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Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort

Since the emergence of promissory estoppel, some commentators have proclaimed the death of contract and the fusion of contract and tort.1 Despite the theoretical overlap, the separation of tort and contract has practical remedial consequences. Tort victims may recover all consequential damages flowing from the wrongful act.2 Parties injured in contract, on the other hand, face several obstacles to full recovery.3

Because tort remedies are more expansive, it is important to identify


2. While the major limitation on tort recovery is proximate cause, other factors may diminish plaintiff's recovery. See RESTATEMENT (SECOND) OF TORTS §§ 918-923 (1977).

3. First, the rule of Hadley v. Baxendale bars recovery for special damages unless the breaching party knew the particular risks at the time of contracting. 9 Ex. 341, 156 Eng. Rep. 145 (1854). See also RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979). See generally Farnsworth, Legal Remesdies for Breach of Contract, 70 COLUM. L. REV. 1145, 1200-10 (1970). Second, courts are reluctant to award damages for mental distress in contract cases. See RESTATEMENT (SECOND) OF CONTRACTS § 333 (1979) (recovery for emotional disturbance excluded unless the breach also caused bodily harm or serious emotional disturbance was "a particularly likely result"). Third, the expectation measure of damages limits recovery, even if reliance losses exceed expectation. See RESTATEMENT (SECOND) OF CONTRACTS § 349 (1979); see also E. Farnsworth, CONTRACTS § 12.16, at 890 (1982).

These restrictions on contract remedies serve purposes not found in tort law. They protect the parties' freedom to bargain over special risks and they promote contract formation by limiting liability to the value of the promise. This encourages efficient breaches, resulting in increased production of goods and services at lower cost to society. See RESTATEMENT (SECOND) OF CONTRACTS § 344 Reporter's Note at 101-02 (1979); R. Posner, supra note 1, at 88-93. Thus, parties in contract may set their own standards of conduct and penalties for violation, within certain limits, and may break contractual promises provided they pay the price. See Cooter, Prices and Sanctions, 84 COLUM. L. REV. 1523, 1537, 1545 (1984). However, where the parties cannot set the terms of their bargain because they are strangers or because public policy considerations warrant intervention, courts and legislatures fix the duty and the remedy through tort law. They establish a penalty rather than a price for violations. See id. at 1538-44. These tort remedies seek to deter injurers rather than merely compensate victims. See RESTATEMENT (SECOND) OF TORTS § 901 (1977). Unlike contract, tort implicitly attaches a moral stigma to liability. See W. Keeton, D. Dobbs, R. Keeton & D. Owen, PROSSER AND KEETON ON THE LAW OF TORTS § 1, at 21-23 (5th ed. 1984) [hereinafter cited as PROSSER & KEETON].
the circumstances where tort law creates duties and remedies. The
guidelines can be reasonably clear when the legislature creates a tort, or
identifies some public policy allowing courts to imply tort duties. In
the absence of such legislative action, courts develop tort duties based on
social and moral requirements. For example, the creation of affirmative
duties may reflect ad hoc moral judgments about what behavior warrants
punishment even though it is unaddressed in the law.

Where these considerations are present, the existence of a contractual
relationship will not bar tort liability. Courts have enforced such
norms in the course of a contractual relationship by finding an independent
tort. Thus, tort liability extends to a railway company for wrong-
fully ejecting a ticketed passenger, to a bailee for negligent loss of the
goods, to a physician for malpractice, and to a landlord for wrongful
eviction. Similarly, outrageous misconduct or intentional infliction of
emotional distress may be tortious even if the parties have a contractual
relationship. In each case, freedom of contract does not denote com-
plete freedom of conduct. Rather, external moral norms protect the par-
ties from socially unacceptable behavior.

The requirement of good faith and fair dealing in contracts also
reflects the imposition of external social norms in contractual rela-
tionships. Recently, courts have applied tort remedies for breach of the
obligation of good faith and fair dealing in insurance cases. Even though
bad faith conduct may not have risen to the level of malicious or outra-
geous behavior, the courts have focused on the inequality of bargaining

4. See, e.g., Tameny v. Atlantic Richfield Co., 27 Cal. 3d 167, 176, 610 P.2d 1330, 1335, 164
Cal. Rptr. 839, 844 (1980).
5. See R. Dworkin, Taking Rights Seriously 86-87 (1977); J. Rawls, A Theory of
Justice 46-53 (1971); see also Prosser & Keeton, supra note 3, § 92, at 655.
(defendant liable to "social guest" for injury caused by broken faucet despite fact that under traditional
common law classification, plaintiff would be "licensee" who could not recover). Justice Car-
dozo's famous dictum in Wagner v. International Ry., 232 N.Y. 176, 180, 133 N.E. 437, 437 (1921),
"danger invites rescue," epitomizes the ad hoc creation of duty based on perceived moral needs. In
Wagner, the court held the defendant liable for injuries the plaintiff sustained while searching for his
cousin, who fell out of the train when its conductor was driving negligently.
7. See, e.g., Hibschman Pontiac, Inc. v. Batchelor, 266 Ind. 310, 314, 362 N.E.2d 845, 847
(1977); Prosser & Keeton, supra note 3, § 92, at 655 ("These [tort] obligations, commonly
referred to as duties, are often owed to all those within the range of harm or at least to some consid-
erable class of people that can include parties to a contract."); see also Prosser, The Borderland of
Tort and Contract, in Selected Topics on the Law of Torts 380, 412 (1953) ("The question
appears to be . . . whether the defendant's performance, as distinct from his promise or his prepara-
tion, has reached the point where it is to be regarded as a positive act undertaking the obligation and
affecting the plaintiff's chances of safety.").
8. See cases cited in Prosser, supra note 7, at 402-416.
9. Courts tend to find the requisite "extreme and outrageous" conduct where the defendant
abuses some position of power over plaintiff. Prosser & Keeton, supra note 3, § 12, at 61. See,
e.g., Eckenrode v. Life of Am. Ins. Co., 470 F.2d 1, 4 (7th Cir. 1972).
power between insurer and insured in imposing tort remedies. Absent such a "special relationship," however, courts have been reluctant to recognize tort remedies to enforce the norms of good faith and fair dealing in ordinary commercial contracts.11

In Seaman's Direct Buying Service, Inc. v. Standard Oil Co.,12 the California Supreme Court considered whether a violation of good faith and fair dealing in ordinary commercial contracts should give rise to a tort action. The court declined to base liability on breach of the implied covenant of good faith and fair dealing. Instead, in a narrow ruling, the court based tort liability on the defendant's wrongful act of "denying, in bad faith and without probable cause, that the contract exists."13

This Comment argues that breach of the implied covenant of good faith and fair dealing should be recognized as a tort action in the formation and enforcement of all contracts. Part I describes the legal background to Seaman's Direct Buying Service and the development of breach of the implied covenant as a tort. It then criticizes attempts to limit the tort to "special relationships." Part II reconstructs the tort by defining the interest protected, the requisite conduct and mental state, and the justification for tort remedies. It distinguishes a tortious breach of the implied covenant of good faith and fair dealing from willful breach of contract, and excludes bad faith conduct in performance from the tort model. Finally, it argues that punitive damages should be awarded only in cases where statutory requirements such as malice, fraud, and oppression are met and not for mere breach of the implied covenant of good faith and fair dealing.

I
LEGAL BACKGROUND

A. The Early Cases

The tort theory of breach of the implied covenant of good faith and fair dealing developed in a series of California cases involving insurers' wrongful refusal to settle policy claims. In Comunale v. Traders & General Insurance Co.,14 plaintiff sued his insurance company for indemnification for refusing to defend him in a third-party action and refusing to accept a reasonable settlement offer. In holding the insurer liable for a judgment in excess of the policy limits, the California Supreme Court

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11. See infra Part I, Section A.
13. Id. at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363. The court reasoned that such conduct "goes beyond the mere breach of contract. It offends accepted notions of business ethics. . . . Acceptance of tort remedies in such a situation is not likely to intrude upon the bargaining relationship or upset reasonable expectations of the contracting parties." Id. (citations omitted).
stated that "[t]here is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement." Therefore, the court held, an insurer who wrongfully refuses to defend the insured and rejects a reasonable settlement offer is liable in tort for breach of the implied covenant. While the court stated in dicta that "wrongful refusal to settle has generally been treated as a tort," it applied California Civil Code section 3300, which provides for contract remedies.

Nine years later, in Crisci v. Security Insurance Co., the court cited the Comunale dicta to justify a tort remedy for mental suffering caused by an insurer's wrongful refusal to settle a third-party claim against the insured. Crisci expanded the principle of Comunale in two ways. First, it applied tort remedies under California Civil Code section 3333, including damages for mental distress, rather than contract remedies under section 3300. Second, it distinguished insurance contracts from ordinary commercial contracts, suggesting that insureds seek "peace of mind and security" in addition to "commercial advantage." This language supplied the special relationship basis for expanding liability under breach of the implied covenant.

In Gruenberg v. Aetna Insurance Co. and Silberg v. California Life Insurance Co., the court expanded the tort of breach of the implied covenant to include an insurer's wrongful refusal to settle a first-party claim. In both cases, the court found that by "unreasonably and in bad faith" withholding an insurance payment, the insurers had breached the

15. Id. at 654, 328 P.2d at 200 (citation omitted).
16. The court found the refusal to defend wrongful because it violated the express policy obligation to defend any personal injury suit covered. It found the refusal to accept a reasonable settlement wrongful because the insurance company "failed to consider [the insured's] interest in having the suit against him compromised by a settlement within the policy limits." Id.
17. Id. at 663, 326 P.2d at 203 (citing Keeton, Liability Insurance and Responsibility for Settlement, 67 HARV. L. REV. 1136, 1138 (1954)). Professor Keeton's article, while significant in its time, did not discuss either a rationale for tort liability or its relation to the implied covenant of good faith and fair dealing. It merely suggested that courts tended to treat insurers' breach of contractual duties as sounding in tort.
19. While the court implicitly recognized in a footnote that Comunale provided a contractual remedy, it explained that "the tort duty is ordinarily based on the insurer's assumption of the defense and of settlement negotiations . . . [and] in Comunale the insurer did not undertake defense or settlement but denied coverage." Id. at 432 n.3, 426 P.2d at 178, 58 Cal. Rptr. at 18 (citation omitted).
20. Id. at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19. Some commentators have argued that the court was merely defining an insurance contract as a "personal" contract, instead of a "commercial" contract, to permit damages for mental suffering. See D. DOBB, HANDBOOK ON THE LAW OF REMEDIES § 12.4 at 820 n.22. But see Note, The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from the Breach of First Party Insurance Contracts, 56 S. CAL. L. REV. 1345, 1361 (1983).
implied covenant. In contrast to Comunale, Gruenberg and Silberg emphasized the breach of the implied covenant as a quasi-fiduciary, extra-contractual duty of good faith and fair dealing rather than a breach of a contractual duty to settle. In addition, Silberg defined bad faith in breach of the implied covenant as a mental state distinct from the malice, fraud, or oppression required to support punitive damages.

After Silberg, two seminal cases upheld the award of punitive damages for an insurer's breach of the implied covenant. In the first case, Neal v. Farmers Insurance Exchange, the insurer unreasonably refused a settlement offer. The court awarded punitive damages, but only on proof of malicious intent beyond bad faith. In the second case, Egan v. Mutual of Omaha Insurance Co., the insurer denied a claim without thoroughly investigating it. The court awarded punitive damages, but confused the distinction between malice and bad faith articulated in Neal. Although it found sufficient evidence to establish malice, the court stated that it was the special relationship between the insurer and the insured that justified the imposition of punitive damages under California Civil Code section 3294.

Some California cases suggest that tort liability for breach of the implied covenant could extend beyond the insurance context. In

23. Gruenberg, 9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486. In Gruenberg, the insurer's bad faith conduct consisted of falsely accusing the insured of arson in order to avoid liability under the policy. In Silberg, the conduct consisted of violating the policy's promise to "Protect the insured Against the Medical Bills That Can Ruin You" by refusing to pay the claim until after a workers' compensation proceeding, by which time plaintiff had incurred "ruinous medical bills." Silberg, 11 Cal. 3d at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

24. Silberg, 11 Cal. 3d at 462, 521 P.2d at 1109, 113 Cal. Rptr. at 717 ("The scope of the duty of an insurer to deal fairly with its insured is prescribed by law and cannot be delineated entirely by customs of the insurance industry."); Gruenberg, 9 Cal. 3d at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485 ("[T]he obligation . . . is deemed to be imposed by the law.").

