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SURVEY

SURVEY: GOOD FAITH AND FAIR DEALING: AN ANALYSIS OF RECENT CASES

Jim Hubble

I. INTRODUCTION

The tort of breach of the covenant of good faith and fair dealing has grown explosively in Montana. Montana courts initially implied the covenant in relationships involving insurance companies and their insured in the 1960s.¹ Until the late 1970s, the courts refused to imply the covenant out of that context. In the 1980s, the courts have imposed the covenant in many relationships, not only where one of the parties occupies a superior bargaining position, but also where the parties are of relatively equal strengths.²

Business people, insurance companies, banks, and lawyers complain that all of their actions are subject to such scrutiny by customers, clients, employees, lawyers, courts, and juries that they feel “damned if they do” and “damned if they don’t.” They fear that there is no clear standard for good faith and fair dealing, and therefore compliance is impossible.

This survey addresses the current status of the tort by reviewing conduct that the Montana Supreme Court has found significant in recent cases. The survey attempts to provide some guidance to Montana lawyers on how to advise their clients to avoid claims of bad faith and/or to spot significant facts in a client’s case that can support a claim for breach of the tort of the covenant of good faith and fair dealing.

To date, the Montana courts have found the covenant to exist not only in the insurance context, but also in employment, banking, fee arrangements between lawyer and client, and recently in commercial contracts between parties of relatively equal strength.³ Lawyers representing clients engaged in any of those activities have the duty to inform their clients of the conduct that juries and courts have found to support a claim of bad faith.

1. *Jessen v. O’Daniel*, 210 F. Supp. 317 (D. Mont. 1962).

2. *Nicholson v. United Pac. Ins. Co.*, ___ Mont. ___, 710 P.2d 1342, 1347 (1985).

3. *Id.* at ___ 710 P.2d at 1348.

II. EMPLOYMENT

A. History

The Montana Supreme Court first implied the covenant of good faith and fair dealing in an employment relationship in *Gates v. Life of Montana Insurance Co.*⁴ The court held that by failing to follow its own written policies for discharging employees, the employer had unjustly "shattered the peace of mind" of its employees and had violated the covenant.⁵ In a second decision in the same case, the court ruled that sufficiently culpable conduct on the part of the employer will support a claim for punitive damages.⁶ The employer's culpable conduct included not following its written policies, refusing to return a letter of resignation obtained under duress, and not giving a positive employment reference that was promised in exchange for the letter of resignation.⁷

In a subsequent case, *Dare v. Montana Petroleum Marketing Co.*,⁸ the Montana Supreme Court held that proof of the employer's violation of a written policy was not necessary for a finding of a breach of the covenant where an employee had reason to believe that her job was secure.⁹ This holding protected the investment of a worker in a job that she reasonably believed secure as long as she performed satisfactorily.¹⁰

In *Crenshaw v. Bozeman Deaconess Hospital*,¹¹ the court found that the employer had breached the covenant by relying on false charges that it should have investigated when it terminated an employee. The employer later repeated those charges to the state job service. In doing so, the employer deprived the employee of employment in the local medical community and jeopardized her career.¹²

The court in *Crenshaw* also upheld the trial court's admission of expert testimony concerning the hospital's breach of the covenant.¹³ The expert testified that the hospital had committed numerous errors and that the discharge was unjustified.¹⁴ The court

4. 196 Mont. 178, 638 P.2d 1063 (1982) (commonly referred to as *Gates I*).

5. *Id.* at 184, 638 P.2d at 1067.

6. *Gates v. Life of Mont. Ins. Co.*, ___ Mont. ___, 668 P.2d 213, 215 (1983) (*Gates II*).

7. *Id.*

8. ___ Mont. ___, 687 P.2d 1015 (1984).

9. *Id.* at ___, 687 P.2d at 1020.

10. *Id.*

11. ___ Mont. ___, 693 P.2d 487 (1984).

12. *Id.* at ___, 693 P.2d at 492.

13. *Id.* at ___, 693 P.2d at 494-95.

14. *Id.* at ___, 693 P.2d at 498.

found that "fault arising from breach of implied covenant of good faith and fair dealing is not easily comprehensible to the average person."¹⁵

The court further held that it was not error for the trial court to instruct the jury on negligence as a possible theory of recovery in the case.¹⁶ The court reasoned that by not interviewing all key witnesses the hospital's conduct failed to meet the legal standard of protecting the employee from unreasonable risk.¹⁷ Unfortunately, the court failed to clearly state whether negligence is an issue in an action involving the covenant of good faith and fair dealing. However, the court ruled that the hospital's actions amounted to more than "ordinary negligence" and that the evidence supported the jury's award of damages.¹⁸

B. *Flanigan—Recent Developments*

The court affirmed its prior holdings in the most recent case involving the covenant in an employment relationship: *Flanigan v. Prudential Federal Savings & Loan Association*.¹⁹ In *Flanigan*, the jury found that the employer's conduct was so outrageous as to warrant an award of \$1.3 million in exemplary damages, \$94,000 in economic damages, and \$100,000 for emotional distress.²⁰ The supreme court affirmed the award in a 4 to 3 decision.

