the principal reason a hotel owner, such as the insured, would initially purchase fire insurance is to guard against the consequences of a fire, namely financial distress.¹⁰⁰ Finally, the court reasoned that limiting an insurer’s liability to the terms of the policy limit unnecessarily encourages insurers to delay settlement in an attempt to coerce a financially pressured claimant into accepting an unfair settlement.¹⁰¹

90. See *Shimer v. United Fire & Cas. Ins. Co.*, No. C5-98-64 (D. Minn. March 5, 1999).

91. See *Lawton*, 392 A.2d at 577.

92. *Id.* at 578.

93. See *id.* at 578. This is the problematic issue courts adopting the tort approach try to correct. See *supra* note 75 and accompanying text.

94. *Lawton*, 392 A.2d at 580.

95. See *id.* at 580-81.

96. *Id.* at 580.

97. *Id.*; see also Henderson, *The Tort of Bad-Faith in First-Party Insurance Transactions After Two Decades*, *supra* note 31, at 1153 (citing cases adopting the tort standard).

98. See *Lawton*, 392 A.2d at 580.

99. See *id.* at 579.

100. See *id.*

101. See *id.* at 579-80; see also Freemon, *supra* note 87, at 108 (noting that the

The *Lawton* court concluded by holding, simply, that “allegations of an insurer’s wrongful refusal or delay [in] settl[ing] a first-party [insurance] claim do[es] not state a cause of action in tort.”¹⁰² Yet, the court placed an interesting spin on the rule: if the facts constituting the breach of contract also constitute a breach of the duty owed by an insurer to an insured, independent of a written agreement, an insured may dip one’s hand in the tort bucket.¹⁰³

2. *The Beck Decision*

The cases discussed *supra* deal with insured real property. However, it appears contract theory principles flow through the veins of automobile insurance, thanks to a relatively recent decision by the Utah Supreme Court.

In *Beck v. Farmers Insurance Exchange*,¹⁰⁴ a no-fault dispute arose out of the plaintiff’s hit-and-run automobile accident.¹⁰⁵ The plaintiff injured his knee in a car accident and received a small settlement on a no-fault claim.¹⁰⁶ When the plaintiff demanded his uninsured motorist policy limits, the insurer rejected the claim without explanation.¹⁰⁷ After months of unsuccessful negotiation with his insurer, the plaintiff sued, alleging a breach of the implied covenant of good-faith and fair dealing.¹⁰⁸

Initially, the court, as in *Lawton*, recognized that a majority of states permit a first-party insured to institute a tort action against their insurer when the insurer fails to bargain in good-faith.¹⁰⁹ Through a demeaning critique of the tort theory,¹¹⁰ the court decided to award damages based on a contract theory of recovery.¹¹¹

In embracing the contract theory, the court proclaimed it was not ignoring the essential policy considerations driving the adoption of the tort approach. The court expressly recognized the need to provide rem-

field of insurance defense law has been “extensively altered” through the evolution of multiple, inconsistent theories of an insured’s right to recovery); Mark E. Lish, *Insurers Have a Common Law Duty To Deal Fairly and in Good-Faith with Their Insureds: Arnold v. National County Mutual Fire Insurance Co.*, 725 S.W.2d 165 (Tex. 1987), 19 TEX. TECH L. REV. 1163, 1172-73 (1988) (discussing the *Lawton* decision and its rejection of a cause of action in tort for bad-faith conduct of an insurer in first-party situations).

102. *Lawton*, 392 A.2d at 581.

103. *See id.* at 579-80.

104. 701 P.2d 795 (Utah 1985).

105. *See Beck*, 701 P.2d at 796.

106. *See id.* at 796.

107. *See id.*

108. *See id.* at 797.

109. *See id.* at 798.

110. *See id.* at 799; *see infra* notes 210-217 and accompanying text.

111. *See Beck*, 701 P.2d at 798.

edy exposure exceeding policy limits, thereby reducing the incentive to act in bad-faith.¹¹² Thus, they held insurer damages are not limited to the dollars recoverable under the policy terms.¹¹³

In adopting the contract approach, Justice Zimmerman explained that damages recoverable for a breach include those that are general and consequential.¹¹⁴ He offered a detailed explanation of why the contract theory is the proper theory.

He reasoned that as parties to a contract, both the insured and the insurer have parallel obligations to perform in good-faith, which inhere in every contractual relationship and cannot be waived.¹¹⁵ The court, echoing the rule proposed by the court in *Lawton*, noted that nothing inherent in contract law mandates a narrow definition limiting damages recoverable to the policy limit.¹¹⁶ In fact, the Utah Supreme Court has repeatedly recognized that consequential damages for breach of contract may reach beyond the bare contract terms.¹¹⁷ The court concluded that because the insured essentially bargained for performance of the contract, the insurer had an obligation to perform its duty.¹¹⁸ Therefore, the insurer would be liable for damages suffered in consequence of a breach.¹¹⁹

3. *The Hayseeds Decision*

One year later, the highest court of West Virginia adopted the standards proposed in *Beck* and *Lawton*. In *Hayseeds, Inc. v. State Farm Fire & Casualty*, the plaintiff purchased a fire policy from the defendant.¹²⁰ Subsequently, a fire ripped through the interior of the plaintiff's restaurant.¹²¹ The insurer initiated an investigation, which revealed arson.¹²² The insurer refused to pay because the insured alleged that the plaintiff set the restaurant ablaze.¹²³ The jury, however, disagreed, and found no evidence that the insured was an arsonist.¹²⁴ Subsequently, the plaintiffs sought pu-

112. See *id.* at 801.

113. See *id.*

114. See *id.*

115. See *id.*

116. See *id.*

117. See *id.* at 801-802 (citing *Pacific Coast Title Ins. Co. v. Hartford Accident & Indem.*, 325 P.2d 906, 907 (Utah 1958) (stating that attorney fees incurred for settling and defending claims were foreseeable result of contractor's default)); *Bevan v. J.H. Constr. Co.*, 669 P.2d 442, 444 (Utah 1983) (stating that home purchasers were entitled to damages for loss of favorable mortgage interest rate resulting from builder's breach of contract).