25. Silberg, 11 Cal. 3d at 456, 462-63, 521 P.2d at 1106, 1110, 113 Cal. Rptr. at 714, 718.


27. The court noted that under California Civil Code § 3294 plaintiff must show "oppression, fraud or malice." Id. at 922, 582 P.2d at 987, 148 Cal. Rptr. at 395 (citations omitted). It further stated that bad faith is distinct from malice and is relevant only to liability for compensatory, and not punitive, damages. Id. at 921 n.5, 582 P.2d at 986, 148 Cal. Rptr. at 395. The court, however, found the requisite malice in the insurer's attempt to use plaintiff's physical, emotional, and financial weakness to extract an unjustifiably favorable settlement. Id. at 922-23, 582 P.2d at 986-87, 148 Cal. Rptr. at 395.


29. Id. at 819, 598 P.2d at 457, 157 Cal. Rptr. at 487. The court reasoned that the duty of good faith and fair dealing requires the insurer to consider the insured's interest in peace of mind and security from financial disaster. Therefore, the insurer "cannot reasonably and in good faith deny payments to its insured without thoroughly investigating the foundation of its denial." Id.

30. Id. at 821, 598 P.2d at 458, 157 Cal. Rptr. at 488.

31. Id. at 820, 598 P.2d at 457, 157 Cal. Rptr. at 487.

32. In addition, many other state courts and legislatures have followed the California cases by imposing tort liability for an insurer's breach of the implied covenant of good faith and fair dealing.
Tameny v. Atlantic Richfield Co., the California Supreme Court held an employer liable in tort for wrongfully discharging an employee who refused to commit a criminal act. The court did not base liability on breach of the implied covenant. In dicta, however, it suggested that wrongful discharge violated a tort duty of good faith and fair dealing, noting that prior California cases had established liability for breach of the implied covenant in tort as well as in contract. Other California cases since Tameny have extended the suggestion.

B. The Seamen's Direct Buying Service Case

In Seaman's Direct Buying Service, Inc. v. Standard Oil Co., Seaman's Direct Buying Service, a close corporation, sought to expand its operations by developing a marine-fuel dealership in conjunction with Eureka City's waterfront redevelopment. Before the city would approve a long-term lease in the marina, Seaman's had to secure a binding commitment from an oil supplier. Seaman's reached a tentative agreement with Standard Oil, which signed a letter of intent.


33. 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980).

34. The court justified tort liability by finding that the ordered crime violated "a duty imposed by law upon all employers . . . to implement the fundamental public policies embodied in the state's penal statutes." Id. at 176, 610 P.2d at 1335, 164 Cal. Rptr. at 844. It distinguished implied-in-law duties based on public policy from contractual duties designed to protect performance of the promise.

35. Id. at 179 n.12, 610 P.2d at 1337, 164 Cal. Rptr. at 846.

36. Id.

37. See, e.g., Cleary v. American Airlines, Inc., 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980) (termination of employment without legal cause after 18 years of service violates the implied covenant of good faith and fair dealing); Canceller v. Federated Dep't Stores, 672 F.2d 1312, 1318 (9th Cir.), cert. denied, 459 U.S. 859 (1982) (arbitrary or unfair employment termination violates implied covenant). Linking "public policy" objections to the implied covenant of good faith and fair dealing is disturbing because it suggests that the implied covenant creates a tort duty not to terminate employment without legal cause. This is the same as a contractual obligation to continue employment. The implied covenant thus becomes equivalent to the duty to perform contractual promises, which makes breach of contract tortious on the basis of violating "public policy." But see infra text accompanying notes 146-61.

was subject to government approval of the contract, continued approval of Seaman's credit status, and future agreement on specific arrangements. Seaman's offered the letter to the city and signed a long-term lease. Shortly thereafter, new federal regulations limited oil supply. As a result, Standard Oil refused to perform unless Seaman's obtained an exemption from the Federal Energy Office. Seaman's received an exemption and a supply order from the agency. Standard Oil appealed and persuaded the agency to reverse the order. Seaman's then appealed the reversal. The agency reissued the supply order contingent on a court determination that a valid contract existed between the parties. Seaman's asked Standard Oil to stipulate to the existence of a valid contract, stating that a refusal would force Seaman's to discontinue operations. Standard Oil refused. Seaman's discontinued operations and sued Standard Oil for breach of contract, fraud, intentional interference with contractual relations, and breach of the implied covenant of good faith and fair dealing.

The jury verdict was in favor of Seaman's on all claims except for fraud. It awarded a total of $2,382,300 in compensatory damages and $22,117,620 in punitive damages. On appeal, the California Supreme Court affirmed the breach of contract claim and reversed the claim for intentional interference with contractual relations. In addition, the court reversed and remanded the claim for breach of the implied covenant because of prejudicial failure to include a bad faith requirement in the jury instructions. That is, the lower court failed to instruct that Standard Oil could be liable only if it "adopt[ed] a 'stonewall' position ('see you in court') without probable cause and with no belief in the existence of a defense." It thus permitted the jury to hold Standard Oil liable without a finding of bad faith.

Chief Justice Bird, concurring in part and dissenting in part, urged that precedent "compelled" a finding that bad faith denial of the existence of a valid contract was a tortious breach of the implied covenant. Bird stressed that such conduct violated the injured party's basic expectation of compensation in the case of a contract breach. Additionally, Bird suggested that if at the time of contracting "the possibility that the contract will be breached is not accepted or reasonably expected by the parties," then breach of contract itself could constitute a tortious breach of the implied covenant, independent of a showing of "bad faith."

39. Following Standard Oil's motion for a new trial, Seaman's consented to a reduction of punitive damages to $7 million, of which $1 million represented the claim for breach of the implied covenant. Seaman's Direct Buying Service, 36 Cal. 3d at 762, 686 P.2d at 1162, 206 Cal. Rptr. at 358.
40. Id. at 769-70, 686 P.2d at 1167, 206 Cal. Rpt. at 363.
41. Id. at 775, 686 P.2d at 1171, 206 Cal. Rptr. at 367 (Bird, C.J., concurring and dissenting).
42. Id. at 780, 686 P.2d at 1174, 206 Cal. Rptr. at 370 (Bird, C.J., concurring and dissenting).
C. Analysis

1. The Special Relationship Model

The majority in *Seamen's Direct Buying Service* cautioned against extending tort liability for breach of the implied covenant of good faith and fair dealing beyond parties with special relationships to ordinary commercial agreements. It identified two reasons. First, in special relationship cases such as those involving insurance contracts, "elements of public interest, adhesion, and fiduciary responsibility" leave plaintiffs unprotected from conduct that breaches the implied covenant. In commercial contracts, on the other hand, the parties' relatively equal bargaining power provides them an opportunity to allocate their own risks. Second, in commercial contracts, "it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectations of the parties." These rationales invite courts to limit the expansion of tort remedies for breach of the implied covenant to other special relationships. Since *Seamen's Direct Buying Service*, two California appellate courts have extended tort remedies for breach of the implied covenant on this ground. In *Commercial Cotton Co. v. United California Bank*, the court held that since banking and insurance share the special relationship characteristics outlined in *Seamen's Direct Buying Service*, a "stone-walling effort to prevent an innocent depositor from recovering money entrusted to and lost through the bank's own negligence" is a tortious breach of the implied covenant of good faith and fair dealing. Similarly, in *Wallis v. Superior Court (Kroehler Manufacturing Co.)*, the court held a defendant who wrongfully terminated a former employee's payments liable in tort for breach of the implied covenant. The court interpreted *Seamen's Direct Buying Service* to require five "similar char-

43. *Seaman's Direct Buying Service*, 36 Cal. 3d at 769, 686 P.2d at 1166, 206 Cal. Rptr. at 362.
44. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.
46. In addition, one California court has denied tort damages for breach of the implied covenant of good faith and fair dealing based on a reading of *Seaman's Direct Buying Service*, on the ground that a special relationship was lacking. See Quigley v. Pet, Inc., 162 Cal. App. 3d 223, 235-38, 208 Cal. Rptr. 394, 401-02 (1984).
47. *Id.* at 511, 209 Cal. Rptr. 551 (1985).
48. *Id.* at 516, 209 Cal. Rptr. at 554.
49. *Id.* at 1109, 207 Cal. Rptr. 123 (1984).
characteristics" to an insurance contract that would make breach of the implied covenant tortious:

1. the contract must be such that the parties are in inherently unequal bargaining positions; (2) the motivation for entering the contract must be a non-profit motivation, i.e., to secure peace of mind, security, future protection; (3) ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party "whole"; (4) one party is especially vulnerable because of the type of harm it may suffer and of necessity, places trust in the other party to perform; and (5) the other party is aware of this vulnerability. It concluded that "the characteristics of the insurance contract which give rise to an action sounding in tort are also present in most employer-employee relationships."

2. Limitations of the Special Relationship Model

The attempts to limit expansion of the tort to special relationships are based on historical developments which are analytically questionable. The notion that a breach of the implied covenant of good faith and fair dealing might be tortious emerged from dicta asserting that insurers' wrongful refusal to settle has generally been regarded as tortious. Yet subsequent cases never explained the reason for this link, nor have they justified why breach of the implied covenant generally should be treated as a tort.

The special relationship limitation is subject to several criticisms. First, none of its proponents have explained why a special relationship justifies tort liability for conduct that otherwise might be legal, or perhaps subject to contract remedies. Since tort damages serve to prevent and

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50. Id. at 1118, 207 Cal. Rptr. at 125. See also Louderback & Jurika, supra note 45, at 227.
52. The use of a special relationship as the determining factor for imposing tort liability has been criticized in various areas of the law. See, e.g., Note, Professional Obligation and the Duty to Rescue: When Must a Psychiatrist Protect His Patient's Intended Victim?, 91 YALE L.J. 1430, 1437 (1982) ("However attractive the term 'special relationship,' the 'special relationship' analysis is analytically vulnerable and lacks a principled basis for acceptance by other courts... [T]he judicial method applying the label of 'special relationship,' without articulating the components of the relationship that create affirmative duties, does not itself rise to the level of principled justification."). In many cases, the term special relationship serves merely as a conclusory label to justify liability. See Sullivan, Punitive Damages in the Law of Contract: The Reality and the Illusion of Legal Change, 61 MINN. L. REV. 207, 226-40 (1977). In other cases, courts have denied the existence of a special relationship as a basis for tort liability despite the clear logical connection and close personal relation between the parties. See Murphy, Evolution of the Duty of Care: Some Thoughts, 30 DE PAUL L. REV. 147, 174 (1980) ("[C]ourts wishing to deny liability will find the principles embodied in [Restatement (Second) of Torts] Section 315 [on special relationships] a convenient and plausible device.") (citing cases denying a special relationship between parties such as insurer and insured, rehabilitation program officer and probation patient, passenger and driver, veterans' home and resident patient, city and public high school student).
punish socially unreasonable conduct, their recovery should turn on the nature of the conduct, rather than on the nature of the contractual relationship.\textsuperscript{53} Moreover, since the implied covenant exists in every contract, it is illogical to have breach of the implied covenant give rise to tort liability in special relationships but to mere contract liability in commercial relationships.\textsuperscript{54}

Second, the special relationship limitation currently is inadequate to define the scope and application of a tort duty of good faith and fair dealing. Since the doctrine is triggered by a relationship between the parties rather than by an act, the special relationship model is both overinclusive and underinclusive. On the one hand, the special relationship could be used to justify tort liability for any breach of contract. On the other hand, since the model fails to define proscribed conduct, it may allow parties to avoid tort liability by drawing artificial distinctions between various types of conduct within the special relationship.\textsuperscript{55} For example, wrongful denial of the existence of a contract could be deemed tortious, while wrongful denial of a particular obligation in the contract may be deemed not tortious. Therefore, the doctrine lacks a unifying definition of what conduct violates the implied covenant.

Third, the special relationship model fails to distinguish between breach of the implied covenant of good faith and fair dealing and "bad faith breach of contract."\textsuperscript{56} If breach of the implied covenant is synony-

\textsuperscript{53} See, e.g., Bullis v. Security Pac. Nat'l Bank, 21 Cal. 3d 801, 812-13, 582 P.2d 109, 115, 148 Cal. Rptr. 22, 28 (1978) (basing bank's liability for estate's loss on negligent conduct rather than on a duty to control trustee created by the special relationship doctrine); see also Rulon-Miller v. IBM, 162 Cal. App. 3d 242, 252-53 (1984). Rulon-Miller interprets Seaman's Direct Buying Service as resting on a "broader principle" than the special relationship between insurer-insured or employer-employee. "The conduct of the breaching party is the focus of the tort, particularly where there is an attempt to shield oneself from liability, in bad faith and without probable cause." Id. at 253.

\textsuperscript{54} See Burton, Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 HARV. L. REV. 369, 372 n. 17 (1980) ("Good faith . . . should not be equated with 'good faith' . . . as a fiduciary duty, because the doctrine obviously could not mean that every contract requires 'something stricter than the morals of the marketplace.' ")

\textsuperscript{55} See infra note 63.