Ms. Flanigan had worked for Prudential Savings and Loan in Butte for 28 years. During that time she had performed a number of jobs, all of them satisfactorily.²¹ During early 1980, the company eliminated her position as an assistant loan counselor and retrained her as a teller.²² A few weeks later the company terminated her employment without notice and without hearing.²³ More than a year later the company offered to reinstate her as a part-time teller.²⁴

As in *Crenshaw*, Ms. Flanigan introduced expert testimony. The expert testified that the company had violated its own personnel policies regarding job security and job rights thirteen times

15. *Id.* at ____, 693 P.2d at 494.

16. *Id.* at ____, 693 P.2d at 493.

17. *Id.*

18. *Id.* at ____, 693 P.2d at 495-96.

19. ____, Mont. ____, 720 P.2d 257 (1986).

20. *Id.* at ____, 720 P.2d at 258.

21. *Id.* at ____, 720 P.2d at 259.

22. *Id.*

23. *Id.*

24. *Id.*

when it terminated Ms. Flanigan.²⁵ The company failed to give Ms. Flanigan notice, or a hearing, and failed to recall her to fill vacant positions.²⁶

The court found that the testimony of company officials could have indicated to the jury that the company had ulterior motives for terminating Ms. Flanigan's employment.²⁷ Her former supervisor testified initially that Ms. Flanigan was terminated as part of a reduction in force, unrelated to her job performance.²⁸ However, he changed his testimony later in the trial when he stated that she was terminated on account of poor job performance.²⁹ The court found that the lack of credibility of the supervisor's testimony may well have caused the jury "not to believe [the company's] whole case."³⁰

At the time of her termination, her supervisor told her that she was "not making it as a teller" and that she was "vindictive" in using her seniority to claim the month of August as her vacation period.³¹ However, several months later the president of the company informed her that her termination was the result of a company-wide reduction in force and that her seniority and job performance had no bearing on the decision to terminate her.³²

Additionally, the company president's testimony indicated that Ms. Flanigan's age was a prime reason for her termination. He "referred to older employees as 'dead wood,' 'old dead wood,' and 'ballast.' He reiterated at the time of trial that he considered Mildred Flanigan to be 'ballast.'"³³ The court referred to his attitude as "calloused."³⁴ "Implicit throughout the respondent's case [was] the allegation that she was terminated because of her age and because of a desire on the part of the employer to cut costs associated with respondent's pension."³⁵

The company gave her no warnings that her employment was in jeopardy due to her job performance.³⁶ In fact, her supervisor testified that her performance was not bad enough to warrant

25. *Id.* at ____, 720 P.2d at 264.

26. *Id.* at ____, 720 P.2d at 259.

27. *Id.* at ____, 720 P.2d at 262.

28. *Id.* at ____, 720 P.2d at 260.

29. *Id.*

30. *Id.* at ____, 720 P.2d at 262.

31. *Id.* at ____, 720 P.2d at 261.

32. *Id.*

33. *Id.* at ____, 720 P.2d at 265.

34. *Id.*

35. *Id.* at ____, 720 P.2d at 261.

36. *Id.*

termination.³⁷

The court did not split over the issue of liability, but over the amount of damages. The majority held that it would not substitute its judgment for that of the jury even though the damages were "large."³⁸ The majority discussed punitive damages in conjunction with the company president's testimony regarding older employees and reasoned that "[t]he jury could have inferred malice from the lack of candor on the part of the [bank]."³⁹ The dissenters disagreed only with the majority's opinion regarding the affirming of the \$1.3 million punitive damage award.⁴⁰

Therefore, employers and their lawyers should not interpret this case as being a close call on liability. They should look at the facts of this case in light of their own policies and practices as they apply to the termination of employment. The court agreed with the jury that the employer had not dealt in good faith and fairly with Mildred Flanigan when it terminated her after 28 years of evidently satisfactory job performance without warning or notice in violation of its own policies and for an evidently discriminatory purpose.

In addition to its questionable handling of the termination, the company subsequently changed its position relative to the reason for termination on at least two occasions: once before and once during the trial. To be even minimally credible, an employer has to at least adopt and maintain the same position regarding actions that affect its employees, particularly in the face of a lawsuit alleging wrongful termination.

Employers should establish systems to monitor and review

37. *Id.*

38. *Id.* at ____, 720 P.2d at 265.

39. *Id.* While this survey deals mainly with the conduct that the Montana Supreme Court has found to constitute a breach of the covenant of good faith and fair dealing, it also includes some discussion of punitive damage awards. "Section 72-1-221, MCA provides for punitive awards in cases of 'actual' malice and 'presumed' malice." *Owens v. Parker Drilling Co.*, __ Mont. ____, 676 P.2d 162, 163 (1984); MONT. CODE ANN. § 27-1-221 (1985). In *Owens*, the court adopted the following standard for "presumed" malice:

When a person knows or has reason to know of facts which create a high degree of risk of harm to the substantial interests of another, and either deliberately proceeds to act in conscious disregard of or indifference to that risk, or recklessly proceeds in unreasonable disregard of or indifference to that risk, his conduct meets the standard of willful, wanton, and/or reckless to which the laws of this State will allow imposition of punitive damages on the basis of presumed malice.

Owens, __ Mont. at ____, 676 P.2d at 164. MONT. CODE ANN. § 27-1-221 (1985) also defines presumed malice, as well as actual malice, oppression, and fraud. It also provides that juries may award exemplary or punitive damages upon finding oppression, fraud, actual malice, or presumed malice. MONT. CODE ANN. § 27-1-221 (1985).