118. See *Beck*, 701 P.2d at 800.

119. See *id.* at 801.

120. See 352 S.E.2d 73, 75 (W. Va. 1986).

121. See *id.* at 75.

122. See *id.*

123. See *id.*

124. See *id.* at 75-76.

nitive damages¹²⁵ and attorneys' fees for the insurer's failure to make a "fair, good-faith investigation of the facts and circumstances surrounding the fire."¹²⁶

Early in its opinion, the Supreme Court of West Virginia addressed the punitive damages sought by the insured.¹²⁷ The court stated that, "[g]enerally, punitive damages are unavailable in an action for breach of contract unless the conduct of the [insurer] constitutes an *independent, intentional tort*."¹²⁸ Consequently, punitive damages for failure to settle a property dispute will not be granted to an insured, unless the policyholder can establish "actual *malice* in the settlement process."¹²⁹ Because the *Hayseeds* insured failed to present evidence of malice, the court denied punitive damages and reversed the state district court's punitive award of \$50,000.¹³⁰

In considering an award of *consequential*, as opposed to *punitive*, damages,¹³¹ the *Hayseeds* court fashioned two important public policy considerations not pronounced by the New Hampshire or Utah Supreme Court. The court seemed to consider the implications for the insurer and insured, as well as the community in which insured property may be located. First, the court pronounced that insurance contracts are qualitatively different from other types of contracts,¹³² and therefore warrant special examination and standards. Second, the court noted that one major advantage of adopting the contract theory is that it encourages a quick trial,¹³³ there is little reason, according to Justice Neely, that property damage claims cannot be tried within six months.¹³⁴ After pronouncing that an insured does not purchase a contract of insurance for "a lot of vexatious,

125. If Professor Kimball is correct, this move was an attempt by the plaintiff to persuade the West Virginia Supreme Court to adopt the tort theory of liability. See KIMBALL, *supra* note 31, at 499. The court, however, declined the plaintiff's invitation. See *Hayseeds*, 352 S.E.2d at 81.

126. *Hayseeds*, 352 S.E.2d at 76.

127. *See id.* at 80.

128. *Id.* (emphasis added).

129. *Id.* (emphasis added). The court considers this an altitudinous threshold and burden for an insured to meet. *See id.* "Malice," according to the court, exists when an insurer knows the policyholder's demand is suitable, but the insurer "willfully, maliciously, and intentionally" controverts the claim. *Id.* at 80.

130. *See id.* at 81.

131. *See supra* text accompanying notes 28 and 30 (discussing the relationship between punitive and consequential damages).

132. *See Hayseeds*, 350 S.E.2d at 77. The court notes that in the context of an insured business structure, "Not only do policyholders rely upon insurance policies, but a host of third-party creditors rely upon those policies as well." *Id.* at 77. Moreover, the court notes that "[a] lack of immediate rebuilding may cost the company a significant portion of its skilled employees and may cause employees the loss of their jobs, pensions, and seniority." *Id.* at 78.

133. *See id.* at 80.

134. *See id.*

time consuming [and] expensive litigation with [the] insurer,"¹³⁵ the court concluded that "the insurer . . . contracted to defend the insured and failed to do so. It guessed wrong as to its duty, and should be compelled to bear the consequences thereof."¹³⁶

In sum, courts endorsing the contract theory allow consequential damage awards in excess of an insured's policy limits. For example, an insured may recover net income loss because of an insurer's bad-faith breach as long as such losses were reasonably foreseeable by the parties at the time of contract formation. Simultaneously, punitive damages do not exist under the contract theory, absent an independent tort.

III. PREDICTING MINNESOTA'S APPROACH

Whether Minnesota courts will allow an insured's remedy in contract or tort is not as obvious as California, Wisconsin, Utah or West Virginia. Yet, Minnesota appellate courts have dealt with issues very similar to the issues discussed in the *Gruenberg*, *Anderson*, *Beck*, and *Hayseeds* decisions over the last century. Several pronouncements by the Minnesota Supreme Court line up with those of jurisdictions that favor tort recovery. Yet, the court often sounds as though it is in favor of the contract approach. Therein lies the essential question posed by this article: Is Minnesota apt to become a tort or contract state?

A. *Minnesota Decisions Inferring the Contract Theory*

The contract theory of recovery seems alive in some Minnesota appellate decisions. Most of the relevant language that indicates that the contract theory is preferred stems from decisions crafted in the last two decades. However, many of the modern principles stem from some early contract cases.

1. *The Whittaker and Independent Grocery Decisions*

As early as 1885, the Minnesota Supreme Court adopted a standard resembling the modern contract theory. The Minnesota Supreme Court in *Whittaker v. Collins*,¹³⁷ squarely framed the issue as "what rule applies in what are sometimes called actions for torts founded on contracts or ac-

135. *Id.* at 79.

136. *Id.* (quoting 7 C.J. APPLEMAN, INSURANCE LAW AND PRACTICE, § 4691 at 282-83 (Berdal ed., 1979)).

137. 34 Minn. 299, 25 N.W. 632 (Minn. 1885). *Whittaker* involved an action for damages caused by the alleged negligence and unskillfulness of a physician and surgeon. See *Whittaker*, 34 Minn. at 299, 25 N.W. at 632. After breaking his leg, the plaintiff employed the defendant to care and treat him. See *id.* at 300, 25 N.W. at 632. The court determined that the defendant caused the plaintiff's injuries. See *id.*

tions *ex quasi contractual*?¹³⁸ The court answered by stating:

The principle running through all the cases seems to be that where the action is maintainable for the tort simply, without reference to any contract between the parties, the action is one of tort purely, although the existence of a contract may have been the occasion or furnished the opportunity for committing the tort. But where the action is not maintainable without pleading and proving the contract,—where the gist of the action is the breach of the contract, either by malfeasance or nonfeasance, —it is, in substance, whatever may be the form of the pleading, an action on the contract¹³⁹

Thirty-five years later, the Minnesota Supreme Court revisited the issues presented in *Whittaker* within the context of a first-party insurance dispute. In *Independent Grocery Co. v. Sun Insurance Co.*,¹⁴⁰ the plaintiff brought an action seeking consequential damages for the insurer's alleged "malicious and wrongful delay of defendants in adjusting the insurance loss complained of."¹⁴¹ The court dealt with two questions: First, did the claim present a claim sounding in tort or contract?¹⁴² Second, was the plaintiff entitled to the damages sought?¹⁴³

Foremost, the court upheld the standard enunciated in *Whittaker*, as well as the rule(s)¹⁴⁴ of *Hadley v. Baxendale*,¹⁴⁵ by stating that a complaint alleging damages from malicious delay in settlement and payment of insurance states a breach of contract action.¹⁴⁶ Next, the court held no damages were recoverable because:

Neither the loss of trade nor the inability of plaintiffs to pay their creditors, or even that they were likely to have creditors in the event of a destruction of the insured property by fire, or the loss of the good will of the business, flowed naturally or proximately from the delay of defendants in adjusting and paying the

138. *Id.* at 300, 25 N.W. at 632-33.