\textsuperscript{56} This lack of distinction stems in part from the insurance cases' confusion between breach of a contractual promise to pay benefits under the insurance policy and breach of an implied duty to fairly and in good faith administer the insured's interest in the policy benefits. For example, the court in Silberg v. California Life Ins. Co. found a breach of the implied covenant in defendant's breach of a contractual obligation, namely, the "express promise to protect [plaintiff] against ruinous medical bills." 11 Cal. 3d 452, 461, 521 P.2d 1103, 1109, 113 Cal. Rptr. 711, 717 (1974). A second factor is the shift in emphasis from the Crisci dicta that "wrongful refusal to settle [arises generally been treated as a tort"] to the notion in Tameny, Seaman's Direct Buying Service, and Wallis of breach of the implied covenant as an independent tort outside the original insurance context. Thus, breach of the promise to maintain employment or postemployment benefits is implicitly equated with breach of an implied covenant not to terminate employment or benefits. A third factor may be the tendency to merge tortious breach of the implied covenant with such existing doctrines as unconscionability and infliction of emotional distress. For example, Gruenberg relied on precedents using two different theories to find the wrongful withholding of insurance payments tortious. In Richardson v. Employ-
mous with mere willful breach of contract, then every intentional breach of contract becomes tortious.\textsuperscript{57} This result undermines basic premises of contract law: that contract damages serve to limit liability, that willful breaches carry no moral stigma, that compensation is the main goal of contract remedies, and that punishing intentional breaches would be inefficient and would deter contract formation.\textsuperscript{58} Moreover, if contractual imbalance is a key factor in finding a special relationship, then it is not clear why tort remedies are necessary, since contract doctrines such as unconscionability, mistake and capacity already address problems of adhesion under contract law.\textsuperscript{59}

Fourth, the special relationship model fails to explain why punitive damages are an appropriate remedy. If the true concern is to punish breach of a fiduciary duty, then perhaps criminal fines and sanctions would be the most effective legal response. On the other hand, if bad faith does not rise to the level of culpability of malice, then punitive damages are too harsh a sanction for a violation of good faith and fair dealing.\textsuperscript{60} And, since the conduct and intent elements of the tortious breach of the implied covenant are so imprecisely defined, the prospect of punitive damages might serve to unfairly chill legitimate conduct. Finally, if contract remedies are inadequate, then the possibility of tort remedies or amplified contract remedies should be explored before using the volatile mechanism of punitive damages to correct remedial deficiencies.

\textsuperscript{57} Indeed, the confusion between breach of the implied covenant of good faith and fair dealing and breach of contract is reflected in the fact that leading articles refer to the tort as "bad faith breach of contract." See, e.g., Diamond, The Tort of Bad Faith Breach of Contract: When, If At All, Should It Be Extended Beyond Insurance Transactions?, 64 MARQ. L. REV. 425, 433-39 (1981) (equating tortious breach of the implied covenant with intentional, inefficient breach of contract); Louderback & Jurika, supra note 45, at 220-23 (suggesting that mere breach of contract may be tortious where four elements exist: contractual imbalance, contracting for the purpose of purchasing peace of mind, fiduciary relationship, and an attempt to deny contract rights). This misnomer suggests that the emerging tort would offer punitive damages, in certain relationships, for mere willful breach of contract. See also Holmes, Is There Life After Gilmore's Death of Contract?—Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts, 65 CORNELL L. REV. 330, 356-59 (1980); Comment, The New Tort, supra note 32.

\textsuperscript{58} See supra note 3.

\textsuperscript{59} In each case, the remedy is rescission, not tort liability. For example, the Restatement (Second) provides that abuse of a fiduciary relationship makes a contract voidable when the contract is on fair terms or the beneficiary manifests assent with full understanding of his legal rights and relevant facts that he knows or should know. RESTATEMENT (SECOND) OF CONTRACTS § 173 (1979).

\textsuperscript{60} In fact, under the California statutory scheme, punitive damages may not be awarded except for oppression, fraud, or malice. CAL. CIV. CODE § 3294 (West 1984). See infra notes 171-80 and accompanying text (distinguishing malice from bad faith).
II
RECONSTRUCTING BREACH OF THE IMPLIED COVENANT OF
GOOD FAITH AND FAIR DEALING AS TORT

A. Requisite Conduct and Mental State

To reconstruct the broad duty of good faith and fair dealing implied in every contract, it is necessary to return to the definition set out in Comunale. "There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."61 Those benefits consist in either the agreed upon performance or the value of that performance in the event of breach. When a party breaches the contract, whether willfully or unintentionally, the other party retains the right to obtain the contract benefits by resort to litigation. That is, the party can seek expectation remedies which will provide the economic means to a market substitute for the breached performance. However, when the breaching party also wrongfully obstructs the aggrieved party's pursuit of expectation remedies, either by denying or by asserting liability "without probable cause and with no belief" in the claim, he creates another kind of injury. Such conduct injures the aggrieved party's right to receive the benefits of the agreement through the substitutionary value. Hence, the implied covenant of good faith and fair dealing is breached whenever one party wrongfully obstructs the other's interest in receiving accurate compensation for the unfulfilled promise.62

Obstruction of remedies may take many forms. For example, it may consist of wrongfully refusing to defend an insured against a third party (Gruenberg); wrongfully using the other party's physical, financial, or emotional weakness to extract an unfair settlement (Neal); wrongfully failing to properly investigate the insured's claim (Egan); stonewalling by wrongfully denying the existence of a contract (Seaman's Direct Buying Service); wrongfully coercing a party to pay more than is due under a lawsuit (Adams); or wrongfully disputing liability or an obligation under the contract.63 In each case, liability will turn not on the nature of the relationship between the parties, but on their conduct: whether a wrongful act obstructed the injured party's interest in securing the substitution-

62. Accurate compensation means the level of compensation the injured party would be entitled to under contract law, assuming the injurer was not distorting the court's assessment of liability by asserting or denying a claim in bad faith and unreasonably.
63. In this respect the focus of Seaman's Direct Buying Service is too narrow, since it creates an artificial distinction between disputing the existence of a contract and disputing duties, performance, and other aspects of the bargaining process. See Traynor, Bad Faith Breach of a Commercial Contract: A Comment on the Seaman's Case, 8 BUS. L. NEWS 1, 10-12 (1984) (a publication of the California State Bar Association). For other forms of tortious breach of the implied covenant, see infra text accompanying notes 118-33.
ary value of the agreement. 64

Now that the interest to be protected has been identified, the next issue in the reconstruction of the tort is the requisite level of culpability. The language of the implied covenant provides both a subjective requirement, "good faith," and an objective requirement, "fair dealing." In other words, a party breaches the implied covenant by initiating conduct or taking a position that lacks both subjective validity and objective legitimacy. The actor violates the requirement of good faith if he subjectively lacks belief in the validity of the act. He violates the requirement of fair dealing if the conduct or claim is objectively unreasonable. 65 These standards correspond to the language of Seaman's Direct Buying Service that


The law of corporations also suggests an analogy in the doctrine of piercing the corporate veil. Generally, courts recognize incorporation as a legal form to achieve limited liability. H. HENN & J. ALEXANDER, LAW OF CORPORATIONS § 146, at 344 (1983). But "[p]erversion of the concept to improper uses and dishonest ends (e.g., to perpetuate fraud, to evade the law, to escape obligations), on the other hand, will not be countenanced." Id. at 346. In such cases, courts will disregard the corporate form and impose unlimited liability on the shareholder. See, e.g., Walkovszky v. Carlton, 18 N.Y. 414, 223 N.E.2d 6, 276 N.Y.S. 585 (1966).

Procedural rules also provide sanctions for bad faith conduct which frustrates a party's right to the benefits of a contractual relationship or legal process. For example, courts may provide sanctions for willful failure to comply with discovery. See Fed. R. Civ. P. 37(b). Similarly, courts may impose sanctions for filing a frivolous appeal. See Fed. R. App. P. 38; Martineau, Frivolous Appeals: The Uncertain Federal Response, 1984 Duke L.J. 845. Indeed, the good faith requirement under the Federal Rules of Civil Procedure resembles the definition of breach of the implied covenant of good faith and fair dealing reconstructed here. Under Rule 11, an attorney must certify that every pleading, motion or other paper to the best of his knowledge, information and belief formed after reasonable inquiry . . . is well grounded in fact and is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law, and . . . is not interposed for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation. Fed. R. Civ. P. 11. The rule, like the implied covenant of good faith and fair dealing, imposes a duty to avoid acting "in bad faith [and unreasonably] in instituting or conducting litigation." Fed. R. Civ. P. 11 advisory committee note. The sanction for violation may include the other party's expenses, id., which is the functional equivalent of tort liability for a plaintiff's consequential losses.

65. Many commentators have attempted to formulate a definition of good faith. See, e.g., Reiter, supra note 10, at 706 n.3 (citing proposed definitions, including "fairness," "decency," "a common ethical sense," and "a spirit of solidarity"). See generally Summers, "Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code, 54 Va. L. Rev. 195, 204-06 (1968).

The model of good faith and fair dealing proposed here is functional. It focuses on the requisite objective and subjective mental states necessary to satisfy the tort. The objective requirement is the familiar reasonableness standard for negligence. The test is whether a reasonably prudent person
proscribes conduct initiated "in bad faith and without probable cause." They serve to define which obstructions of accurate compensation are wrongful.

The subjective standard is necessary to exclude cases of overreaching where a party honestly believes it is asserting a legitimate claim or defense. Negligent assertion of an invalid position should not suffice for tort liability because that would hinder the assertion of legitimate claims. For example, the fear of potential liability for breach of the implied covenant could chill the settlement process and force parties to accept offers they found unfair. Similarly, parties might be deterred from asserting their rights for fear the jury might find such efforts unreasonable and impose tort liability for a breach of the implied covenant.

The objective standard also serves to protect leeway in disputing obligations. Subjective bad faith is difficult to distinguish from mere

would have acted similarly under the circumstances. The subjective requirement is the standard of knowledge; the actor must be aware that he is making a false claim or invalid denial.

Of course, a requirement of absolute awareness for knowledge would be difficult to meet. A person could claim that he was not absolutely certain that the conduct had no validity. Therefore, the requirement of knowledge should be satisfied when a person is aware there is a high probability that his action has no legal basis, so long as he does not actually believe he has a legitimate claim or valid denial. Cf. United States v. Jewell, 532 F.2d 697 (9th Cir.), cert. denied, 426 U.S. 951 (1976); MODEL PENAL CODE § 2.02(7) (Proposed Official Draft 1962).

In addition, the requirement of knowledge must be distinguished from purpose. If the actor acts with the purpose of depriving plaintiff of compensation, then his conduct might be considered malicious, fraudulent, or oppressive, rendering him liable for punitive damages. If the actor merely knows that he is asserting a groundless claim, then he may not have the requisite intent to injure, nor even knowledge with substantial certainty that the injury will follow. See PROSSER & KEETON, supra note 3, § 8, at 35. The actor may be attempting to gain illegitimate advantages or to illegitimately shield himself from liability. Since a violation of good faith and fair dealing does not satisfy the intentional tort model per se, it cannot itself be a sufficient basis for punitive damages. See infra Part III, Section B.


67. "'[I]t is not a tort for a contractual obligor to dispute his liability under [a] contract... if the dispute is honest and undertaken in good faith... Similarly, it is not a tort for one party to deny, in good faith, the existence of a binding contract." Seaman's Direct Buying Service, 36 Cal. 3d at 770, 686 P.2d at 1167, 206 Cal. Rptr. at 363 (quoting Sawyer v. Bank of Am., 83 Cal. App. 3d 135, 139, 145 Cal. Rptr. 623, 625 (1978)). But see RESTATEMENT (SECOND) OF CONTRACTS § 205 comment d (1979) ("Subterfuges and evasions violate the obligation of good faith... even though the actor believes his conduct to be justified.")."


69. Cf. PROSSER & KEETON, supra note 3, § 119, at 871 ("The law supports the use of litigation as a social means for resolving disputes, and it encourages honest citizens to bring criminals to
doubt about the legitimacy of an act or claim. Consequently, imposing liability on a subjective basis alone could discourage parties from pursuing plausible, if dubious, claims in which a jury might find merit.