40. *Flanigan v. Montana City of Montana*, 720 P.2d at 266-67 (Weber, J., dissenting).

each termination decision to ensure compliance with the standards of conduct established by the foregoing court decisions. Employers must follow their own policies. Even if the employer does not have such policies the courts will imply an obligation to have a "fair and honest reason" to terminate an employee's services.⁴¹ With or without written policies, employers should examine each termination decision to be sure that the termination is not motivated by such ulterior reasons as vindictiveness or discrimination.

III. ATTORNEY CLIENT RELATIONSHIPS

A. *Morse v. Espeland*

Lawyers have a duty to act in their client's best interests. This duty amounts to a fiduciary obligation.⁴² But when negotiating or attempting to collect a fee from a client the fiduciary relationship ceases to exist and the lawyer must operate at arm's length from his client.⁴³

In *Morse v. Espeland*, the lawyer was representing his client in a dissolution.⁴⁴ The client testified that, in their initial dealings, the lawyer told her that his fee would be \$5,000, or slightly higher if the case became complicated. The attorney testified that they had agreed on an hourly fee rate of \$60. However, there was no written agreement to confirm any fee arrangement.⁴⁵

Eventually the client won a judgment for \$667,555.75 in the dissolution.⁴⁶ The lawyer then told the client that his services would be very expensive. When she reminded him of the \$5,000 figure they had agreed on, he said, "I wouldn't dig ditches for that."⁴⁷ The lawyer sued the client for his fee, expenses, and costs. The client counterclaimed in constructive fraud, negligent breach of fiduciary duty and deceit.⁴⁸ The trial court granted summary judgment in favor of the lawyer, but the supreme court reversed that decision, finding that the client had alleged enough facts in her counterclaim to make out a case for bad faith on the part of the lawyer.⁴⁹ The court allowed the client to amend her complaint so that she could gain a recovery if she could prove what she had

41. *Id.* at ____, 720 P.2d at 262.

42. *Morse v. Espeland*, __ Mont. ____, 696 P.2d 428, 430 (1985).

43. *Id.*

44. *Id.* at ____, 696 P.2d at 429.

45. *Id.*

46. *Id.*

47. *Id.*

48. *Id.*

49. *Id.* at ____, 696 P.2d at 430.

alleged.⁵⁰

The court did not specifically set out what particular conduct of the lawyer was objectionable. However, it appears that the failure to reduce the fee arrangement to writing, the failure to keep accurate records of the work he performed, and his subsequent demands and "ditch digging" comment were enough evidence to support a claim of bad faith. The implications are obvious for lawyers: put fee arrangements in writing, keep records, and avoid making unnecessary, insulting remarks to your clients.

IV. BANKING

A. *Twombly*—Good Faith Obligation

Banks owe their customers an obligation to deal with them fairly and in good faith.⁵¹ The bank in *First National Bank v. Twombly*,⁵² anticipating that it would be in a poor collateral position, accelerated the balance on the Twomblys' note prior to its due date, after promising that it would renegotiate the loan and put it on an installment basis.⁵³ The bank also used the Twomblys' checking account balance to partially offset the delinquent loan, without notifying the Twomblys.⁵⁴ As a result, the Twomblys did not have sufficient funds in their account and the bank dishonored several checks.⁵⁵ The bank's officers avoided talking to the Twomblys even though the Twomblys called and visited the bank to discuss the matter.⁵⁶ The bank sued to recover the balance of the delinquent loan and the Twomblys counterclaimed, alleging that the bank had breached its duty of good faith.⁵⁷

The Twomblys won compensatory damages in a jury trial, but the trial court refused to instruct the jury regarding punitive damages, holding that punitive damages were inappropriate in an action on a contract.⁵⁸ On appeal, the supreme court ruled that, because the breach of "the duty to exercise good faith . . . [was] tortious," and if the bank's conduct was sufficiently culpable, the jury could award punitive damages.⁵⁹ The court remanded the case

50. *Id.* at ____, 696 P.2d at 431.

51. See *First Nat'l Bank v. Twombly*, ____, Mont. ____, 689 P.2d 1226, 1230 (1984).

52. *Id.*

53. *Id.* at ____, 689 P.2d at 1228.

54. *Id.* at ____, 689 P.2d at 1229.

55. *Id.*

56. *Id.*

57. *Id.* at ____, 689 P.2d at 1227.

58. *Id.*

to the district court for a trial on the issue of punitive damages only.⁶⁰

The court concluded that a jury could find all of the elements necessary for a punitive damages award in the bank's conduct. These elements included reckless disregard of the Twomblys' rights amounting to malice, oppression in using the Twomblys' checking account funds to offset the loan, and fraud in misrepresenting facts to the Twomblys.⁶¹

B. *Tribby—Retaliation*

In *Tribby v. Northwestern Bank*,⁶² the court implied the covenant again and affirmed its holding in *Twombly* regarding punitive damages. Tribby had an agreement with the bank that it would not honor any of his partnership's checks unless both he and his partner had signed them.⁶³ Subsequently, Tribby and his partner agreed that either partner could sign checks, but they did not notify the bank of this change.⁶⁴ However, at his partner's request the bank issued new signature cards indicating that either partner and Tribby's partner's wife could sign checks singly. The bank did this without notifying Tribby or obtaining his authorization.⁶⁵ The bank honored checks without Tribby's signature. Tribby complained and instructed the bank to discontinue this practice. When he asked to see the signature card the bank initially informed him that it was lost, but later showed him the card. This was his first notice that new signature cards had been issued. The bank then stopped honoring checks with only one signature.⁶⁶

Tribby sued the bank for negligently issuing a new signature card without notifying him.⁶⁷ The bank retaliated by cancelling his overdraft account without notice, saying he was overextended when the account was actually current. The bank also refused to honor several items before notifying him that the bank had cancelled the account.⁶⁸ The bank further refused to renew a loan to Tribby that it had renewed for several years. Additionally, the bank affected his credit status by flagging one of his loans onto a

60. *Id.* at ____, 689 P.2d at 1231.