139. *Id.* at 300, 25 N.W. at 633.

140. 146 Minn. 214, 178 N.W. 582 (Minn. 1920).

141. *Id.* The plaintiffs owned a grocery store insured by the defendant. *See id.* at 215, 178 N.W. at 582. After sustaining losses as a result of a fire, notice of the loss was duly given to the insurer. *See id.* Negotiations resulted in a settlement in which the insurer agreed to pay \$1,100 in full discharge of its liability. *See id.* The insurer delayed payment, which resulted in further alleged losses to the plaintiff's business. *See id.* at 215, 178 N.W. at 582-83.

142. *See id.* at 216, 178 N.W. at 583.

143. *See id.* at 217, 178 N.W. at 583.

144. *See supra* text accompanying note 79.

145. 145 Eng. Rep. 145, 145 (1854).

146. *See Independent Grocery Co.*, 34 Minn. at 216, 178 N.W. at 583.

loss; nor can it be said that the financial condition and business situation of plaintiffs as pictured by the complaint was within the contemplation of the parties when the contract was entered into. Those facts therefore furnish no basis for the recovery of damages, for as to the breach of the contract, whether malicious or not, plaintiffs' recovery, within the rule stated, must be *limited to the amount of the legal liability under the policy* with interest.¹⁴⁷

The *Independent Grocery* opinion remained untouched for the better part of the twentieth century.

2. *The Olson Decision*

In 1979 the Minnesota Supreme Court overruled *Independent Grocery*. The Court in *Olson v. Rugloski*¹⁴⁸ did so, however, only "to the extent that . . . [the court in] *Independent Grocery* . . . h[eld] that an insured is limited to recovering only the amount of the policy."¹⁴⁹ Thus, as an initial proposition, the Minnesota Supreme Court has not expressly disposed of the early contract theory of first-party insured recovery enunciated in *Independent Grocery*. It has merely added an element to the rule: consequential damages may exceed policy limits.¹⁵⁰

The *Olson* case involved a first-party insurance dispute.¹⁵¹ The insurer appealed a judgment of the Ramsey County district court awarding a plaintiff \$35,000 in *punitive* damages and \$7,500 in compensatory relief.¹⁵² The lower court held that the defendant insurer engaged in willful, wanton, and malicious refusal to pay proceeds.¹⁵³

Reversing in part, the *Olson* court held that lost profits might be recovered if they are a natural and proximate result of the breach and are proved with reasonable certainty.¹⁵⁴ Does this assertion sound a little like the rule in *Hadley v. Baxendale*? Absolutely. Hence, without little argument, it seems the *Olson* court adopted a "contract" mode of thinking.¹⁵⁵

Not only has the Minnesota Supreme Court retained the rule pro-

147. *Id.* at 217, 178 N.W. at 583. (emphasis added).

148. 277 N.W.2d 385 (Minn. 1979).

149. *See id.* at 388.

150. *See id.* at 388.

151. *See id.* at 386.

152. *See id.*

153. *See id.*

154. *See id.* at 388. The *Olson* court affirmed the trial court's award of compensatory damages totaling \$7,500. *See id.* However, the court reversed the \$35,000 punitive damage award. *See id.*

155. One author believes that the *Olson* decision indicates a shift toward a less constrained view of consequential damages stemming from the breach of a first-party insurance agreement. *See* Freemon, *supra* note 87, at 108 ("A majority of states have adopted the concept, in its myriad of forms and applications, that an insurer owes a duty of good-faith and fair dealing to its insured.").

posed by Chief Justice Brown's *Independent Grocery* opinion, but it has implicitly embraced the principle in its reasoning in *Olson*. Chief Justice Wahl's opinion in *Olson* echoes the spirit of the highest courts of Delaware, Maine, New Hampshire, Utah, West Virginia, found in *Tackett*,¹⁵⁶ *Lawton*,¹⁵⁷ *Marquis*,¹⁵⁸ *Beck*,¹⁵⁹ and *Hayseeds*¹⁶⁰ respectively; each of these courts has adopted the contract theory of recovery *in specie*.¹⁶¹

Since the *Olson* decision, the Minnesota Supreme Court has embraced the rule that insurance policies are contracts and, unless there are statutory laws to contrary, general principles of contract law apply, on at least four occasions.¹⁶²

3. *The Haagenson Decision*

In 1979, the Minnesota Supreme Court disposed of the key feature of the tort theory of recovery in first-party bad-faith: punitive damages. In

156. See *Tackett v. State Farm Ins. Co.*, 653 A.2d 254, 254 (Del. 1995).

157. See *Lawton v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 576, 576 (N.H. 1978).

158. See *Marquis v. Farm Family Mut. Ins. Co.*, 628 A.2d 644, 644 (Me. 1993).

159. See *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 795 (Utah 1983).

160. See *Hayseeds, Inc. v. State Farm Fire & Cas.*, 352 S.E.2d 73, 73 (W. Va. 1986).

161. See *supra* notes 89-137 and accompanying text. For example, the New Hampshire Supreme Court in *Lawton* held that:

Defendant's argument that the insurance contract itself restricts the damages that are recoverable for breach of the contract to the policy limits is . . . unpersuasive. The policy limits restrict the amount the insurer may have to pay in the *performance* of the contract, not the damages that are recoverable for its *breach*.