Thus, the elements of the tortious breach of the implied covenant of good faith and fair dealing which plaintiff should prove are: (1) assertion of a right or denial of an obligation (2) made in bad faith (with actual knowledge that the claim or denial has no foundation) and unreasonably (where a reasonable person under the circumstances would find the claim or denial groundless) (3) that obstructs the injured party's ability to receive the substitutionary value of the agreement.\textsuperscript{70}

This formulation of the tort adopts the "excluder" conceptualization of the duty of good faith and fair dealing.\textsuperscript{71} It excludes behavior which violates the duty of good faith and fair dealing instead of defining an affirmative behavioral requirement. The reason for this conceptualization is that a positive definition of good faith and fair dealing would either "spiral into the Charybdis of vacuous generality or collide with the Scylla of restrictive specificity."\textsuperscript{72} The excluder conceptualization pre-
vents good faith from becoming an overly broad, abstract tool to enforce judges' individual sensibilities, yet permits individual cases such as *Seaman's Direct Buying Service* to serve as factual analogies for expanding the tort. Moreover, "the typical judge who uses this phrase [of good faith and fair dealing] is primarily concerned with ruling out specific conduct, and only secondarily, or not at all, with formulating the positive content of a standard." Finally, the excluder conceptualization minimizes interference with freedom of contract by focusing on normative violations rather than placing affirmative burdens on the contracting parties. It permits flexibility in the contractual relationship by ruling out unacceptable behavior without creating rigid rules to regulate conduct.

**B. Justifying Tort Liability**

Tort liability is appropriate for breach of the implied covenant of good faith and fair dealing for several reasons. The obligation to deal fairly and in good faith is imposed by the law, not by the parties. Compelled observance of the obligation is proper to protect a party's interest in accurate compensation for breach of contract. And, violation of the implied covenant provides justification for shifting the cost of consequential losses from victim to injurer. Thus, doctrinal, normative, and remedial considerations place a violation of good faith and fair dealing in the realm of tort rather than contract.74

1. **Doctrinal Considerations**

From a doctrinal perspective, the major distinction between tort and contract is the absence in tort of a bargained agreement. In contract the parties voluntarily assume duties and allocate risks. In tort, the law imposes duties and shifts losses.75 The obligation of good faith and fair dealing is not voluntarily assumed by the parties. Irrespective of the contractual promise to perform, the implied covenant requires each party to refrain from obstructing the other's interest in accurate compensation. The duty of good faith and fair dealing, as the court recognized in

nates the need for detailed specification of the parties' rights and duties and provides flexibility for change); *Restatement (Second) of Contracts* § 205 comment a (1979) (The duty "excludes a variety of types of conduct characterized as involving 'bad faith' because they violate community standards of decency, fairness or reasonableness."). For criticisms of the excluder concept and a reply, see Summers, *supra* note 71, at 816-835. See also Burton, *More of Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 *Iowa L. Rev.* 497, 508-11 (1984).


74. Indeed, the *Restatement (Second)* suggests that tort remedies may be appropriate for breach of the implied covenant. *See Restatement (Second) of Contracts* § 205 comments a-c (1979) ("The appropriate remedy for a breach of the duty of good faith also varies with the circumstances. . . . Bad faith in negotiation . . . may be subject to sanctions . . . [and] remedies for bad faith in the absence of agreement are found in the law of torts or restitution.").

75. The policies underlying these distinctions are discussed *supra* in note 3.


Gruenberg and Silberg,\textsuperscript{76} is nonconsensual and extracontractual. Since courts and legislators impose tort duties to deter socially unreasonable conduct and to compensate victims when such conduct causes them harm,\textsuperscript{77} it makes sense to consider breach of the implied covenant of good faith and fair dealing a tort. A breach of the implied covenant is socially unreasonable, because the defendant is trying to avoid his legal obligation to provide compensation for breach of contract.\textsuperscript{78} It differs from breach of contract, because plaintiff's interest in honoring the implied covenant is not offset by a legitimate defendant's interest in breach.\textsuperscript{79} Unlike breach of contract, which the law deems reasonable, conduct which violates the duty of good faith and fair dealing merits tort liability.

2. Normative Considerations
   a. Moral Arguments

   Social unreasonableness generally provides the moral "fault" necessary for tort liability. Fault consists of failure to meet an objective societal standard of behavior or of personal blameworthiness.\textsuperscript{80} In breach of the implied covenant of good faith and fair dealing, the injurer is personally blameworthy because he subjectively knows he is injuring plaintiff without producing a countervailing social benefit. The injurer objectively is at fault because he departs from communal standards of fair dealing. Such fault creates moral responsibility for consequential losses, and hence provides a justification for shifting losses from victim to injurer through tort liability.\textsuperscript{81} Tort liability for breach of the implied covenant is also justified from

\textsuperscript{76} See supra note 24. The term "implied covenant" evokes the notion of contract, and therefore, the term "duty" might be more appropriate for treating the violation of good faith and fair dealing as a tort. Indeed, the Restatement (Second) and the Uniform Commercial Code use the latter language. See infra note 114. Nonetheless, since the term "implied covenant" of good faith and fair dealing is embedded in case law, this Comment uses the two terms interchangeably.

\textsuperscript{77} PROSSER & KEETON, supra note 3, § 1, at 5-6.

\textsuperscript{78} Conduct may be considered socially unreasonable when plaintiff's interest in freedom from harm outweighs defendant's interest in freedom of action. Id.

\textsuperscript{79} Indeed, in an efficient breach of contract, defendant's interest in breaching outweighs plaintiff's interest in performance. Breach will result in plaintiff's receiving a substitutionary value for the performance in court and in defendant's gaining an overall economic benefit.

\textsuperscript{80} See generally PROSSER & KEETON, supra note 3, § 4, at 21-23. Strict liability, of course, is an exception, although "liability without fault," as it is often termed, may be a misnomer. Id. § 75, at 534. Strict liability may be viewed as incorporating notions of fault, where fault denotes creating an undue risk of harm to others. Id. § 75, at 538. However, such a concept of fault may so divorce the legal standard from personal blameworthiness as to render the notion of fault meaningless. Id. Thus, strict liability will turn on efficiency concerns, such as which party is in a better position to administer the risk. Id. § 75, at 537. From such an efficiency perspective, tort liability also is justified for breach of the implied covenant. See infra notes 92-100 and accompanying text.

\textsuperscript{81} PROSSER & KEETON, supra note 3, § 4, at 21-23.
a normative perspective, because tort law already recognizes the interest in freedom from interference in economic relations. In protecting this interest, existing torts provide analogies for breach of the implied covenant of good faith and fair dealing, but leave a gap in legal protection. For example, the tort of intentional interference with contractual relations proscribes the intentional and improper obstruction of the right to the benefits of a contractual relationship with a third party.\textsuperscript{82} Similarly, the tort of interference with prospective advantage prohibits the obstruction of potential contractual relations or profits.\textsuperscript{83} In these torts, the gravamen of the injury is the same: a wrongful attempt to obstruct the pursuit of the economic benefits of a contractual or business relationship.\textsuperscript{84} Yet none of these torts addresses the use of bad faith and unreasonable claims to wrongfully obstruct a party’s ability to obtain compensation for the unfulfilled promise. The implied covenant of good faith and fair dealing serves to protect against this kind of obstruction.

Another class of torts that recognizes interests similar to those protected by the implied covenant of good faith and fair dealing involves misuse of legal procedure. Yet here, too, tort law leaves a gap. The torts of malicious prosecution, wrongful civil proceedings, and abuse of process protect the interest in freedom from unjustifiable litigation.\textsuperscript{85} Malicious prosecution and wrongful civil proceedings consist of initiating unsuccessful proceedings against another without probable cause, primarily for a purpose other than justice or proper adjudication.\textsuperscript{86} Abuse of process entails using legal process for an improper purpose.\textsuperscript{87} Each tort proscribes the use of the legal system for improper ends, and each could conceivably protect parties from bad faith and unreasonable claims during litigation. Nonetheless, these torts fail to remedy bad faith and unreasonable conduct outside of litigation.\textsuperscript{88} A tort theory of the implied covenant of good faith and fair dealing will provide a legal remedy for such conduct.

If breach of the duty of good faith and fair dealing is tortious, then

\begin{enumerate}
\item \textsuperscript{82} Id. § 129, at 978.
\item \textsuperscript{83} Id. § 130, at 1005. A related tort is injurious falsehood, which consists of intentionally disparaging another’s property interests to the person’s economic detriment. Id. § 128, at 967.
\item \textsuperscript{84} Id. § 128, at 962.
\item \textsuperscript{85} Id. § 119, at 870.
\item \textsuperscript{86} See Restatement (Second) of Torts §§ 653, 674 (1977).
\item \textsuperscript{87} Id. § 682.
\item \textsuperscript{88} Indeed, because these torts encompass only misuse of legal procedures to initiate affirmative claims, they fail to remedy the problem of misuse of legal procedures to initiate wrongful denials or defenses. See Van Patten & Willard, The Limits of Advocacy: A Proposal for the Tort of Malicious Defense in Civil Litigation, 35 Hastings L.J. 891, 907-08 (1984). Even a tort of malicious defense, however, would not remedy the problem of bad faith and unreasonable claims during the contractual relationship which do not entail litigation or legal process. Such conduct, by inducing the other party to believe his interest in compensation will be obstructed, may cause injury without use or threatened use of legal process. See infra notes 104-07 and accompanying text.
\end{enumerate}
the law should prohibit the parties from disclaiming the obligation.\textsuperscript{89} Tort law sets social norms that limit freedom of contract in order to allocate liability for socially unreasonable conduct in a fair and efficient manner.\textsuperscript{90} Assigning tort liability for breach of the covenant prevents injurers from consistently placing the costs of their behavior upon the injurer. The notion that the implied covenant of good faith and fair dealing protects tort interests—that is, interests outside the bargaining process—is consistent with U.C.C. section 1-102, which prohibits disclaimer of the implied covenant of good faith and fair dealing.\textsuperscript{91}

\textbf{b. Economic Arguments}

From an economic perspective, tort liability for breach of the implied covenant is necessary to force injurers to take an efficient level of precaution and internalize the costs of bad faith conduct.\textsuperscript{92} The law promotes an efficient level of precaution and maximizes social efficiency whenever both parties internalize the sum of precaution and accident costs.\textsuperscript{93} Tort liability accomplishes this by providing injurers with an incentive to take the efficient level of care. A rule of no liability or of strict liability creates inefficiency because it places all the risk on one party. The party not at risk has no incentive to take precaution.\textsuperscript{94} Since contract damages do not compensate the victim for injuries from wrongful obstruction, the victim is forced to absorb all the costs. Therefore, contract damages permit the injurer to overrely on the victim's level of

\textsuperscript{89} See Restatement (Second) of Torts § 195 (1977); Prosser & Keeton, supra note 3, § 92, at 656. In contrast, contract duties usually may be disclaimed, since the nature and purpose of contract is to maximize the parties' sphere of bargaining. See B. Anderson, Uniform Commercial Code § 1-102:60, at 62-63 (3d ed. 1981).

\textsuperscript{90} As an example, courts do not permit physicians to bargain with their patients over care that is below the negligence standard for malpractice. The rationale is that courts, not the parties, set the standard of reasonable care, below which public policy will not permit bargaining. See Tunkl v. Regents of Univ. of Cal., 60 Cal. 2d 92, 383 P.2d 441, 32 Cal. Rptr. 33 (1963) (refusing to enforce release from liability for negligence as condition of admission to hospital). For an argument to the contrary, see Epstein, Medical Malpractice: The Case for Contract, 1 Am. B. Found. Res. J. 87 (1976).

\textsuperscript{91} "[T]he obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable." U.C.C. § 1-102 (1978).

\textsuperscript{92} The term "bad faith conduct" is used in this Comment as a convenient shorthand to denote conduct which violates the duty of good faith and fair dealing. It is not meant as a surrogate for "bad faith breach of contract," nor is it meant to exclude the objective element of fair dealing in the definition in Part II, Section A.

\textsuperscript{93} See Cooter, Unity in Tort, Contract, and Property: The Model of Precaution, 73 Calif. L. Rev. 1 (1985). Professor Cooter gives the example of a factory whose smoke soils the wash at a commercial laundry. The law can maximize social efficiency by imposing a pollution tax equal to the cost of the harm caused. "The factory will bear the tax and the laundry will bear the smoke, so pollution costs will be internalized by both of them, as required for social efficiency." Id. at 3-4.

\textsuperscript{94} Id. at 5-7, 28.
precaution. The injurer knows that no added liability—that is, no damages apart from those for the contract breach—will come from bad faith conduct.\textsuperscript{95}

A fault standard for breach of the implied covenant will induce both parties to take precautions in order to avoid liability.\textsuperscript{96} By forcing the injurer to pay the cost of bad faith conduct, tort liability gives the injurer an incentive to refrain from such conduct and to adopt a more efficient level of precaution.\textsuperscript{97} It restores efficiency by distributing the sum of the costs of precaution and of harm among injurer and victim.\textsuperscript{98}

In addition, tort liability is required to preserve net social gains. Unlike breach of contract, breach of the implied covenant of good faith and fair dealing creates inefficiency and causes net harm to society. Since the injurer's bad faith conduct obstructs the victim's ability to obtain compensation, the law cannot presume the victim indifferent to fulfillment or violation of the implied covenant.\textsuperscript{99} Tort liability for breach of the implied covenant would remedy both the injurer's overreliance on the victim's precaution and the net loss to society from the obstruction of compensation.\textsuperscript{100}

3. Remedial Considerations

From a remedial viewpoint, tort liability for breach of the implied

\textsuperscript{95} Conversely, if the victim knew the injurer would be strictly liable for consequential damages, he would take no precaution against the bad faith conduct. The tort rule of avoidable consequences prevents the victim from overrelying on the injurer's level of precaution. See infra note 106.