61. *Id.* at ____, 689 P.2d at 1230.

62. ____, Mont. ____, 704 P.2d 409 (1985).

63. *Id.* at ____, 704 P.2d at 413.

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

“watch list.”⁶⁹

The court held that evidence of such “conduct might support a finding of reckless disregard of Tribby’s rights.”⁷⁰ The court ruled that the trial court had not erred when it issued instructions to the jury to “consider recovery under tort principles and, accordingly, punitive damages.”⁷¹

C. *Eystad*—A Standard for Fairness?

In an even more recent case, *Central Bank v. Eystad*,⁷² the supreme court affirmed the trial court’s finding that the bank had not breached the covenant of good faith and fair dealing.⁷³ The evidence of the bank’s candidness and reasonable treatment of the Eystads, as well as the court’s endorsement of the bank’s conduct may be taken as a standard of conduct that banks should adopt in dealing with customers so as to avoid claims of bad faith dealings.

The bank gave the Eystads more than six month’s notice of its intention not to renew their loan unless the Eystads substantially reduced the principal. The bank’s officers were open and frank in their discussions with the Eystads and when the Eystads failed to reduce the principal, the bank gave them even more time to make other arrangements before accelerating the balance.⁷⁴ Additionally, the bank kept extensive records of its dealings with the Eystads which tended to support its evidence of good faith dealing.⁷⁵

Central Bank’s treatment of the Eystads was considerably different from the banks’ dealings with their customers in *Twombly* and *Tribby*. In those cases the banks were not forthright with the customers, nor did they give advance notice of their actions affecting the customers. Moreover, the banks seemed reluctant to discuss the matters in an open fashion with their customers. As a result, the court not only implied the duty of good faith and fair dealing, it also held that punitive damages were appropriate recoveries for the plaintiff customers, based on the banks’ “reckless disregard” of their customers’ rights from which a jury could infer malice, oppression, or fraud.⁷⁶

69. *Id.*

70. *Id.* at ____, 704 P.2d at 419.

71. *Id.*

72. ____ Mont. ____, 710 P.2d 710 (1985).

73. *Id.* at ____, 710 P.2d at 714.

74. *Id.* at ____, 710 P.2d at 712.

75. *Id.* at ____, 710 P.2d at 713.

76. *Twombly*, ____ Mont. ____, 689 P.2d at 1230; *Tribby*, ____ Mont. ____, 704 P.2d

V. CONTRACTUAL RELATIONSHIPS

A. *Nicholson—Implying the Covenant*

In a far-reaching decision, *Nicholson v. United Pacific Insurance Co.*,⁷⁷ the Montana Supreme Court found that the covenant existed in a contractual relationship where the parties were relatively equal in bargaining strength. Nicholson, a developer and contractor, and United Pacific agreed that Nicholson would remodel certain office space to meet United Pacific's needs and that United Pacific would then lease the space from Nicholson. The parties further agreed that they would confer regarding the remodeling and that the final plans were subject to mutual approval.⁷⁸

Problems arose very soon after the parties signed the agreement. United Pacific criticized Nicholson's remodeling plans as incomplete and Nicholson soon found it difficult to communicate with anyone at United Pacific about the project. The day before the project was to be completed, United Pacific notified Nicholson that it was rescinding the lease agreement.⁷⁹ Nicholson's expenses for the remodeling were in excess of \$90,000 at that time.⁸⁰ Nicholson subsequently notified United Pacific that it was in default and filed a complaint, alleging among other things that United Pacific had acted in bad faith toward him, and requested exemplary damages for United Pacific's breach of the covenant of good faith and fair dealing.⁸¹

United Pacific maintained that Nicholson's shoddy work and failure to meet specifications were justification for its rescission.⁸² However, during discovery Nicholson learned that United Pacific was considering a reorganization that would have made the office space unnecessary. Nicholson alleged that was the reason why United Pacific became impossible to deal with.⁸³ Nicholson prevailed in a jury trial and won substantial compensatory and punitive damages.⁸⁴

The supreme court upheld the judgment, reasoning that due to their agreement both parties had an obligation to deal reasonably with each other.⁸⁵ The court held that unreasonable, capri-

77. ___ Mont. ___, 710 P.2d 1342 (1985).

78. *Id.* at ___, 710 P.2d at 1344.

79. *Id.*

80. *Id.*

81. *Id.* at ___, 710 P.2d at 1345.

82. *Id.*

83. *Id.* at ___, 710 P.2d at 1344.

84. *Id.* at ___, 710 P.2d at 1345.