Lawton, 392 A.2d at 579 (emphasis added). Similarly, the West Virginia Supreme Court in *Hayseeds* noted, "when a policyholder substantially prevails in a property damage suit against an insurer, the policyholder is entitled to damages for net economic loss caused by the delay in settlement, as well as an award for aggravation and inconvenience." *Hayseeds*, 352 S.E.2d at 80. Analogously, the Minnesota Supreme Court in *Olson* stated that "[w]hen the insurer refuses to pay or unreasonably delays payment of an undisputed amount, it breaches the contract and is liable for the loss that naturally and proximately flows from the breach." *Olson v. Rugloski*, 277 N.W.2d 385, 388 (Minn. 1979) (citing *Frank v. Jensen*, 303 Minn. 86, 92, 226 N.W.2d 739, 745 (1975)).

162. See *Vetter v. Security Continental Ins. Co.*, 567 N.W.2d 516, 521 (Minn. 1997) (involving a claim for breach of annuity contracts); *Epland v. Meade Ins. Agency Assoc. Inc.*, 564 N.W.2d 203, 207 (Minn. 1997) (involving a breach of contract suit against a medical insurer); *Waseca Mut. Ins. Co. v. Noska*, 331 N.W.2d 917, 926 (Minn. 1983) (discussing the interaction between an insured's no-fault automobile benefits and her homeowner's insurance policy); *St. Paul Sch. Dist. No. 625 v. Columbia Transit Corp.*, 321 N.W.2d 41, 45 (Minn. 1982) (involving the automobile liability insurance policy of a school bus company).

Haagenson v. National Farmers Union Property and Casualty Co.,¹⁶³ the plaintiff sustained injuries in an auto accident and filed a claim for no-fault benefits.¹⁶⁴ The insurer denied coverage.¹⁶⁵ In district court, the jury determined the insurer breached the good-faith obligation by acting with malice in denying the plaintiff's benefits.¹⁶⁶ The jury awarded \$60,000 in no-fault benefits through stacking the plaintiff's policies.¹⁶⁷ Additionally, the jury awarded the plaintiff \$50,000 for emotional distress and an additional \$300,000 in punitive damages.¹⁶⁸

On appeal, Justice Peterson announced, "[a] malicious or bad-faith motive in breaching a contract does not convert a contract action into a tort action."¹⁶⁹ Thus, the plaintiff was not entitled to the extra-contractual damages at issue.¹⁷⁰ Hence, the court adopted a standard similar to the *Lawton* decision sounding in contract. Moreover, the *Haagenson* court announced that extra-contractual relief is possible in first-party insurance disputes, assuming an *independent* tort accompanies the breach.¹⁷¹ Again, this language squares well with the contract-based analysis provided in *Lawton*.

4. *The Saltou Decision*

Seven years post *Olson* and *Haagenson*, the Minnesota Court of Appeals revisited first-party bad-faith issues. In *Saltou v. Dependable Insurance Co., Inc.*,¹⁷² fire destroyed an insured's mobile home.¹⁷³ After a number of payment requests, the insurer issued proceeds under the policy ten weeks post-fire.¹⁷⁴ The insurer's agent denied coverage for personal property loss, and eventually wrote the check to the wrong party.¹⁷⁵ After the insurer ultimately withheld payment, the insured was hospitalized for emotional trouble.¹⁷⁶

After commencing an action for breach of contract and intentional

163. 277 N.W.2d 648, 648 (Minn. 1979).

164. *Haagenson v. National Farmers Union Property & Cas. Co.*, 277 N.W.2d, 648, 650 (Minn. 1979).

165. *See id.* at 651.

166. *See id.* at 650.

167. *See id.*

168. *See id.*

169. *Id.* at 652 (citing *Wild v. Rarig*, 302 Minn. 419, 442, 234 N.W.2d 775, 790 (Minn. 1975) (offering guidance on the relationship between a bad-faith breach of contract and tort damages)).

170. *Id.* at 650.

171. *See id.* at 655.

172. 394 N.W.2d 629, 629 (Minn. Ct. App. 1986).

173. *See id.* at 631.

174. *See id.*

175. *See id.* at 631-32.

176. *See id.* at 632.

infliction of emotional distress, the lower court granted summary judgment in favor of the insurer.¹⁷⁷ On appeal, Judge Randall announced that the plaintiff could only recover punitive damages if the breach was accompanied by an independent tort.¹⁷⁸ Such language is consistent with *Lawton*, *Olson*, and *Haagenson*, sounding in contract, as is the court's pronouncement that "[t]he failure to pay an insurance claim in itself, no matter how malicious, does not constitute a tort."¹⁷⁹

Not only did the *Saltou* court implicitly dispose of the tort theory of recovery, but it supported the contract theory by noting that "[w]hen the insurer refuses to pay or unreasonably delays payment of an undisputed amount, it breaches the contract and is liable for the loss that naturally and proximately flows from the breach."¹⁸⁰ Such a rule parallels the holding in *Hayseeds* and *Beck*, where both rules sound in contract.

5. *The Pillsbury Decision*

A Minnesota appellate court more recently adopted first-party bad-faith occurred in *Pillsbury Co. v. National Union Fire Insurance Co.*¹⁸¹ The *Pillsbury* case, as may be inferred from the name, involved what some scholars refer to as a "sophisticated insured."¹⁸² In 1983, an insurer issued Pillsbury a "Products Integrity Impairment Loss of Revenue and Product Recall Extra Expense Insurance Policy."¹⁸³ Under the terms of the agreement, the insured paid an annual premium of \$280,000 for insurance coverage totaling \$150 million.¹⁸⁴

In 1985, the insured suffered a claimed loss exceeding \$70 million.¹⁸⁵ After settlement negotiations failed, the insurer denied the claim alleging misrepresentation in procuring coverage and a failure to cooperate during the investigation of the claim.¹⁸⁶ Pillsbury brought suit, claiming the insurer breached its contract in bad-faith.¹⁸⁷ Pillsbury sought punitive damages.¹⁸⁸

177. *See id.*

178. *See id.* at 633.

179. *Id.*

180. *Id.* (citing *Olson v. Rugloski*, 277 N.W.2d 385, 387-88 (Minn. 1979)).

181. 425 N.W.2d 244, 244 (Minn. Ct. App. 1988).