\textsuperscript{96} See Cooter, supra note 93, at 7.

\textsuperscript{97} In tort law, the legal standard of negligence is defined as the efficient level of care, \textit{id.} at 7 n.18 (citing the Learned Hand formula in \textit{United States v. Carroll Towing Co.}, 159 F.2d 169 (2d Cir. 1947)), although it is not certain that the reasonable person standard in fact promotes the optimally efficient level of care. Injurers may underestimate the cost of liability because the probability of enforcement of the legal standard is too low. Thus, adding a subjective requirement of bad faith to the standard of unreasonableness could result in greater efficiency. Whether or not the level of efficiency achieved is precisely optimal, it is clear that shifting consequential losses to injurers through tort liability will promote a more efficient level of precaution among the parties than would the absence of liability for bad faith conduct.

\textsuperscript{98} A further source of efficiency will be the reduction in the cost of contracting, including the cost of gathering information as to contracting partners' compliance with standards of good faith and fair dealing, and the cost of negotiating with a party engaged in bad faith conduct. See Burton, supra note 54, at 393.

\textsuperscript{99} Such indifference is presumable only if the injurer provides a substitutionary value for breach of the implied covenant—that is, if he pays for the harm created by his bad faith conduct. Tort liability for consequential losses forces the injurer to internalize these costs.

\textsuperscript{100} In addition, economic arguments based on the policy goal of deterring bad faith conduct favor tort liability over contract liability. The fault rule in tort liability serves as a sanction to bad faith conduct because it forces the injurer to pay for such conduct. Cooter, supra note 93, at 33; see also Cooter, supra note 3, at 1538-39. Tort liability would thus strongly deter bad faith conduct. In contrast, strict liability serves as a price for breach of contract, because it creates marginal changes in cost according to the injurer's conduct. Cooter, supra note 93, at 34; see also Cooter, supra note 3, at 1539-40.
covenant provides more adequate compensation for victims of bad faith conduct. The remedy is supposed to restore the injured party to the position he would have been in had the breach of duty not occurred. However, the remedial limitations inherent in contract law—the Hadley rule, the restrictions on awarding mental distress, and the use of expectation as a cap on recovery—all prevent contract damages from restoring victims of bad faith conduct to the status quo ante. Tort liability is necessary to adequately compensate victims of bad faith conduct and to shift the cost of consequential losses from the bad faith conduct to injurer instead of the victim.

The Hadley rule poses the greatest barrier to adequate recovery for breach of the implied covenant of good faith and fair dealing. The rule bars plaintiff from recovering unforeseeable consequential losses unless he has informed defendant of their likelihood, "[i]f the special circumstances been known, the parties might have specially provided for the breach of contract by special terms as to the damages."" Yet, wrongful obstruction of compensation is the very kind of conduct the parties are least likely to provide for in the contract. It is difficult to imagine parties foreseeing and negotiating the risk of bad faith conduct, let alone the damages such conduct might cause.

Moreover, if the Hadley rule serves to bar a plaintiff from recovering because he had the best information to control the losses, it should not apply to a breach of the implied covenant of good faith and fair dealing. Essentially, the bad faith conduct leaves plaintiff uncertain as to whether he will be accurately compensated for the cost of covering his losses. This could induce plaintiff not to seek cover for the contract breach. Thus, the purpose of Hadley is not served by placing the loss on the plaintiff since the injurer has prevented him from making the efficient choice in controlling the loss.

As an example, suppose in addition to failing to deliver the shaft, the carrier in Hadley v. Baxendale in bad faith and unreasonably denied the contractual obligation to deliver the shaft. Under these circumstances, the miller would be forced to choose between: (1) seeking cover with the prospect of not recovering compensation, or (2) deciding not to replace the shaft and losing the profits. In the case of breach of the

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101. See supra note 3 and accompanying text.
103. Even if the parties could accurately forecast the cost of bad faith conduct, the law should prohibit disclaimer of the obligation of good faith and fair dealing. See supra note 91.
104. See Bishop, supra note 1, at 253-54, 260-61. The rationale articulated in Hadley is consistent with the modern formulation. Both recognize the fairness and efficiency of a rule that makes a party responsible for all losses he could have avoided more easily than the other. Both also recognize that the rule induces the party with superior knowledge of the risk to bargain for the optimal allocation of that risk.
implied covenant, plaintiff's calculus is less certain than the decision to cover in the case of simple breach of contract, because the injurer's bad faith conduct threatens to deprive plaintiff of compensation for his cover. Plaintiff may then consider it cheaper to absorb the consequential loss than to absorb the cost of cover. Under Hadley, plaintiff would be barred from recovering for the unforeseeable consequential losses. Yet, assuming his choice of consequential losses rather than cover losses is reasonable, there is no reason why defendant should not be liable. Unlike the case of breach of contract in Hadley, breach of the implied covenant prevents plaintiff from controlling the risk of consequential losses.

105. Other consequential losses apart from lost profits are conceivable which would not be recoverable under Hadley. For example:

Suppose a party to a contract did not make available necessary information which according to culpa in contrahendo he had to disclose. The other party hired the services of experts to acquire this indispensable information and finally entered into the contract. Why should he be barred from claiming the expenses he incurred as a result of the mala fides behavior of the other negotiating party?

Ben-Dror, The Perennial Ambiguity of Culpa in Contrahendo, 27 AM. J. LEGAL HIST. 142, 198 n.312 (1983). Again, plaintiff could refuse to enter into the contract, and could seek an alternative contractual partner. The duty of mitigation would require him to choose the cheaper alternative. Assuming he chose reasonably, defendant should bear this cost of his bad faith conduct though Hadley would bar plaintiff from such recovery.

As further examples of consequential losses that defendant should be legally responsible for, but which the rule of Hadley would bar, Professor Summers suggests the case of a debtor who wrongfully refuses to pay a creditor in full, and the case of a car dealer who wrongfully repossesses a car. As a result of the bad faith conduct, the debtor may be financially ruined and the car owner may lose his transportation and thus his job. Yet the Hadley rule would bar recovery of these losses, and contract law would only allow recovery of the debt and of the car. Summers, supra note 65, at 260. Moreover, simply relaxing the Hadley rule would not be sufficient to recognize the bad faith conduct as a source of injury distinct from breach of contract:

Contract theory might be modified to allow the creditor recovery for consequential losses specifically traceable to his debtor's bad faith since the debtor is in breach for failure to pay in the first place. But the debtor's bad faith consists of his capricious refusal to pay in order to force a more favorable settlement. This misconduct, rather than mere nonpayment, constitutes the distinctive wrong. In the [car repossession] case, contract theory cannot be modified to allow the buyer affirmative relief, for the seller is not in breach of his contract. Accordingly, the tort alternative offers itself as all the more worthy of consideration.

Id. at 160.

106. Under the tort rule of mitigation, plaintiff must choose the reasonably cheapest course of action, since he will be liable for any damages he could have avoided through reasonable effort. See RESTATEMENT (SECOND) OF TORTS § 918 (1977). A similar result is reached under Professor Cooter's model of precaution. See supra notes 93-96 and accompanying text. If plaintiff knows he can easily prove that defendant's bad faith and unreasonable claim is groundless, the law should not permit him to over rely on defendant's liability so as to build up consequential losses. The rule of mitigation gives plaintiff an incentive to take a more efficient level of precaution.

107. The meritless claim may force the victim into a conundrum that parallels the choice between cover and consequential damages created by the meritless denial, namely: (1) accede to the injurer's meritless claim, or (2) refuse to accede. If the victim accedes, his ability to receive the full value of the contract will be diminished by the value of the claim. If the victim refuses, the injurer may treat the contract as breached, and the victim could incur consequential losses for which contract law would bar recovery.
In addition to the *Hadley* rule, contract law’s limitation on the award of damages for mental distress can result in the undercompensation of victims of bad faith conduct. Contract law presumes that parties are indifferent between performance or breach, that breach is morally neutral, and that expectation damages are adequate to make the injured party whole. For these reasons, though breach of contract may cause mental anguish, that harm is not recognized as legally compensable. These presumptions, however, are invalid when the implied covenant has been breached: the violation is not morally neutral, the parties cannot be expected to contemplate the possibility of a bad faith and unreasonable claim, and the notion of cover is less meaningful because defendant has injured plaintiff’s ability to recover damages. Therefore, plaintiff should not be expected to bear the resulting mental distress as a cost of the contractual enterprise. The defendant should have to compensate plaintiff for the anger, humiliation, and anxiety that result from the bad faith conduct.

Finally, the contract doctrine of limiting reliance damages to an expectation measure also would not adequately compensate plaintiffs for a breach of the implied covenant of good faith and fair dealing. The purpose of the rule is to avoid putting plaintiff in a better position than he would have been in had the contract been performed. Here, however, consequential damages are necessary to put plaintiff in the same position he would have been in had the contract been performed, and had defendant not wrongfully obstructed plaintiff’s remedies. Recovery of consequential losses addresses the costs of defendant’s breach of the implied covenant of good faith and fair dealing, not the costs of plaintiff’s reliance on defendant’s promise to perform the contract. Thus, from a remedial perspective, tort liability is appropriate for breach of the implied covenant of good faith and fair dealing, because the remedial limitations in contract undercompensate victims of bad faith conduct. In addition, the policies underlying these limitations do not apply to remediying bad faith conduct.

4. **Distinguishing Breach of Contract**

Reconstructing the implied covenant of good faith and fair dealing as a tort will not interfere with the remedial limitations of contract law because breach of the implied covenant is distinguishable from breach of

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contract. The implied covenant protects plaintiff's interest in freedom from wrongful obstruction of remedies; the contract protects his interest in performance. When there is an alleged breach of contract, the party may dispute or assert a claim, if he does not do so unreasonably and in bad faith.111

In addition, awarding tort remedies for breach of the implied covenant will not distort parties' contractual expectations. The duty of good faith and fair dealing targets behavior outside the scope of these expectations.112 Parties to a contract neither expect nor are expected to bargain over wrongful obstructions of remedies and bad faith and unreasonable claims, just as they do not contemplate and are not expected to contemplate the costs of intentional interference with contract, malicious prosecution, or other torts that may be committed in the course of a contractual relationship. Therefore, since the parties do not bargain about wrongful obstruction, applying tort remedies for breach of the implied covenant will not distort the contractual relationship or disturb contract law.113

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111. As the tortious denial is distinguishable from breach of contract, the tortious assertion differs from duress. Duress is defined as "an improper threat . . . that leaves the victim no reasonable alternative." RESTATEMENT (SECOND) OF CONTRACTS § 175(1) (1979). In breach of the implied covenant, the injurer asserts a claim that obstructs the victim's ability to receive accurate compensation for the breach. The claim need not be a threat. It need not extract an action or a promise from the victim. It may leave the victim a reasonable alternative, see supra note 107, requiring the victim to mitigate damages.

On the other hand, an act that constitutes duress might not be sufficient for breach of the implied covenant. For example, an injured party might successfully claim duress if the injurer took advantage of a superior bargaining position to extract excess payments or performance. But this would not breach the implied covenant of good faith and fair dealing. Some additional conduct, such as a claim that the contract entitled the injurer to the coerced payments or performance, would be necessary.

Finally, the remedy for duress is avoidance of the coerced agreement. RESTATEMENT (SECOND) OF CONTRACTS § 175(1) (1979). In contrast, tortious breach of the implied covenant permits the victim to recover consequential damages, which is a more appropriate remedy. See supra text accompanying notes 101-10.

112. As Chief Justice Bird noted in Seaman's Direct Buying Service:

This type of conduct violates the non-breaching party's justified expectation that it will be able to recover damages for its losses in the event of breach. That expectation must be protected. Otherwise, the acceptance of the possibility of breach by the contract parties and by society as a whole may be seriously undermined.

Seaman's Direct Buying Service, 36 Cal. 3d at 775, 686 P.2d at 1171, 206 Cal. Rptr. at 363 (Bird, C.J., concurring and dissenting).

113. Since breach of the implied covenant and breach of contract are separate causes of action, the award of tort remedies for breach of the implied covenant will not preclude contract remedies for breach of contract. However, to the extent both the contract and the tort remedies compensate plaintiff for reliance losses, damages should be awarded only once, to avoid double recovery.
III
THE SCOPE AND APPLICATION OF BREACH OF THE IMPLIED COVENANT AS TORT

A. Forms of Bad Faith Conduct

Both the Restatement (Second) of Contracts and the Uniform Commercial Code imply the duty of good faith and fair dealing in every contract without regard for either the nature of the contract or the parties. To analyze the scope and application of this obligation, it is useful to separate breach of the implied covenant into three areas of the contracting process: formation, performance, and enforcement. While the Restatement (Second) and the U.C.C. do not explicitly cover good faith and fair dealing in formation, courts may apply the implied covenant in formation as a matter of common law, or as a "general principle of law or equity" supplementing the provisions of the U.C.C. Enforcement and formation may be treated under the tort model, but performance may require different remedial treatment.