85. *Id.* at ___, 710 P.2d at 1348.

cious, or arbitrary conduct on the part of one of the parties will subject that party to liability for compensatory damages because such conduct was beyond the "justifiable expectations" of the other party.⁸⁶

The court thus imposed a "reasonable person" standard against which to measure the conduct of parties to agreements. The court stated that contract breaches, even intentional breaches motivated by self-interest were to be expected and even encouraged. But the parties have "a justifiable expectation that the other will act as a reasonable person."⁸⁷ When one of the parties fails to act as a reasonable person, that party will be liable for damages.⁸⁸ The court found that United Pacific's conduct was unreasonable in that it arbitrarily refused to cooperate with Nicholson, making it impossible for him to perform and then rescinded the agreement for his failure to perform.⁸⁹

The court also affirmed the jury's award of punitive damages, finding that United Pacific not only breached the agreement in bad faith, but had done so in such a manner that a jury could find the conduct amounted to "presumed malice."⁹⁰ While a breach of the covenant will support a claim for compensatory damages, to recover punitive damages the plaintiff has to prove malice, oppression, or fraud.⁹¹

B. *Thiel—Contract for Deed*

In *Thiel v. Johnson*,⁹² the Montana Supreme Court affirmed its holding in *Nicholson*.⁹³ The court held that the plaintiffs had acted unreasonably by waiving the time for payments on a contract for deed and then by obtaining possession of the property from the defendants under a court order prior to service of the required notices of default and acceleration of payments.⁹⁴ The court also found that, prior to declaring default and moving to retake possession, the plaintiffs had unreasonably notified the utility companies that they were going to take possession and that the defendants

86. *Id.*

87. *Id.* (citing *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978)).

88. *Nicholson*, ___ Mont. at ___, 710 P.2d at 1348.

89. *Id.* at ___, 710 P.2d at 1346.

90. *Id.* at ___, 710 P.2d at 1349 (citing *Owens v. Parker Drilling Co.*, ___ Mont. at ___, 676 P.2d at 164).

91. *Id.*; MONT. CODE ANN. § 27-1-221 (1985); see *supra* note 40.

92. ___ Mont. ___, 711 P.2d 829 (1985).

93. *Id.* at ___, 711 P.2d at 833.

94. *Id.*

could not pay their bills.⁹⁵ While the jury awarded only actual damages on the defendant's counterclaim alleging fraudulent and malicious acts,⁹⁶ the court found that the conduct was such that it supported the defendant's claim for "bad faith."⁹⁷

C. *McGregor v. Mommer*—"Honesty in Fact" Jury Instruction Inadequate

In *McGregor v. Mommer*,⁹⁸ the court again affirmed its holding in *Nicholson* and ruled that a jury instruction that good faith means honesty in fact inadequately defined the tort. "The tort of the breach of the implied covenant of good faith and fair dealing, as defined in *Nicholson*, requires more than a lack of 'honesty in fact.'"⁹⁹ The court further held that the tort, as defined in *Nicholson*, requires at least arbitrary, capricious, or unreasonable conduct on the part of the defendants.¹⁰⁰ The court remanded the case for retrial because of the inadequate jury instruction, overturning the jury's award of damages for mental distress.¹⁰¹

D. *Bushnell v. Cook*—Intentional Conduct Standard

The court seemingly set a standard requiring proof of intentional conduct to support a claim for breach of the covenant in *Bushnell v. Cook*.¹⁰² *Bushnell* involved a contract to purchase development property. The court held that the trial court did not err by refusing to give jury instructions on the breach of the covenant because one defendant had no actual knowledge of any defect in the land and the plaintiff failed to sustain her burden of proof as to "constructive fraud" against the other defendant.¹⁰³ The court ruled that the plaintiff would have had to prove intentional concealment of the defect, in order to succeed in her claim of bad faith and as she did not sustain her burden of proof on constructive fraud an instruction on breach of the covenant "would have been superfluous."¹⁰⁴

The ruling in *Bushnell* provides an apparent answer to the confusion engendered by the ambiguous ruling in *Crenshaw v.*

95. *Id.*

96. *Id.* at ____, 711 P.2d at 831.

97. *Id.* at ____, 711 P.2d at 833.

98. ____ Mont. ____, 714 P.2d 536 (1986).

99. *Id.* at ____, 714 P.2d at 543.

100. *Id.*

101. *Id.* at ____, 714 P.2d at 545.

102. ____ Mont. ____, 718 P.2d 665 (1986).

103. *Id.* at ____, 718 P.2d at 668.

104. *Id.*

*Bozeman Deaconess Hospital*¹⁰⁵ where the court failed to spell out if simple negligence would support a claim of bad faith.¹⁰⁶ Of course, *Crenshaw* was an employment case while *Bushnell* involved a real estate contract, so practitioners cannot be certain that the intentional conduct standard will apply out of that context. However, the tort seems to resist classification. For example, in a recent insurance case, *Britton v. Farmers Insurance Group*,¹⁰⁷ the court approved a *Nicholson* "unreasonable" behavior jury instruction on what constitutes bad faith. This survey reviews *Britton* in some detail in the succeeding section.