182. *See* KIMBALL, *supra* note 31, at 27. Professor Kimball considers a sophisticated insured as one that is "[a] large [and] economically powerful [business]." *Id.*

183. *See Pillsbury*, 425 N.W.2d at 244. The policy intended to serve the food industry and protect against the adverse effects associated with negative publicity that might stem from the discovery of toxins in a product. *See id.* at 246-47.

184. *See id.* at 246.

185. *See id.* at 247.

186. *See id.*

187. *See id.*

188. *See id.*

As in *Olson*, the court stated, “[a]n insurance policy is a contract, the terms of which determine the rights and obligations of the contracting parties.”¹⁸⁹ The court affirmed its belief that the rule of *Hadley v. Baxendale*, naturally sounding in contract, applied by stating “[t]he damages recoverable for breach of a contract are such as either arise naturally from the breach itself or such as may reasonably be supposed to have been contemplated by the parties when making the contract as the probable result of the breach.”¹⁹⁰ Moreover, the court cited the *Saltou* and *Haagenson* decisions for their holdings, both sounding in contract.¹⁹¹

B. Minnesota Decisions Inferring the Tort Theory

Several Minnesota decisions indicate that the Minnesota courts may willingly adopt the tort approach to extra-contractual recovery if they recognize first-party bad-faith. None of these decisions offer the kind of express language provided in the *Gruenberg* and *Anderson* decisions sounding in tort. However, close scrutiny of the reasoning proffered in, ironically, *Olson* and *Pillsbury*,¹⁹² as well as *R.L.B.*, suggests that the Minnesota Supreme Court might consider the tort theory a viable option. Additionally,¹⁹³ several leading scholars explicitly consider Minnesota a tort state.

1. The *Olson* Decision Cited in the *Pillsbury* Decision

Recall that *Olson* involved a first-party insured that brought action against his insurer for failure to pay benefits owed under the policy.¹⁹⁴ In reversing the lower court, Chief Justice Wahl in *Olson* held “punitive damages are not recoverable . . . except in exceptional cases where the breach of contract (1) constitutes or is (2) accompanied by an independent

189. See *id.* at 248 (citing *Olson v. Rugloski*, 277 N.W.2d 385, 387 (Minn. 1979)).

190. *Id.* (citing *Francis v. Western Union Tel. Co.*, 58 Minn. 252, 260, 59 N.W. 1078, 1079 (Minn. 1894)).

191. The Minnesota Court of Appeals constructed an analysis similar to the one constructed in the *Pillsbury* decision in *Cherne Contracting Corp. v. Wasau Ins. Co.*, 572 N.W.2d 339, 339 (Minn. Ct. App. 1997). In *Cherne*, the court addressed a first-party insured’s claim that its insurer breached the good-faith obligation. See *id.* at 341. In declining to adopt the bad-faith tort doctrine, Judge Harten stated “[w]hile Minnesota courts have recognized that an insurer owes a duty of good-faith, such [a] duty has never been expressed as a tort duty.” *Id.* at 343.

192. See also *Cherne*, 572 N.W.2d at 339.

193. See KEETON & WIDISS, *supra* note 33, at 878. Professors Keeton and Widiss state “an insurance company’s obligation regarding settlement has frequently been viewed as the breach of a duty to the insured that sounds in tort, rather than as a claim that is based on breach of the insurance contract.” *Id.* at 878 (citing *Norwood v. Travelers Ins. Co.*, 204 Minn. 585, 585, 284 N.W. 785, 785 (1939)).

194. See *Olson*, 277 N.W.2d at 386.

tort.”¹⁹⁵ This language suggests two standards apply.

First, punitive damages are not recoverable absent an *independent*, willful tort. Such language is wholly consistent with the *Lawton* decision of New Hampshire, creating the contract theory of recovery, along with the *Saltou*, and *Haagenson* decisions.¹⁹⁶

The second standard proposed for punitive damages reads something like this: punitive damages are not recoverable unless the breach of contract *constitutes* a tort. This standard echoes that of the *Gruenberg* decision of the California Supreme Court, creating the tort theory of first-party recovery.¹⁹⁷ Hence, the tort theory seed may indeed blossom in Minnesota.

Like *Gruenberg*, *Olson* dealt with the duties obligating an insurer in handling the claim of an insured, namely a duty not to withhold, unreasonably, payments due under a particular insurance policy.¹⁹⁸ In essence, what *Olson* states is that, like *Gruenberg*, the *breach* itself may involve a violation of the implied good-faith obligation, thereby triggering an insured's right to punitive relief.

Pillsbury sounds in tort for the same reasons as *Olson*. In short, *Pillsbury* cites *Olson* for the proposition that “[p]unitive damages . . . are not recoverable . . . except in exceptional cases where the breach of contract constitutes . . . [a] tort.”¹⁹⁹ Without reiterating the arguments set forth immediately above, *Pillsbury*, therefore, sounds in tort as well.

2. The R.L.B. Decision

Wedged between *Olson* and *Pillsbury*, a 1986 decision of the Minnesota Court of Appeals suggests that the tort theory of recovery governs an insured seeking damages exceeding her insurance policy limits with an insurer. The Minnesota Court of Appeals decision in *R.L.B. Enterprises v. Liberty National Fire Insurance Co.*,²⁰⁰ involved the alleged breach of contract by an insurer. In *R.L.B.*, a couple purchased a business on a contract for deed, which required them to be named as co-insureds on all policies covering the business until the debt was paid in full.²⁰¹ The prior owner's insurance agent met with him to suggest a change in insurance carriers.²⁰²

195. *Id.* at 388.

196. *See supra* notes 88-104, 164-181.

197. *See supra* notes 37-57.

198. *See Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1037 (Cal. 1973).

199. *Pillsbury Co. v. National Union Fire Insurance Co.*, 425 N.W.2d 244, 248 (Minn. Ct. App. 1988); *see also Cherne Contracting Corp. v. Wausau Ins. Co.*, 572 N.W.2d 339, 344 (Minn. Ct. App. 1997) (stating that an insurer has no duty independent of the contract).

200. 413 N.W.2d 551 (Minn. Ct. App. 1987).

201. *See id.* at 552.