1. Enforcement

In enforcement, conduct which breaches the implied covenant of good faith and fair dealing involves illegitimate "assertion, settlement and litigation of contract claims and defenses." Therefore, Seaman's Direct Buying Service and its precursors are paradigmatic cases of bad faith, unreasonable denials of legal obligations. Wrongful assertions of legal obligations, the counterpart of wrongful denials, may involve "conjuring up a dispute, adopting an overreaching interpretation, or taking advantage of the other party in order to obtain a favorable settlement."
Case law contains many additional examples of sham claims and denials of obligations during enforcement.\(^\text{121}\) For example, there could be a tortious breach of the implied covenant of good faith and fair dealing during enforcement where an employer coerces a logger into accepting a lesser sum for wages due,\(^\text{122}\) where a party overreaches in construing a cancellation or termination clause,\(^\text{123}\) or where an architect coerces a bonus in exchange for completing the supervision of a building project.\(^\text{124}\) In each of these cases, the court used bad faith defensively—to rescind a coerced promise or enforce a denied obligation. Under the tort model, courts instead would use breach of the implied covenant of good faith and fair dealing affirmatively to award tort damages for consequential losses.\(^\text{125}\)

2. Formation

The model developed here for breach of the implied covenant of good faith and fair dealing as tort also could apply to the formation of a contract. For example, bad faith conduct which breaches the implied covenant could involve “negotiating without serious intent to contract, abusing the privilege to break off negotiations, [and] entering a transaction without having the intent to perform.”\(^\text{126}\) The nature of the tort is the same: bad faith and unreasonable conduct that obstructs the injured party’s ability to receive the benefits of the agreement. Thus, formation is the reverse side of enforcement. Plaintiff may be seeking enforcement where defendant denies formation.\(^\text{127}\) Some case law exists allowing

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\(^{121}\) Another example of a case involving a bad faith and unreasonable denial of liability in the enforcement of a contract is Chicago Coliseum Club v. Dempsey, 265 Ill. App. 542 (1932). Jack Dempsey breached a contract to fight Harry Wills for the championship title. In addition, Dempsey sent plaintiff a telegram stating “as you have no contract suggest you stop kidding yourself and me also.” The court could have held Dempsey liable in tort for breach of the implied covenant of good faith and fair dealing, as well as for breaching the contractual promise. For additional examples, see Summers, supra note 65, at 243-48 (citing cases).


\(^{123}\) See, e.g., Sylvan Crest Sand & Gravel Co. v. United States, 150 F.2d 642 (2d Cir. 1945); Chrysler Corp. v. Quimby, 51 Del. 264, 144 A.2d 123 (1958).

\(^{124}\) Lingenfelder v. Wainwright Brewery Co., 103 Mo. 578, 15 S.W. 844 (1891).

\(^{125}\) On distinguishing bad faith and unreasonable claims from duress, see supra note 111.

\(^{126}\) Summers, supra note 65, at 216, 220-32. Each case may involve bad faith conduct which does not itself suffice for fraud or misrepresentation. For example, a seller may fail passively to disclose defects rather than actively misstate the product’s true condition. Similarly, a party may take advantage of another’s inferior bargaining capacity by asserting a claim unreasonably and in bad faith, yet the disparity between the parties may not be so great as to be unconscionable. Id. at 278-79.

\(^{127}\) Seaman’s Direct Buying Service reflects this relationship. In Seaman’s Direct Buying Service, plaintiff asserted the existence of an enforceable contract, while defendant took the position that the parties had only entered into preliminary negotiations. Seaman’s Direct Buying Service, 36 Cal. 3d at 760-62, 686 P.2d at 1160-62, 206 Cal. Rptr. at 357-58.
plaintiffs to recover noncontractual remedies for such conduct at the formation stage, often applying theories of promissory estoppel or restitution. 128

In applying breach of the implied covenant to bad faith conduct during formation, the question arises: how can the injuring party be said to obstruct the injured party's receipt of the substitutionary value of the agreement, if the parties have not yet reached a binding agreement? The answer is found in the theory of reliance, which creates the binding agreement. The doctrine of promissory estoppel permits the injured party to recover when the promisor induces reasonable reliance on an express or implied promise. 129 In this situation, the promisee has a right to expect the benefits of the promise, either through performance or compensatory damages. A bad faith and unreasonable claim would obstruct the promisee's receipt of the benefits of the agreement the injurer has led him to believe existed. Thus, a party could be held liable in tort if it made a bad faith and unreasonable claim after inducing reasonable reliance on a promise.

A further problem arises in introducing the implied covenant into formation: at what point in the contractual process should courts enforce the duty of good faith and fair dealing? Some precedent suggests the obligation should encompass conduct that precedes acceptance of an offer. In Drennan v. Star Paving Co., Justice Traynor held that a contractor's reliance on a subcontractor's bid before acceptance was reasonable, and awarded damages on a theory of promissory estoppel. 130 Under this view of reliance, courts would award tort damages if the defendant broke off negotiations or withdrew an offer knowing he had created the expectation that a binding agreement existed, and then unreasonably and in bad faith denied the existence of a binding obligation. 131

128. See, e.g., Hoffman v. Red Owl Stores, 26 Wis. 2d 683, 133 N.W. 2d 267 (1965).
129. RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979). Courts and commentators are uncertain as to whether promissory estoppel operates as a contract or tort doctrine. Professor Williston presented the doctrinal dilemma during the drafting of the Restatement (First) of Contracts section on promissory estoppel:

Either the promise is binding or it is not. If the promise is binding it has to be enforced as it is made... but it seems to me you have to take one leg or the other. You have either to say the promise is binding or you have to go on the theory of restoring the status quo. Fuller & Perdue, The Reliance Interest in Contract Damages, 46 YALE L.J. 52, 65 n.14 (1936) (quoting 4 A.L.I. Proc. app. 103-04 (1926)). Section 90 of the Restatement (Second) retains the ambiguity by providing that the promise is "binding if injustice can be avoided only by enforcement of the promise;" however, "the remedy granted for breach may be limited as justice requires." RESTATEMENT (SECOND) OF CONTRACTS § 90 (1979).

130. 51 Cal. 2d 409, 333 P.2d 757 (1958). See also Restatement (Second) of Contracts § 87(2) (1979) (option contract created by substantial and foreseeable reliance on an unaccepted offer). Cf. Restatement (Second) of Contracts § 45 (1979) (option contract created by part performance or tender).

131. Some courts, however, would hold that reliance on an offer before acceptance is unreasonable, and therefore, that promissory estoppel should not apply to enforce the promise. For example,
The case of Hoffman v. Red Owl Stores\footnote{132} suggests that the implied covenant could extend into the negotiating process even before a firm offer is made. In Hoffman, the court held defendants liable under a promissory estoppel theory for a series of representations that induced plaintiff to make expenditures in the expectation of obtaining a franchise. Thus, a party could be held liable in tort if it made a bad faith and unreasonable claim, after making representations short of a firm offer that induced plaintiff to reasonably believe a contract existed.

A tort obligation of good faith and fair dealing could extend even further to cases where formation is imperfect because of mistake, ambiguity, lack of capacity, or misrepresentation. If the injurer denies or asserts a legal obligation, knowing and having reason to know the obligation is unenforceable because formation is imperfect, then his conduct fits the tort model for breach of the implied covenant. Since the contract is unenforceable, any claim or denial made by the injurer is in bad faith and unreasonable, because it obstructs the victim's interest in accurate compensation for the breached agreement. This resembles the notion of \textit{culpa in contrahendo}, or "fault in negotiating," which exists in various forms in many civil law systems.\footnote{133} The underlying premise is that a party who knowingly injures another party during formation should be liable for consequential losses incurred by the innocent party's reliance on the purported contract. The award of reliance damages for bad faith negotiation at common law, and of \textit{culpa in contrahendo} in civil law, support a tort theory of good faith and fair dealing that allows compensation of plaintiffs according to consequential loss rather than promissory value.

in Jaimes Baird Co. v. Gimbel Bros., 64 F.2d 344 (2d Cir. 1933), the court denied a contractor's claim for promissory estoppel where the contractor had relied on a subcontractor's bid before accepting it. Judge Learned Hand stated that a promise could not be binding until an offeree accepted it because otherwise, the offeree would be unfairly bound to a "one-sided obligation." \textit{Id.} at 346. Under this view of reliance, courts would deny liability for breach of the implied covenant before an offer is accepted because plaintiff has no legal right to expect any benefits from the defendant. Thus, a party could deny the existence of a contractual obligation before the offer was accepted without breaching the implied covenant of good faith and fair dealing.

132. 26 Wis. 2d 683, 133 N.W. 2d 267 (1965).

133. \textit{See generally} Kessler & Fine, \textit{Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study}, 77 Harv. L. Rev. 401 (1964). The authors suggest that doctrines such as unilateral mistake employ the concept of \textit{culpa in contrahendo} to "soften the rigor of the objective theory of contracts," which would otherwise enforce unfair contracts and unjustly enrich the party who knew or should have known of the mistaken reliance. \textit{Id.} at 437, 447; \textit{see also} Ben-Dror, \textit{supra} note 105; Eisenberg, \textit{The Responsive Model of Contract Law}, 36 Stan. L. Rev. 1107 (1984). For an early discussion of the duty of good faith in formation in labor negotiations, see Cox, \textit{The Duty to Bargain in Good Faith}, 71 Harv. L. Rev. 1401 (1958).
3. **Performance**

a. **Breach of the Implied Covenant in Performance as Breach of Contract**

The performance area does not fit the tort model for breach of the implied covenant of good faith and fair dealing. It is distinguishable from formation and enforcement because violation of the implied covenant in performance threatens only a party’s contract rights, whereas violation in formation and enforcement obstructs a party’s right to the benefits of the agreement through compensation.\(^{134}\)

This distinction flows from the definition of the implied covenant in performance as the duty to meet reasonably and in good faith a party’s *contractual* obligation to perform.\(^{135}\) When a party fails to meet that obligation, he deprives the aggrieved party only of his contract rights to performance, not of his rights to the contract benefits through compensation. Expectation remedies will compensate the aggrieved party for the loss in value of the performance not rendered. Therefore, a violation of the implied covenant in performance is equivalent to willful or bad faith breach of contract.\(^{136}\)

Courts have tended to identify breach of the implied covenant with willful or bad faith breach of contract, failing to recognize that this is appropriate only for a violation of good faith and fair dealing in performance. This confusion explains why courts have tended to award contract remedies in cases involving a violation of good faith and fair dealing,\(^{137}\) and have failed to recognize that bad faith conduct in formation and enforcement merits separate remedial treatment under tort law.\(^{138}\)

\(^{134}\) See supra note 70.

\(^{135}\) The implied covenant in performance requires “a good faith effort by the contracting parties to perform their contractual obligations . . . [and to] make reasonable effort to meet [their] obligations under the contract.” R. Anderson, Anderson on the Uniform Commercial Code § 1-203:4, at 378-79 (3d ed. 1981); see also Burton, Good Faith Performance of a Contract Under Article 2 of the Uniform Commercial Code, 67 Iowa L. Rev. 1, 3 n.16 (1981) (“Bad faith by a party engaged in contract performance often constitutes the breach of an implied promise and entitles the injured party to the normal remedies for contract breach.”); Farnsworth, Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code, 30 U. Chi. L. Rev. 666, 669 (1963) (Good faith performance requires “cooperation on the part of one party to the contract so that the other party will not be deprived of his reasonable expectations.”).

\(^{136}\) See Restatement (Second) of Contracts § 241 comment f (1979) (“willful” is an imprecise term for failing to comply with standards of good faith and fair dealing in performance). Such conduct, unless it involves an independent tort, is deemed socially acceptable and does not involve the sanction of punitive damages. Even in a “particularly aggravated breach,” the willfulness incurs only compensatory and not punitive damages. See Restatement (Second) of Contracts § 355 comment a (1979).