E. *Dunfee—Breaching the Covenant Without Breaching the Contract*

In *Dunfee v. Baskin-Robbins, Inc.*,¹⁰⁸ the court implied the covenant in a franchise agreement. Due to loss of sales and their inability to continue operation of their franchise, the Dunfees requested permission to relocate the franchise from a location for which Baskin-Robbins had a fifteen-year lease. Baskin-Robbins had the sole authority under the franchise agreement to determine the location of the franchise.¹⁰⁹ Baskin-Robbins denied the request and soon the Dunfees' franchise failed due to lack of adequate sales volume.¹¹⁰ The court held that Baskin-Robbins had breached the covenant by: (1) not properly reviewing the Dunfees' request; (2) not attempting to renegotiate the fifteen-year lease, even though the lease was terminable after five years and Baskin-Robbins had the right to sublet the property; and (3) not directing the Dunfees' request to a company official who could approve it.¹¹¹

As Baskin-Robbins had the full right under the contract to select franchise locations, they did not breach the contract by refusing to grant the Dunfees' request to move.¹¹² Yet, Baskin-Robbins breached the covenant because they did not act reasonably in considering "the facts regarding relocation," and because they did not inform the Dunfees of the lease provisions so that the Dunfees could locate another tenant.¹¹³

The trial court instructed the jury on oppression, fraud, and

105. ___ Mont. ___, 693 P.2d 487 (1984).

106. *Id.* at ___, 693 P.2d at 493.

107. ___ Mont. ___, 721 P.2d 303, 317-18 (1986).

108. ___ Mont. ___, 720 P.2d 1148 (1986).

109. *Id.* at ___, 720 P.2d at 1150.

110. *Id.*

111. *Id.* at ___, 720 P.2d at 1155.

112. *Id.* at ___, 720 P.2d at 1153.

113. *Id.* at ___, 720 P.2d at 1153-54.

presumed malice as requirements for an award of punitive damages.¹¹⁴ The Dunfees convinced the jury that Baskin-Robbins had breached the covenant and had acted oppressively, fraudulently, or with presumed malice. The supreme court upheld the jury's award of punitive damages in its 4 to 3 majority opinion, finding that while the facts presented it with a close question, there was sufficient evidence in the record to support the verdict.¹¹⁵ However, it is not apparent from the opinion what conduct of Baskin-Robbins was so egregious and culpable to warrant the "large" award. The majority mentioned misrepresentation and a "vindictive attitude,"¹¹⁶ but failed to discuss how either might support a punitive damage award. As the dissent pointed out, there was also a lack of evidence in the record regarding the "vindictiveness" of Baskin-Robbins.¹¹⁷

VI. INSURANCE

A. History

In *Jessen v. O'Daniel*,¹¹⁸ the Montana Federal District Court first implied the covenant in the insurance context as it related to an insurer's failure to consider its insured's interests as well as its own, resulting in a judgment against the insured in excess of his liability coverage limit.¹¹⁹ Since *Jessen*, the Montana Supreme Court has found that the covenant exists in cases involving the insurer's failure to pay benefits to an insured,¹²⁰ and has allowed injured parties to proceed directly against the tortfeasor's insurance company when the insurance company failed to handle the claims in good faith.¹²¹ A 1984 Montana Law Review article provides an excellent review of the growth of the tort in the insurance context.¹²²

114. *Id.* at ____, 720 P.2d at 1154-55.

115. *Id.* at ____, 720 P.2d at 1155.

116. *Id.*

117. *Id.* at ____, 720 P.2d at 1156-57 (Weber, J., dissenting).

118. 210 F. Supp. 317.

119. *Id.*

120. *Weber v. Blue Cross*, __ Mont. ____, 643 P.2d 198 (1982).

121. *Klaudt v. Flink*, __ Mont. ____, 658 P.2d 1065 (1983).

122. *Graham & Luck, The Continuing Development of the Tort of Bad Faith in Montana*, 45 MONT. L. REV. 43 (1984). In addition to describing the history and state of the tort in 1984, the article pointed out that the courts had not yet answered several questions. Although the scope of this survey is to deal primarily with the issue of what sort of conduct will support a claim of breach of the covenant of good faith and fair dealing, the courts have, in part, answered the questions posed by Graham and Luck. Obviously, the courts have provided an affirmative answer to the question: "Will the courts find the covenant in relationships outside of the insurance and employment contexts?"

B. *Conduct in the Insurance Context*

1. *Fode*

The plaintiff in *Fode v. Farmers Insurance Exchange*,¹²³ complained that the defendant insurance company had wrongfully denied any legal liability resulting from a traffic accident involving its insured, the plaintiff, and a third party. The plaintiff alleged that even though liability was clear the insurance company refused to settle the claim.¹²⁴ The district court granted summary judgment for the insurance company in *Fode's* bad faith action. The supreme court overruled, holding that Section 33-18-201 of Montana Code Annotated created a duty in the insurer to deal fairly with third party claimants.¹²⁵ The court further stated that a claimant does

The other question dealt primarily with the tort and its place in the insurance context. The questions included: (a) whether the courts would affirm awards for mental distress in an action for breach of the implied covenant of good faith and fair dealing in an insurance case; and (b) whether the courts would continue to allow plaintiffs to proceed against insurance companies for breach of the covenant before the plaintiff had succeeded in establishing the original tortfeasor's liability.

The answer to the first question concerning damages for mental distress came in *Gibson v. Western Fire Ins. Co.*, ___ Mont. ___, 682 P.2d 725 (1984). In *Gibson*, the supreme court upheld a jury's award of damages for mental distress suffered by an ophthalmologist whose insurance company had breached the covenant by failing to settle in good faith a malpractice claim against the doctor. *Id.* at ___, 682 P.2d at 729. The trial in the underlying action resulted in a verdict in excess of the doctor's policy limit. The doctor introduced evidence of his mental distress in his bad faith action against his insurance company and the court found no reason to overturn the jury's award of damages compensating the doctor for that mental distress. *Id.* at ___, 682 P.2d at 739.