202. *See id.*

All involved parties agreed on the change.²⁰³ Consequently, an insurance binder totaling \$162,000 was prepared.²⁰⁴ However, the insurer never transferred the binder to the new insurance company.²⁰⁵ After fire destroyed the business, the insurer agreed to pay \$145,000, the amount it claimed was the policy limit at the time of loss.²⁰⁶ Significantly, the court asked whether the insured was entitled to consequential and/or punitive damages.²⁰⁷

The court noted that the insureds were not entitled to consequential damages from a fire insurer who allegedly breached a contract absent allegation that the insurer had committed an independent tort.²⁰⁸ In its reasoning, the court stated that the consequential and punitive damages cannot be recovered for breach of contract unless the breach is accompanied by an independent tort.²⁰⁹ Therefore, under *R.L.B.*, as a condition to recovering *any* extra contractual damages, a tort must exist. Such a notion disposes of the key to the contract theory: that an insured is *always* allowed to seek damages that were reasonably foreseeable at the time of contract formation, whether or not the damages exceed the policy limits.

IV. MINNESOTA SHOULD ADOPT THE CONTRACT THEORY OF RECOVERY

There are two primary reasons Minnesota courts should adopt the contract theory of recovery. First, the tort theory is without sound theoretical foundation. Second, the contract theory of recovery satisfies the concerns of not only the insured, but also of the insurer. Notwithstanding the preceding arguments, it is clear that the *R.L.B.* court reached an improper conclusion through miscalculated reasoning.

A. *R.L.B. Was Improperly Decided*

Regarding the issue of *consequential* damages stemming from first-party insurance disputes, the *R.L.B.* court offered, perhaps, the shortest piece of legal analysis found in any Minnesota decision. The court simply stated, “[i]t is well settled that consequential and punitive damages cannot be recovered for breach of contract unless the breach is accompanied by an independent tort . . . since [the plaintiff] did not allege that [the insurer] has committed [an independent] tort, . . . [the plaintiff was] not

203. *See id.*

204. *See id.*

205. *See id.*

206. *See id.*

207. *See id.*

208. *See id.* at 554.

209. *See id.*

entitled to consequential and punitive damages.”²¹⁰

The *R.L.B.* court was partially correct. True, a plaintiff cannot typically recover punitive damages for a breach of contract unless some tort accompanies the breach.²¹¹ However, the Restatement (Second) of Contracts in no way blends punitive and consequential damages into a single concoction, as the court would have it.²¹² Thus, it is not “well settled” (to place it in the court’s schema) that an insured can collect consequential damages only if a tort exists.

B. *The Tort Theory of Recovery Lacks Theoretical Foundation*

The Supreme Court of Utah in *Beck* constructed a beautiful critique of the controversial tort approach to extra-contractual damages stemming from first-party insurance disputes.²¹³ The court noted, “the analytical weaknesses of the tort approach are easily seen.”²¹⁴

1. *Gruenberg’s Misplaced Reliance on Third-Party Cases*

The *Beck* court pointed out that the *Gruenberg* decision of the California Supreme Court, considered the “birth” opinion of the tort theory of recovery, glossed over some key distinctions between first-party and third-party insureds.²¹⁵ The court noted and criticized *Gruenberg’s* shaky reliance on two third-party, not first-party, insurance disputes.²¹⁶ In essence, the *Gruenberg* court, without precedent, applied the rule of third-

210. See *id.* at 553 (citation omitted).

211. See RESTATEMENT (SECOND) OF CONTRACTS §§ 353, 355 (1981) (“Recovery for emotional disturbance will be excluded unless the breach also caused bodily harm or the contract or breach is of such a kind that serious emotional disturbance was a particularly likely result.”); (“Punitive damages are not recoverable for a breach of contract unless the conduct constituting the breach is also a tort for which punitive damages are recoverable.”).

212. Compare RESTATEMENT (SECOND) OF CONTRACTS § 347 (1981) (stating the expectation interest formula), with RESTATEMENT (SECOND) OF CONTRACTS § 355 (1981) (stating the rule for punitive damages).

213. See *Beck v. Fire Ins. Exch.*, 701 P.2d 795, 799-800 (Utah 1985).

214. *Id.* at 799.

215. See *id.* (citing *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973)). The court notes that such a distinction is “of no small consequence.” *Id.* “In a third-party situation, the insurer controls the disposition of claims against its insured, who relinquishes any right to negotiate on his own behalf.” *Id.* (citing *Craft v. Economy Fire & Cas. Co.*, 572 F.2d 565, 569 (7th Cir. 1978)). “An insurer’s failure to act in good-faith exposes its insured to a judgment and personal liability in excess of the policy limits.” *Id.* (citing *Santilli v. State Farm Life Ins. Co.*, 562 P.2d 965, 969 (Or. 1977)). “In essence, the contract itself creates a fiduciary relationship because of the trust and reliance placed in the insurer by its insured.” *Beck*, 701 P.2d at 799 (citing *Hal Taylor Assoc. v. Union Am., Inc.*, 657 P.2d 743, 748-49 (Utah 1982)).

216. See *id.* (citing *Gruenberg*, 510 P.2d at 1037).

parties to first-parties.

Why does this matter? Drawing a distinction between first-party and third-party insureds is a significant threshold step when examining the obligations between an insurer and insured. For example, the court in *Beck* determined that in third-party circumstances, an insurance company must act in good-faith and be as spirited in protecting the interests of the insured "as it would be in regard to its own."²¹⁷ To the contrary, the court noted that in the first-party area, the insured and the insurer are, essentially, opponents.²¹⁸ Hence, *Gruenberg*, the very foundation upon which courts across the country have relied upon in adopting the tort approach, lacks solidity.

2. Agency Law Dictates a Different Result

The *Beck* court also examined the insurer/insured relationship through the law of agency.²¹⁹ The court noted that when dealing with a third-party insured, the insurer acts as an agent with respect to the claim in controversy.²²⁰ Agency law classifies all agents as a fiduciary with respect to matters falling within the scope of their agency.²²¹

In contrast, in the first-party situation, the rationale for implying a fiduciary relationship does not exist.²²² Stated succinctly, first-party insur-

217. See *id.* One author notes, however, that the duties associated with defending an insured subject to a liability suit can also lead to a conflict of interest, much like a first-party insured situation. See Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1138 (1954) (advocating for a relationship between insurers and insureds that involves mutual duties and rights).