\(^{138}\) See, e.g., Seaman’s Direct Buying Service, 36 Cal. 3d at 768, 686 P.2d at 1166, 206 Cal. Rptr. at 362 (citing cases); Burton, supra note 54, at 374 n.21; see also Restatement (Second) of Contracts § 205 comment e, illustrations (1979) (applying breach of contract theory and remedies to the violation of the implied covenant).
The Restatement (Second) does not explicitly equate breach of the implied covenant in performance with bad faith conduct in the breach of a contract, although the illustrations make this equation apparent. The illustrations of "[s]ubterfuges and evasions" that constitute bad faith conduct in performance include "evasion of the spirit of the bargain, lack of diligence and slackness off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance."139 In the first three examples, specific performance or expectation damages provide the injured party with the full value of the exchange promised. In the latter two instances, the court can supply reasonable terms or compel cooperation. Each case involves only the frustration of satisfactory contract performance.140 The bad faith conduct impedes plaintiff's right to performance, but does not obstruct his ability to seek a substitutionary value for the performance. Therefore, contract remedies are adequate.

Arguably, breach of the implied covenant in performance, though it does not impair the other party's ability to recover benefits through compensation, may require more than expectation damages to make the injured party whole. Rather than merely repudiating performance, the injurer may, in bad faith and unreasonably, render defective performance or disrupt the other party's attempt to perform. Such conduct could cause more damage than mere nonperformance. While notions of efficiency and commercial needs may preclude awarding tort damages,141 courts could supplement compensatory contract remedies with an additional sanction for bad faith performance.

For example, a court might utilize a restitution theory, which would force the injurer to disgorge any benefits acquired as a result of his bad-faith conduct.142 Alternatively, a court might deprive the injurer of an

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140. Professor Burton suggests that breach of the implied covenant in performance occurs when one party exercises discretion to recapture foregone opportunities in a manner that was not within the reasonable contemplation of the parties. See Burton, supra note 135; Burton, supra note 54.

141. See supra note 3. One commentator argues that failure to meet standards of commercial reasonableness could justify tort damages for bad faith breaches. Farber, Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract, 66 VA. L. Rev. 1443, 1476-77 (1980).

142. Cf. 1 R. ANDERSON, supra note 135, § 1-203:14, at 382 (3d ed. 1981) ("When a party acts in bad faith, he will ordinarily be denied the benefit of any provision or concept that would improve his position.").
affirmative defense,\textsuperscript{143} subject the injurer to specific performance, or increase the measurement of damages or the likelihood of contract liability.\textsuperscript{144} Finally, a court might amplify contract remedies by allowing greater leeway in recovery of consequential damages, relaxing standards for enforcing liquidated damages provisions, awarding prejudgment interest, awarding unjust enrichment and attorneys' fees, or encouraging higher compensatory awards within the range of uncertainty.\textsuperscript{145}

\textit{b. Refining Chief Justice Bird's Model: Breach of the Implied Covenant in Performance as Tort}

In her concurrence in \textit{Seaman's Direct Buying Service}, Chief Justice Bird argues that breach of contract itself should constitute a tortious violation of the implied covenant of good faith and fair dealing, irrespective of bad faith, if at the time of contracting the parties did not reasonably expect or accept the possibility of breach.\textsuperscript{146} Bird suggests that breach of contract may not be reasonably accepted or expected under two circumstances. The first is "if, at the time of contracting, the parties expressly indicate their understanding that a breach would be impermissible."\textsuperscript{147} The second is if "it [is] clear from the inception of the contract that contract damages would be unavailable or would be inadequate compensation for a breach."\textsuperscript{148}

These two tests are inadequate to single out a class of contract breaches for tort liability. The first test would convert every contract breach into a tort if the parties inserted language into the contract stating that a breach would be unexpected or unacceptable. While courts could attempt to ignore such sham proclamations, presumably the contract language would be persuasive evidence of the parties' true intention. The parties should not be permitted to decree tort liability for breach of contract in this manner, just as they cannot decree liquidated damages that

\textsuperscript{143} Summers, \textit{supra} note 65, at 252-53.

\textsuperscript{144} This approach is consistent with case law which uses bad faith conduct as a factor in determining what kind of compensatory damages are appropriate under contract law. For example, failure to perform in good faith is a significant factor in determining whether the breach is material for purposes of substantial performance doctrine. \textit{Restatement (Second)} \textit{of Contracts} § 241 comment f (1979); \textit{see also} Jacobs & Youngs, Inc. v. Kent, 230 N.Y. 239, 129 N.E. 889 (1921), (Cardozo, J.) ("The willful transgressor must accept the penalty of his transgression."). It may also influence the use of cost of completion as against diminished value as a method of measuring damages. \textit{See, e.g.}, Groves v. John Wunder Co., 205 Minn. 163, 286 N.W. 235 (1939).

\textsuperscript{145} \textit{See} Traynor, \textit{supra} note 63, at 12-14; \textit{see also} Comment, \textit{Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.}, 69 \textit{Minn. L. Rev.} 1161, 1189-96 (1985).

\textsuperscript{146} \textit{See} \textit{Seaman's Direct Buying Service}, 36 Cal. 3d at 780, 686 P.2d at 1175-76, 201 Cal. Rptr. at 370-71 (Bird, C.J., concurring and dissenting).

\textsuperscript{147} \textit{Id.} at 780, 686 P.2d at 1175, 206 Cal. Rptr. at 370 (Bird, C.J., concurring and dissenting).

\textsuperscript{148} \textit{Id.}
would serve as a penalty. Such a rule would destroy the remedial limitations of contract law and substitute tort liability for every breach of contract.

The second test is inadequate because the availability of contract damages at the time of contracting is irrelevant if adequate compensatory damages are available at the time of breach. Moreover, if compensatory damages are inadequate or unavailable at the time of breach, specific performance provides a remedy. Thus, the second test would substitute specific performance with tort liability for breach of contract. In addition, neither test fits the model for breach of the implied covenant in performance, because neither focuses on good faith and fair dealing.

Chief Justice Bird's conceptualization can be refined to provide a limited model for tortious breach of the implied covenant of good faith and fair dealing in performance. The elements of the tortious breach of the implied covenant of good faith and fair dealing in performance should be: (1) repudiation of a contract by default or defective performance (2) made in bad faith and unreasonably (that is, where the party knows and has reason to know that contract remedies will be inadequate or unavailable) (3) where compensatory damages, including specific performance, are in fact inadequate or unavailable. These elements parallel those in the tort model for breach of the implied covenant of good faith and fair dealing in formation and enforcement: a wrongful claim or repudiation, a mental state of bad faith and unreasonableness, and an obstruction of plaintiff's ability to obtain accurate compensation for the substitutionary value of the agreement. Under the above circumstances, the implied covenant would impose a duty to avoid breaching the contract. Breach itself would amount to the bad faith conduct, because the injurer, knowing and having reason to know the breach would leave plaintiff with no effective remedy, would be depriving the victim of the benefits of the bargain.

The second element of the refined test applies the Hadley rule with two modifications. First, the injurer must have knowledge and reason to know that contract remedies will be inadequate or unavailable. If Hadley

149. See U.C.C. § 2-718 (1978). Similarly, the parties can neither create nor deny the grant of specific performance by so stipulating in the contract. As a matter of equitable relief, the grant or denial of specific performance lies solely in the court's discretion. See Restatement (Second) of Contracts § 357 comment c (1979); id. § 361 (specific performance may be granted even though the parties have stipulated liquidated damages).

150. See Restatement (Second) of Contracts §§ 359-60 (1979) (specific performance may be awarded if damages are inadequate to protect the injured party's expectation interest).

151. In such contracts the rationale of the insurance cases, that the injured party purchases 'peace of mind and security' as part of the contract benefits, could apply. The party seeks only performance, not its value. As in the insurance cases, the duty of good faith and fair dealing requires the breaching party to consider the other party's interest in performance equivalent to his own interest in breach.
were applied without modification, liability would be shifted to the breaching party only if it knew or had reason to know of the specific consequential losses. The modification draws a parallel between breach of contract with knowledge that contract remedies will be unavailable or inadequate and the bad faith and unreasonable claim or denial. Since the injurer knows and has reason to know the breach will obstruct the injured party's recovery of the benefits of the agreement, actual or constructive knowledge of the specific consequential losses is not required to justify shifting these losses from injurer to victim. The second modification of the Hadley rule shifts the knowledge requirement from the time of contracting to the time of breach. This modification is appropriate because the Hadley rule's focus on the time of contracting is no longer justified in the modern world, where the transaction costs of information exchange are relatively low. If the victim informs the injurer at the time of breach that no adequate substitutionary remedy exists, then the injurer is in the best position to efficiently avoid the loss. The injurer, therefore, should be liable for the consequential loss.

The third element of the refined test, that compensatory damages be unavailable or inadequate, can be analyzed under the Restatement (Second) standards for the award of specific performance when contract damages are inadequate or unavailable. The Restatement (Second) suggests three criteria for determining whether the remedy is adequate: "(a) the difficulty of proving damages with reasonable certainty, (b) the difficulty of procuring a suitable substitute performance by means of the money awarded as damages, and (c) the likelihood that an award of damages could be collected." In the first category, the Restatement

152. The nature of the contractual relationship itself may give the breaching party reason to know that contract damages will be unavailable or inadequate in the case of breach. Cover may be foreseeably inadequate because the time lag between breach and cover would nullify its effectiveness as a substitute. Also, cover foreseeably could be unavailable because the value of the injury would exceed that of any reasonable substitute. For instance, the insurer could have reason to know that the insured "will suffer great hardship if the benefits are not paid promptly," or that the "severe harm to an employee's reputation and ability to find new employment . . . cannot be undone by an award of back pay," Seaman's Direct Buying Service, 36 Cal. 3d at 780, 686 P.2d at 1174, 206 Cal. Rptr. at 370 (Bird, C.J., concurring and dissenting).

153. Rather, the conduct and state of mind themselves justify liability for consequential losses. See supra Part II, Section B.


155. See Note, An Economic Approach to Hadley v. Baxendale: EVRA Corporation v. Swiss Bank Corporation, 62 NER. L. REV. 156, 169 (1983) (Judge Posner's analysis of which party could have most efficiently avoided the loss shifts the focus from parties' knowledge at the time of contracting to the parties' opportunity to efficiently avoid risks at the time of breach).


157. Id.
(Second) suggests that "[s]ome types of interests are by their very nature incapable of being valued in money," citing as examples "heirlooms, family treasures and works of art that induce a strong sentimental attachment." The second category is illustrated by the breach of requirements contracts and contracts containing covenants not to compete. For example, if parties contract for the sale of widgets, knowing that I (injurer) is the only widget supplier within a reasonable distance, and that V (victim) will fold if his widget supply is cut off, then I's breach of contract cannot be remedied by substitute performance. Defaulting on performance in this example is analogous to denying, in bad faith and unreasonably, that a contract exists. In both cases I knows and should know that his conduct will obstruct V's ability to receive the benefits of the agreement. In both of the Restatement (Second) categories, the breach itself deprives the aggrieved party of not only performance but also of the value of the performance. The third category is illustrated where the breaching party is judgment proof, or conceals his assets. This situation is also analogous to Seaman's Direct Buying Service. In both, the injurer knowingly and unreasonably obstructs the aggrieved party's attempt to enforce or collect compensation for the injurer's violation of legal obligations.

Tort liability under this model would be appropriate for all the doctrinal, normative, and remedial reasons noted earlier. Since the second and third requirements of the revised test—in inadequacy or unavailability of contract damages including specific performance, and knowledge and reason to know of these facts—will be difficult to meet, the tort will not swallow breach of contract. Indeed, breach of certain contracts already constitutes a tort under current law when the promised performance is unique or irreplaceable. Breach of contract by a public utility is one

158. See id. § 360 comment b.

159. As another example, if after promoting an author, a publisher reneges on the agreement and refuses to publish the author's book, the author may lose more than publication. He also could lose his reputation, including the ability to find a substitute publisher. See Summers, supra note 65, at 254-55 (basing example on Schisgall v. Fairchild Publications, Inc., 207 Misc. 224, 137 N.Y.S.2d 312 (Sup. Ct. 1955)).

160. The standards governing the unavailability of specific performance also are set out in the Restatement (Second). Courts may refuse to grant specific performance if: (1) the terms of the contract are not sufficiently certain to provide a basis for an order; (2) a substantial part of the performance is not secured; (3) the relief would be unfair because (a) the contract was induced by mistake or by unfair practices, (b) the relief would cause unreasonable hardship or loss to the party in breach or the third parties, or (c) the exchange is grossly inadequate or otherwise unfair; (4) the compulsion would violate public policy; (5) the burden of court enforcement or supervision would be too great; (6) the performance involves personal service; or (7) the breaching party can substantially nullify the order. See RESTATEMENT (SECOND) OF CONTRACTS §§ 362-68 (1979). But see Schwartz, The Case for Specific Performance, 89 YALE L.J. 271, 298-305 (1979) (defenses to specific performance under current standards are not justified).
That rule has not threatened the overall integrity of contract law. Nonetheless, applying Chief Justice Bird's model would increase the borderland between contract and tort. Therefore, this Comment suggests that the tort model of breach of the implied covenant of good faith and fair dealing exclude bad faith conduct in performance until courts and commentators more fully explore the implications of treating a breach of contract as a tort.