There was no issue as to liability in *Gibson*, as the doctor and the insurer freely admitted that the doctor had negligently caused the injury in the underlying case. However, the insurance company seriously undervalued the case. It offered a settlement for far less than juries had awarded in similar cases. The court concluded that this was the result of the insurer not following established standards for investigation, evaluation, negotiation, and communication with the insured. *Id.* at ___, 682 P.2d at 736-37.

The court's decision in *Fode v. Farmers Ins. Exch.*, ___ Mont. ___, 719 P.2d 414 (1986), provided the answer to the second question. In a previous decision, *Klaudt v. Flink*, ___ Mont. ___, 658 P.2d 1065 (1983), the court had held that a claimant in an action for breach of the covenant of good faith and fair dealing, could proceed against the insurance company before establishing the original tortfeasor's liability. In *Fode*, the court reversed that decision reasoning that a change in the procedure was necessary to balance the interests of both parties. *Id.* at ___, 719 P.2d at 417. The court found that the *Klaudt* rule "unfairly worked a prejudice to insurers" by exposing matters in the bad faith case that would be otherwise protected by the attorney-client relationship in the underlying liability case. *Id.*

Accordingly, the court ruled that there can be no further proceedings in a bad faith action against an insurance company until settlement or judgment have resolved the liability issues in the underlying case. *Id.* The court further held that while the claimant may file a complaint to toll the statute of limitations, the parties may not engage in discovery. *Id.*

123. ___ Mont. ___, 719 P.2d 414 (1986).

124. *Id.* at ___, 719 P.2d at 415.

125. *Id.* at ___, 719 P.2d at 416.

not have to prove that liability is reasonably clear in order to maintain an action in tort against the insurance company under the statute.¹²⁶ Rather, "[t]he 'reasonably clear' requirement is necessary to show a violation of subsections 6 and 13¹²⁷ of the statute, but other provisions may also be violated and give rise to a cause of action in tort."¹²⁸

2. *Britton—New Standards*

In *Britton v. Farmers Insurance Group*,¹²⁹ the Montana Supreme Court gave further definition to an insurance company's lawful duty to deal fairly and in good faith with an insured. The court held that an insurance company cannot rely solely on evidence that would be inadmissible in court to deny payment of a claim.¹³⁰

In *Britton*, the insurance company relied on polygraph examinations tending to implicate their insured in the arson of his property.¹³¹ The court ruled that results of the polygraph examinations were inadmissible in the case.¹³² The court found that the insurance company had also relied on other inadmissible evidence that was irrelevant, rumor, and hearsay.¹³³ The court held that while an insurance company can consider circumstantial evidence and rely on that evidence to deny payment of a claim, the insurance company cannot rely solely on *inadmissible evidence* to refuse payment.¹³⁴

The court stated that the principal determination in the case was that such reliance was unreasonable and could not support the company's refusal to pay the claim.¹³⁵ Thus, the court found that the company unlawfully refused to pay the insured's claim. The company thereby incurred claims for bad faith and unfair settle-

126. *Id.*

127. MONT. CODE ANN. § 33-18-201 (1985) provides that:

No person may, with such frequency as to indicate a general business practice, do any of the following: . . . (6) neglect to attempt in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear . . . (3) fail to promptly settle claims, if liability has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

128. *Fode*, ___ Mont. at ___, 719 P.2d at 416.

129. ___ Mont. ___, 721 P.2d 303 (1986).

130. *Id.* at ___, 721 P.2d at 306.

131. *Id.* at ___, 721 P.2d at 313.

132. *Id.* at ___, 721 P.2d at 315.

133. *Id.*

134. *Id.* at ___, 721 P.2d at 317.

135. *Id.* at ___, 721 P.2d at 306, 316.

ment practices.

The court described in detail other unfair practices and violations of the covenant by the company that were sufficient by themselves for the trial court to submit the case to the jury for determination of extra-contractual damages and punitive damages.¹³⁶ This conduct included: (1) creating an issue of total loss “to avoid the application of the valued policy statute”; (2) failing to pay “the stated value of the loss to the mortgagee bank”; (3) not negotiating its payment to the bank with the insured as required by the terms of the policy; (4) failing to deny coverage within a reasonable time (here for nine months); (5) taking a partial assignment of the bank’s mortgage on the property, thereby not reducing the amount owed on the property by the plaintiff, and precipitating the bank’s foreclosure action; (6) never raising the issue of arson directly with the plaintiff until it filed its answer and cross claim in the bank’s foreclosure action; (7) claiming a subrogation right without first denying the claim; and (8) wrongfully insisting that the plaintiff’s son was an insured under the policy.¹³⁷

Britton establishes an additional standard for insurance companies to comply with in investigating claims: do not rely on evidence that would be inadmissible in court to deny a claim. It follows then that insurance company claims managers and lawyers must evaluate the information gathered in investigating claims to ensure that they do not rely solely on evidence that would be inadmissible in a trial.