218. See *Beck*, 701 P.2d at 799; see also Douglas R. Richmond, *The Two-Way Street of Insurance Good-Faith: Under Construction But Not Yet Open*, 28 LOY. U. CHI. L.J. 95, 107 (1996) (citing State ex rel. Safeco Nat'l Ins. Co. of Am. v. Rauch, 849 S.W.2d 632, 634 (Mo. Ct. App. 1993)). See, e.g., Douglas R. Richmond, *An Overview of Insurance Bad-Faith Law and Litigation*, 25 SETON HALL L. REV. 74, 76 (1994) (arguing that "increasingly, plaintiffs groundlessly allege insurance companies' bad-faith in attempts to win the judicial lottery."); see also Lish, *supra* note 102, at 1172.

219. See *Beck*, 701 P.2d at 799-800.

220. See *id.* at 800.

221. See RESTATEMENT (SECOND) OF AGENCY § 1(1)(1958) ("Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act."); RESTATEMENT (SECOND) OF AGENCY § 390 cmt. d (1958) ("An agent is not, as such, in a fiduciary relation with the principal as to matters in which he is not employed.")

222. See David D. Hallock, Jr., *Recent Developments in Marine Hull Insurance: Charting a Course Through The Coastal States of the Fourth, Fifth, Ninth, and Eleventh Circuits*, 10 U.S.F. MAR. L.J. 277, 326 (1998) (citing *Employers' Fire Ins. Co. v. Love It Ice Cream Co.*, 670 P.2d 160, 164 (Or. Ct. App. 1983)); see also *Bauman*, *supra* note 29, at 739 ("[I]t is quite clear that the first-party situation lacked the fiduciary-like assumption of duty involved in the third-party case, which provided the justification for tort treatment in that context.")

ance agreements do not create a relationship based on trust and reliance.²²³ “Clearly, then, it is difficult to find a theoretically sound basis for analogizing the duty owed in a third-party context to that owed in a first-party context,” as those adopting the tort theory have.²²⁴

3. *What is the Tort Standard Anyway?*

In adopting the contract theory of extra-contractual recovery, courts need to ask one simple question: What losses were reasonably foreseeable, in the event of breach, at the time of contract formation? To the contrary, courts conducting a tort analysis have encountered some trouble resolving what degree of bad-faith is required to maintain suit against an insurer.²²⁵

For instance in *Gruenberg*, the court stated that an insurer may face liability under a bad-faith tort action if 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.”²²⁶ Yet, the court failed to articulate an exact standard for determining bad-faith on behalf of an insurer in first-party predicaments.

Some states have followed the vague guidance offered by *Gruenberg*.²²⁷ Others impose an acrimonious standard for establishing tort liability in first-party insured cases.²²⁸ All said, the lack of an agreed upon standard

223. See *Beck*, 701 P.2d at 800. This assertion is true because “[i]n a third-party situation, the insurer controls the disposition of claims against its insured, who relinquishes any right to negotiate on his own behalf.” *Id.* at 799.

224. *Id.* at 800.

225. See *Beck*, 701 P.2d at 800; see also Bopp, *supra* note 68, at 527-28. Courts must deal with Wisconsin’s *Anderson* standard, California’s *Gruenberg* standard, and an “Alabama,” “Nebraska,” “North Dakota,” “Ohio,” and “Wyoming” standard. See *Beck*, 701 P.2d at 800.

226. *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1037 (Cal. 1973); see also Thomas C. Cady et al., *The Law of Insurance Company Claim Misconduct In West Virginia*, 101 W. VA. L. REV. 1, 4 (1998) (providing an overview of first and third party insurance issues stemming from the common law and West Virginia Code).

227. See, e.g., *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d 141, 146 (Cal. 1979) (“[I]n the context of disability policies, an insurer cannot reasonably and in good-faith deny payments to its insured without thoroughly investigating the foundation of its denial.”); *Nichols v. State Farm Mut. Auto. Ins. Co.*, 306 S.E.2d 616, 619 (S.C. 1983) (“[I]f an insured can demonstrate bad-faith or unreasonable action by the insurer in processing a claim under their mutually binding insurance contract, he [or she] can recover consequential damages in a tort action.”).

228. See, e.g., *National Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1362 (Ala. 1982) (explaining that normally an insured must be entitled to directed verdict on the contract claim); *Aetna Cas. & Surety Co. v. Broadway Arms Corp.*, 664 S.W.2d 463, 465 (Ark. 1984) (explaining that the insurer’s conduct must be dishonest, malicious, oppressive, and not based on misjudgment or negligence); *McCorkle v. Great Atlantic Ins. Co.*, 637 P.2d 583, 587 (Okla. 1981) (requiring a clear showing that the insurer unreasonably, and in bad-faith, withheld payment of the insured’s

throughout the two dozen states that have adopted the tort approach²²⁹ indicates instability and weakness in the merits of such a theory of recovery.

C. The Contract Approach Satisfies the Concerns of Both the Insured and the Insurer

In deciding whether Minnesota courts should adopt the tort or contract theory of recovery in first-party bad-faith disputes, two antagonistic policy objectives must be contemplated. Foremost, courts should protect consumers from an insurance company's unfair delay or denial of reimbursement due in accordance with the terms of the insurer's contract with the insured. After all, the bargaining power of the insurer vis a vis the bargaining power of the insured is "disparate" in the utmost.²³⁰ Nobody could possibly contend that the insured is in a better position to actually create the terms of the contract with an insurer,²³¹ let alone enforce the agreement.

However, those defending the insurance industry contend that the judicial branch should not dissuade insurers from asserting bona fide defenses to suspect claims.²³² In short, a balance must be struck which protects both the insurer and the insured from unwanted, and unjust, financial hardship.

The reasons proffered by various state courts in adopting the tort

claim).