B. Putting Punitive Damages in Perspective

This Section will analyze the appropriateness of punitive damage awards for breach of the implied covenant of good faith and fair dealing. While case law has recognized a distinction between "bad faith" and "malice," courts tend to award punitive damages upon a finding of bad faith conduct that breaches the implied covenant. Such awards have little justification in fairness or efficiency, fail to satisfy the requisite substantive legal standards, and impose punishment which is disproportionate to the level of culpability.

1. Unfairness and Inefficiency

While case law and commentators have not yet produced a coherent rationale for awarding punitive damages for breach of the implied covenant of good faith and fair dealing, several traditional arguments could be advanced. Punitive damages are necessary to compensate otherwise uncompensable injuries from the bad faith conduct; they are necessary to punish and deter the injurer; and they are necessary to generally deter bad faith conduct. None of these arguments provides adequate justification for punitive damages.

Even if punitive damages are generally an appropriate mechanism for punishment and deterrence, they are not appropriate for breach of

161. 5 CORBIN ON CONTRACTS § 1077 (1964); see also RESTATEMENT (SECOND) OF CONTRACTS § 355 comment b (1979) ("In some instances the breach of contract is also a tort, as may be the case for breach of duty by a public utility.").

162. See supra note 25 and accompanying text.


164. Many courts and commentators reject this assumption and either decline to award punitive damages or substantially restrict them. See Sales & Cole, Punitive Damages: A Relic That Has Outlived Its Origins, 37 VAND. L. REV. 1117, 1124-25 (1984); see also RESTATEMENT (SECOND) OF TORTS § 908 comment f (1977) (discussing criticisms and state law restrictions on awarding punitive damages); PROSSER & KEETON, supra note 3, § 2, at 11-12 (Punitive damages have been "condemned as undue compensation beyond the plaintiff's just deserts, in the form of a criminal fine which should be paid to the state, if anyone, with the amount fixed only by the caprice of the jury and imposed without the usual safeguards thrown about criminal procedure, such as proof beyond a reasonable doubt, the privilege against self-incrimination, and even the rule against double jeop-
the implied covenant of good faith and fair dealing. Tort damages already remedy the inadequate compensation and deterrence of contract damages. They significantly expand the range of compensation for consequential losses. Additional punitive damages are unnecessary to redress undercompensation for harm caused by a breach of the implied covenant.\textsuperscript{165}

Furthermore, tort damages provide both specific and general deterrence by motivating injurers to incorporate the cost of consequential losses into their behavioral decisions.\textsuperscript{166} Unlike contract liability, tort liability forces injurers to internalize the harm their bad faith conduct creates.\textsuperscript{167} Moving from contract to tort damages will also serve the purposes of punishment. Tort remedies punish injurers financially by increasing the cost of bad faith conduct, and morally by stigmatizing defendants with a societal judgment of fault.

Since tort remedies provide a fair and efficient level of compensation for bad faith conduct in contract formation and enforcement, punitive damages would overcompensate victims and overdeter injurers. Punitive damages are unfair because they force injurers to pay more than the cost of the injury created by their bad faith conduct. Punitive damages also create inefficiencies. Since punitive damages significantly augment compensatory damages, they are inefficient unless the costs of compliance (or benefits of noncompliance) are exceptionally high.\textsuperscript{168} The costs of compliance with the implied covenant of good faith and fair dealing are not exceptionally high. The obligation merely requires reasonable care and good faith in making a claim or denial. The benefits of noncompliance will be exceptionally high only if the actor derives an "illicit pleasure" from noncompliance, and this tends to occur only when the conduct is

\textsuperscript{165} Even if tort remedies failed to provide adequate compensation, punitive damages would be an inappropriate mechanism to redress the inadequacy. See Ellis, Fairness and Efficiency in the Law of Punitive Damages, 56 S. CAL. L. REV. 1, 10-12 (1982).

\textsuperscript{166} The special costs of bad faith conduct may be significant, as Seaman's Direct Buying Service illustrates. Thus, "[w]hen potential compensatory damages . . . extend to consequential damages as well, including mental suffering, the risk of potential compensatory damages constitutes a substantial deterrent against wrongdoing." Egan, 24 Cal. 3d at 826 n.1, 598 P.2d at 461 n.1, 157 Cal. Rptr. at 491 n.1 (Clark, J., concurring and dissenting); see also Sales & Cole, supra note 164, at 1122, 1164-65. Moreover, moving from the strict liability scheme of contract to the award of consequential damages in tort produces a sharp jump in the cost of bad faith conduct, which serves as a deterrent. See supra note 100.

\textsuperscript{167} See supra notes 93-100 and accompanying text.

\textsuperscript{168} See Cooter, supra note 3, at 1543; Ellis, supra note 165, at 23-33, 77. See generally Cooter, Economic Analysis of Punitive Damages, 56 S. CAL. L. REV. 79 (1982).
intentional, repeated, and gross. If the injurer acts with the purpose of inflicting injury on the victim, punitive damages probably will be available in any event.

2. Substantive Restrictions

Substantive restrictions also preclude the award of punitive damages for mere bad faith and unreasonable conduct that breaches the implied covenant of good faith and fair dealing. Normal tort remedies are deemed sufficient to punish and deter most conduct which is socially unreasonable or undesirable. Therefore, punitive damages are restricted to "conduct that is outrageous, because of the defendant's evil motive or his reckless indifference to the rights of others." Many state statutes phrase the requirement in terms of "malice," "fraud," or "oppression." While the precise meaning of such terms has never been clear, they represent an attempt to restrict punitive damages to cases involving exceptionally bad behavior. Neither unreasonableness nor bad faith meets these standards per se.

The substantive standards for punitive damages emphasize the actor's intent to injure the plaintiff, and fix that evil motive as the justification for punitive damages. Bad faith, in contrast, emphasizes the actor's attempt to evade litigation of liability on the merits, or to gain advantages which litigation might not support. An actor that breaches the implied covenant need not intend to harm plaintiff or to consciously disregard plaintiff's rights. It is sufficient that he act unreasonably and with the knowledge that he is asserting an invalid claim. In short, a

169. Cooter, supra note 168, at 86-89.
170. Such a mental state presumably would satisfy the statutory requirements. See infra text accompanying note 173.
172. Id. § 908(2).
176. Like malice, neither oppression, fraud, nor recklessness is equivalent to bad faith, even though the defendant may knowingly disregard plaintiff's right to remedial relief. For punitive damages purposes, each state of mind requires some additional element of intention or awareness that plaintiff will incur drastic consequences as a result of the wrongful conduct. See, e.g., CAL. CIV. CODE § 3294(c) (West Supp. 1985) (oppression means "subjecting a person to cruel and unjust hardship in conscious disregard of that person's rights"); CAL. CIV. CODE § 3294(c)(3) (West 1984) (fraud means "an intentional misrepresentation, deceit, or concealment of a material fact . . . with the intention . . . of thereby depriving a person of property or legal rights or otherwise causing injury"); RESTATEMENT (SECOND) OF TORTS § 500 (1977) ("reckless disregard of safety" involves knowledge of a risk which is "substantially greater than that which is necessary to make his conduct negligent").

Beyond any technical distinctions, the policy choice that punitive damages be limited to the most outrageous conduct justifies a narrow construction of statutory language setting forth the the
violation of good faith and fair dealing does not reach a level of culpability high enough to merit punitive damages.

Courts finding a breach of the implied covenant of good faith and fair dealing have refused to equate bad faith with malice.\(^\text{177}\) As the California Supreme Court stated in *Neal v. Farmers Insurance Exchange*:

The terms of “good faith” and “bad faith” . . . are not meant to connote the absence or presence of positive misconduct of a malicious or immoral nature — considerations which . . . are more properly concerned in the determination of liability for punitive damages. Here we deal only with the question of breach of the implied covenant and the resultant liability for compensatory damages.\(^\text{178}\)

If breach of the implied covenant itself satisfied the state of mind, motive, and conduct requirements for punitive damages, this could chill parties’ efforts to negotiate liability. The party asserting a claim for breach of the implied covenant would have an economic sword over the party claiming or denying an obligation.

The fact that bad faith conduct normally does not merit punitive damages does not mean that punitive damages are never appropriate. Rather, punitive damages may be awarded whenever the statutory or common law prerequisites are satisfied. For example, punitive damages were awarded in *Neal* because the court found malice in the insurer’s attempt to extract an unjustifiably favorable settlement.\(^\text{179}\) In *Seaman’s Direct Buying Service*, on the other hand, there was evidence that defendant “was cynically attempting to avoid both performance and liability for nonperformance of contractual obligations which it privately recognized to be binding.”\(^\text{180}\) In such a case a jury might not find the requisite malice, fraud, oppression, or otherwise outrageous conduct to justify punitive damages.

3. **Disproportionality**

The requirements of an evil intent and outrageous conduct before punitive damages are awarded reflect a concern for proportionality. Tort
law, criminal law, and constitutional law insist that punishment be proportionate to culpability. Thus, the use of more force than is reasonably necessary to repel an attacker may be a tort upon which the attacker may recover.\(^{181}\) Similarly, sentencing a person to fifteen years of hard labor for falsifying an official record may be cruel and unusual punishment in violation of the eighth amendment.\(^ {182}\) In each case, subjecting the injurer to more punishment than he deserves violates the principle of proportionality. In an analogous manner, punitive damages for mere bad faith and unreasonable conduct impose punishment that is disproportionate and perhaps unconstitutional.\(^ {183}\)

In addition, punitive damages are disproportionate to the injurer's state of mind. Absent malice, fraud, oppression, or their surrogates (recklessness, willfulness, or wantonness, for example), bad faith conduct simply involves a party's attempt to shield himself from liability. It differs from torts such as malicious prosecution or intentional infliction of emotional distress, where defendant desires to injure plaintiff or knows with substantial certainty that injury is likely. The bad faith standard only requires knowledge that the act has no legal validity. The actor may merely be negligent as to the consequences. The culpability involved is not great enough to warrant punitive damages.\(^ {184}\) Thus, substantive and policy rationales require a finding of malice, and not mere bad faith, before punitive damages may be awarded.

The requirement that punitive damages bear a reasonable relationship to compensatory damages injects some proportionality into punitive damage awards,\(^ {185}\) but it does not remedy the imbalance that would exist were punitive damages available for bad faith conduct. The reasonable relationship rule merely serves to determine, on appeal, whether the jury

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182. See Weems v. United States, 217 U.S. 349 (1910). MODEL PENAL CODE § 1.02(1)(e) (Proposed Official Draft 1962) (one purpose of provisions defining offenses is to “differentiate on reasonable grounds between serious and minor offenses”); \textit{id.} at § 1.02(2)(e) (one purpose of provisions governing sentencing is “to differentiate among offenders with a view to a just individualization in their treatment”).


award was the result of passion or prejudice. Moreover, the lack of standards to define what constitutes a reasonable relationship makes it unlikely that punitive damages for breach of the implied covenant of good faith and fair dealing will be proportionate.

CONCLUSION

The duty of good faith and fair dealing protects parties from wrongful obstruction of their interest in accurate compensation for a breach of contract. This Comment defines a violation of the duty of good faith and fair dealing as a bad faith and unreasonable assertion or denial of a legal obligation that obstructs the injured party's interest in receiving the substitutionary value of the defaulted performance. Courts currently use the special relationship doctrine to enforce the public policy against such bad faith conduct. However, since the special relationship doctrine inadequately defines the scope and application of the implied covenant of good faith and fair dealing, and since the covenant is implied in every contract, courts should apply tort remedies for breach of the implied covenant in every contractual relationship.

Tort liability for breach of the implied covenant of good faith and fair dealing is justified because tort remedies most fairly and efficiently protect the injured party's right to receive accurate compensation for breach of contract. Indeed, tort law already recognizes related interests in freedom from interference with economic relations and from misuse of legal process. However, tort law leaves a gap in addressing wrongful obstructions of accurate compensation. The proposed tort model for breach of the implied covenant fills this gap.

The mental state required for a violation of good faith and fair dealing is that of knowing and having reason to know that the actor is asserting a groundless claim. Based on concerns for fairness, efficiency, and proportionality, statutory schemes and common law norms require a higher level of culpability before punitive damages may be imposed. Therefore, courts should require proof of substantive standards such as malice before imposing punitive damages for breach of the implied covenant of good faith and fair dealing.

Recognizing a tort duty of good faith and fair dealing will protect the contracting process from bad faith conduct without intruding on the parties' reasonable expectations as to performance. A substantial body of case law exists which provides illustrations and analogies for expanding

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the tortious breach of the implied covenant. Since, as Karl Llewellyn has noted, "[o]vert tools are never reliable tools," courts should recognize breach of the implied covenant of good faith and fair dealing as a tort action in the formation and enforcement of contracts.

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