3. *Ellinghouse*

In the recent case of *Safeco Insurance Co. v. Ellinghouse*,¹³⁸ the Montana Supreme Court examined the insurance company’s conduct in handling a third-party claim against its insured, finding that the company’s conduct was egregious.¹³⁹ In April 1980, Safeco accepted coverage of a claim for wrongful death filed against Ellinghouse.¹⁴⁰ Safeco appointed a lawyer to represent Ellinghouse and took charge of the defense of the claim.¹⁴¹ However, in August 1981, Safeco determined that there was no coverage under the policy.¹⁴² Without notifying Ellinghouse of the determination of no

136. *Id.* at ____, 721 P.2d at 317.

137. *Id.*

138. ____, Mont. ____, 725 P.2d 217 (1986).

139. *Id.* at ____, 725 P.2d at 223.

140. *Id.* at ____, 725 P.2d at 219.

141. *Id.*

142. *Id.*

coverage and without consulting the lawyer handling the case, Safeco obtained Ellinghouse's signature on a "no waiver" agreement in October 1981.¹⁴³ In November 1981, Safeco formally notified Ellinghouse that it denied coverage.¹⁴⁴ Later, Ellinghouse settled with the third party on his own, taking a mortgage on his house to raise the funds to settle the case.¹⁴⁵

Safeco filed a declaratory judgment action to determine coverage in September 1982. Ellinghouse counterclaimed in bad faith, fraud, misrepresentation, and breach of contract, for actual and punitive damages.¹⁴⁶ The trial court ruled that there was coverage as a matter of law on the bases of waiver and estoppel.¹⁴⁷ The jury awarded Ellinghouse \$5 million in punitive damages, \$200,000 in damages for emotional distress, and \$25,000 in economic damages.¹⁴⁸

The supreme court affirmed the trial court's ruling that there was coverage as a matter of law, holding that Safeco was estopped from denying coverage eighteen months after it accepted coverage.¹⁴⁹ The court found that Safeco's home office had deliberately ignored the general rule in an insurance estoppel case that once an insurer has accepted coverage, without reservation of right, and has assumed control of the defense, the insurer is estopped from subsequently withdrawing and denying coverage.¹⁵⁰ The court held that the evidence proved that the company was well aware of the rule, having been advised by its adjuster, an attorney, and its own claims division supervisor that it had created estoppel by not immediately notifying the insured of the coverage problem.¹⁵¹

In addition to the disregarding of the rule of estoppel, the court listed nine more examples of Safeco's egregious conduct. (1) Safeco extracted the non-waiver agreement by deceit and later used it against Ellinghouse in the declaratory judgment action. (2) Safeco's acceptance of coverage and assertion of control denied Ellinghouse the opportunity to conduct his own early and independent investigation of the case against him. (3) Safeco used Ellinghouse's deposition, given in the death case when he was unaware of the coverage question, against him to support coverage

143. *Id.*

144. *Id.*

145. *Id.* at ____, 725 P.2d at 220.

146. *Id.* at ____, 725 P.2d at 219.

147. *Id.* at ____, 725 P.2d at 220.

148. *Id.* at ____, 725 P.2d at 219.

149. *Id.* at ____, 725 P.2d at 220.

150. *Id.* at ____, 725 P.2d at 221.

151. *Id.* at ____, 725 P.2d at 221, 222.

denial. (4) For eighteen months, Safeco claimed exclusive control of settlement under the policy, and then refused settlement offers within the policy limits, but did not inform Ellinghouse of his personal risk or need for private counsel. (5) Safeco ordered the lawyer representing it and Ellinghouse to cut back on discovery so as not to incur any additional fees. The record does not indicate what preparations were sacrificed because of this. (6) The lawyer that Safeco appointed to represent Ellinghouse stated in June, 1981, he would file a motion for summary judgment for Ellinghouse by early November. Safeco denied on November 9, 1981, and the lawyer never filed a motion for summary judgment. (7) Safeco never sent a reservation of rights notice. Therefore, its denial surprised the unsuspecting Ellinghouse so that he lost his chance to demand and protect his rights. (8) Ellinghouse had to borrow \$25,000 by mortgaging his house because Safeco failed in its legal duty. (9) Safeco's claims division supervisor knew of the prejudice to Ellinghouse very early in the handling of the case.¹⁵²

Britton and *Ellinghouse*, the cases that preceded them, and Montana's Unfair Claims Settlement Practices Act,¹⁵³ establish high standards of conduct for insurers. The lengthy lists of violations in *Britton* and *Ellinghouse* plus the holdings concerning the issues of reliance on inadmissible evidence and estoppel should provide insurance companies and their lawyers with a substantial amount of information regarding the covenant of good faith and fair dealing and will help them avoid claims of bad faith.

VII. CONCLUSION

Insurers, employers, banks, parties to contracts, lawyers, and the like customarily deal fairly and in good faith with their customers, employees, clients, policy holders, and business associates. That conduct is normally characterized by open, forthright communication, reasonable, non-arbitrary and non-capricious behavior, where the parties respect the objectives of the other and do not act to deprive the other of the right to benefit from the relationship.

When the parties begin to act with ulterior motives and disregard the rights of the other party, they open themselves up to charges of bad faith dealing. As has been seen, such conduct will not easily withstand the scrutiny of courts and jurors, and if the plaintiff can prove that the defendant acted with malice, oppression, or fraud, the penalty may be very heavy.

152. *Id.* at —, 725 P.2d at 223, 224.

153. MONT. CODE ANN. § 33-18-201 (1985).