229. See *supra* text accompanying note 37.

230. See 15A COUCH, *supra* note 1, § 58:3 ("The duty of good-faith and fair dealing may also arise due to the inherently unequal bargaining power between the insured and the insurer."); see also Willy E. Rice, *Judicial Bias, The Insurance Industry and Consumer Protection: An Empirical Analysis of State Supreme Courts' Bad-Faith, Breach of Contract, Breach of Covenant-of-Good-Faith, and Excess-Judgment Decisions, 1900-1991*, 41 CATH. U.L. REV. 325, 327 (1992) ("Simply expressed, the two trillion dollar American insurance industry is enormous.")

231. The power given to an insured stems basically from the freedom to choose with whom they wish to contract, not what the terms of their contract will state.

232. See generally Edwark J. Schrenk & Jonathon B. Palmquist, *Fraud and its Effects on the Insurance Industry*, 64 DEF. COUNS. J. 23, 23 (1997) (presenting an overview of the problems and perceptions associated with insurance fraud). The authors point out some startling statistics regarding the insurance industry. First, they note that in 1995, property and casualty insurance fraud cost \$20 billion. See *id.* Additionally, health care fraud that year accounted for \$95 billion. See *id.* The authors note that this amount equates to approximately 10% of claims paid. See *id.* In response, the authors note, "the insurance industry has been apathetic or naive about the impact of fraud" out of concern for tort liability stemming from investigations. *Id.* Unfortunately, the insurance industry deals with the problem by simply passing the costs onto the consumer. See *id.* These costs have included not only blanket losses, but also fraud prevention monies totaling \$200 million annually. See *id.*

theory of recovery include legitimate policy objectives. An insured should be protected; the insurer should compensate the insured for all damages suffered due to the insurer's misconduct. The insurer has very little motivation to cut a check for proceeds legitimately due their insured. Therein lies the heart of the tort theory of recovery: motivate insurers to pay.

However, there is no reason the contract approach to extra-contractual damages does not legitimately serve the same end, while, contemporaneously, serving the legitimate interests of the often-disliked insurance industry. After all, an insured is always entitled to the benefit of the insured's bargain under the contract theory of recovery.²³³

Keep in mind that an insurance policy is nothing more than a *contract* that spreads risk.²³⁴ Under this arrangement, the insured has the right to recover that which the insured is entitled under the terms of the contract in conjunction with the terms implied in law—and nothing further. In some instances, this means the insured recovers an amount equal to or less than the face value of the policy at issue. In other cases, this means the insured recovers an amount above the express policy limits. Nevertheless, under no circumstance does the insured recover a windfall—something nonexistent in the law of contracts.²³⁵

With the foregoing standard in place, the law is a predictable, bright line.²³⁶ Insurers can better calculate the risks²³⁷ associated with challenging a claim raised by the insured, as they are legally entitled, and obligated, to do. Hence, the insurer may be subject to a penalty for a wrongful denial, but the contract theory does not open insurers up to serve as

233. Moreover, Minnesota claims rooted in contract enjoy a generous six-year (instead of the two-year "tort") statute of limitations. Compare MINN. STAT. § 541.05 (1998) ("Except where the Uniform Commercial Code otherwise prescribes, the following actions shall be commenced within six years . . . [u]pon a *contract or other obligation*, express or implied, as to which no other limitation is expressly prescribed . . .") (emphasis added), with MINN. STAT. § 541.07 (1998) ("Except where the Uniform Commercial Code, this section, section 148A.06, or section 541.073 otherwise prescribes, the following actions shall be commenced within two years . . . for libel, slander, assault, battery, false imprisonment, or *other tort*.") (emphasis added).

234. See generally KENNETH S. ABRAHAM, *DISTRIBUTING RISK* (1986) (providing an overview and perspective on what insurance contracts mean).

235. According to Professors Keeton and Widiss, such windfalls pose serious problems to both insurers and insureds. The authors write "multimillion dollar awards of punitive damages to individual claimants may quite literally endanger the financial stability of the insurance industry." KEETON & WIDISS, *supra* note 33, at 923.

236. See *Oki Am., Inc. v. Microtech Int'l, Inc.* 872 F.2d 312, 315 (9th Cir. 1989) (Kozinski, J., concurring) ("In inventing the tort of bad-faith denial of a contract . . . the California Supreme Court has created a cause of action so nebulous in outline and so unpredictable in application that it more resembles a brick thrown from a third story window than a rule of law.") (citations omitted).

237. See *supra* text accompanying note 227.

the golden parachute of one lucky plaintiff and that plaintiff's contingent lawyer.

V. CONCLUSION

A first-party insured believing an insurer erroneously denied a claim has two advantageous distinct legal theories of recovering extra-contractual damages under the bad-faith doctrine. Both the tort and contract means of redress involve theories with independent, though overlapping, elements, defenses and recoveries.²³⁸ Minnesota courts have hinted at adopting both approaches, should the recognition of first-party bad-faith occur.

An exclusive and expressly noted adoption of the contract theory by the Minnesota Supreme Court would serve the needs of all involved in a pending lawsuit: the insurer, the insured, the lawyers representing them, and possibly even the judges themselves.

Nearly any breach of contract claim involves action, or inaction, that a plaintiff's lawyer can strategically construct as negligence, or another intentional tort claim.²³⁹ If left without circumscription, however, the "incessant tide of tort law"²⁴⁰ would nibble at and, in due time, devour contract law as we know it.

238. See *Firstmark Standard Life Ins. Co. v. Goss*, 699 N.E.2d 689, 695 (Ind. Ct. App. 1998) (citing *Egan v. Burkhart*, 657 N.E.2d 401, 405 (Ind. Ct. App. 1995)).

239. See *Princess Cruises, Inc. v. General Elec. Co.*, 950 F. Supp 151, 156 (E.D. Vir. 1996) (discussing the economic loss doctrine).

240. See *id.* at 156; see also Eileen A. Scallen, *Promises Broken vs. Promises Betrayed: Metaphor, Analogy, and the New Fiduciary Principle*, 1993 U. ILL. L. REV. 897, 898-99. Professor Scallen points out that "[c]ontract [law], however, is not dead . . . [to the] contrary, appellate courts, anxious to ease the pressure on increasingly stretched judicial resources, appear to be narrowing the circumstances under which plaintiffs may state a cause of action for tort damages . . . arising from a contractual setting." *Id.* at 899.