EMOTIONAL DISTRESS DAMAGES AND THE TORT OF INSURANCE BAD FAITH

*John H. Bauman**

TABLE OF CONTENTS

I. INTRODUCTION

When an insurance company wrongfully[1] refuses to perform its obligations[2] under an insurance policy, many courts today regard this conduct as

* Professor of Law, South Texas College affiliated with Texas A&M University. Visiting Professor of Law, 1997-98, Pepperdine University School of Law. B.A., 1975, Pomona College; J.D., 1978, Stanford Law School.

1. The qualifier "wrongfully" is meant to distinguish the bad-faith breach of an insurance contract from situations in which the insurance company, though ultimately liable on the policy, was justified in contesting the obligation. The latter situation, which is a mere breach of contract, should not lead to extra contractual damages. Unfortunately, some courts adopt standards that do not carefully observe this distinction. *See infra* note 285 and accompanying text.

2. Virtually any obligation to the insured, at least if deliberately breached, can give rise to bad-faith claims. The most common obligation breached is the duty to pay claims owed directly to the insured under life, health, disability, and property insurance—first-party claims. *See, e.g.*, Deese v. State Farm Mut. Auto. Ins. Co., 813 P.2d 318, 321 (Ariz. Ct. App. 1991) (holding that an insured must first establish that a breach of contract has occurred prior to stating a claim for bad-faith failure to pay a portion of medical benefits under an automobile insurance policy); Staff

something more than a mere breach of contract. Instead, this conduct is viewed as a breach of the insurer's covenant of good faith and fair dealing,[3] and the

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Builders, Inc. v. Armstrong, 525 N.E.2d 783, 787-89 (Ohio 1988) (holding that an insurer's breach of the duty to act in good faith in processing and payment of an insured's claim gave rise to liability in tort); Anderson v. Continental Ins. Co., 271 N.W.2d 368, 373-78 (Wis. 1978) (involving an insured's claim of bad-faith on part of an insurer in its refusal to honor a homeowner's policy); McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 856-61 (Wyo. 1990) (recognizing the tort of first-party bad faith arising out of the insurer's unreasonable denial of a claim). Another common obligation breached is the duty to provide a defense. *See, e.g.*, Standard Oil Co. v. Hawaiian Ins. & Guar. Co., 634 P.2d 123, 128-29 (Haw. Ct. App. 1981) (holding that the insured gave the insurer notice of its duty to defend when the insured forwarded the pleadings that were served on the insured); Snodgrass v. State Farm Mut. Auto. Ins. Co., 804 P.2d 1012, 1021-22 (Kan. Ct. App. 1991) (holding that an automobile insurer which had refused to defend the insured could not be held liable for an amount of judgment in excess of the policy limits); Lipinski v. Title Ins. Co., 655 P.2d 970, 977-78 (Mont. 1982) (holding that punitive damages were proper regarding an insurer's bad-faith refusal to defend the insured, but not liable for the costs and damages of a second undefended lawsuit occasioned by the insured's refusal to abide by the settlement of the first action); Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 755-59 (N.D. 1980) (holding that an alleged failure to defend an insured is sufficient to state a tortious cause of action against the insurer); Garcia v. American Ins. Exch., 812 S.W.2d 25, 33 (Tex. App. 1991) (holding that a nonexecution agreement did not extinguish the insurer's liability in a suit against the insurer for failure to defend the insured's malpractice lawsuit), *rev'd*, 876 S.W.2d 842 (Tex. 1994). Finally, a common obligation breached is the insurer's duty to settle within policy limits under liability insurance policies—third-party claims. *See, e.g.*, Farmers Ins. Exch. v. Henderson, 313 P.2d 404, 409 (Ariz. 1957) (stating that an insurer is liable for the full amount of damages where the insurer fails to settle within the policy limits); Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 266-68 (Miss. 1988) (holding that an insurer's failure to settle within policy limits was not bad faith, but that attorneys had a duty to inform the insured that an amount in excess of the policy was demanded); Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 562 (Mo. Ct. App. 1990) (holding that the fact that the insurer maintained a declaratory judgment action to establish its obligations did not preclude a finding that it acted in bad faith); Braesch v. Union Ins. Co., 464 N.W.2d 769, 778-79 (Neb. 1991) (denying an emotional distress claim for failure to settle within policy limits); Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 773-77 (W. Va. 1990) (upholding damages awarded to the insured for the insurer's failure to settle the claim within policy limits).

3. The covenant of good faith and fair dealing is recognized by the Restatements as an implied covenant in every contract, breach of which is normally a breach of contract. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979). It is based on the idea that neither party may deprive the other of the benefits of the contract by conduct incompatible with the purposes for which they entered into the agreement. *Id.* One concept of the section, expressed by Professor Summers, is that the section operates not so much to define good faith as it does to exclude types of conduct deemed to be bad faith. Robert S. Summers, *The General Duty of Good Faith—Its Recognition and Conceptualization*, 67 CORNELL L. REV. 810, 820-21 (1982); Robert S. Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commerical Code*, 54 VA. L. REV. 195, 196 (1968). Other commentators argue that the concept does have an affirmative content. *See* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 403 (1980); Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497, 499-501 (1984).

insured will have a cause of action sounding not only in contract, but also in tort.[4] When the breach is regarded as tortious in this way, many courts allow a more generous measure of damages in suits by the insured, permitting recovery of not only the amount of the policy, but also consequential economic losses,[5] damages for emotional distress,[6] and punitive damages.[7]

This expanded recovery has profoundly altered the bargaining position of the insurer and insured when a dispute arises between them regarding the losses covered by the policy.[8] An insurer that is found to have committed the tort of bad faith, instead of merely having to pay the disputed amount under the policy, could potentially be liable for damages many times the actual contract amount in dispute.[9] For this reason, the tort of bad faith significantly improves the ability of insureds to pressure insurance companies to pay under their policies. While much attention has been paid to the potential availability of large punitive damage awards in bad-faith cases, the award of damages to compensate for the

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4. *See, e.g.*, Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1041-42 (Cal. 1973) (allowing damages for emotional distress where substantial property damage was incurred and the insurer's conduct was egregious); Crisci v. Security Ins. Co., 426 P.2d 173, 178-79 (Cal. 1967) (allowing an insured to recover both pecuniary loss and mental distress damages from an insurer).

5. *See, e.g.*, Aetna Life Ins. Co. v. Lavoie, 470 So. 2d 1060, 1078 (Ala. 1984), *vacated*, 475 U.S. 813 (1986), *aff'd on remand*, 505 So. 2d 1050, 1052-53 (Ala. 1987) ("[P]laintiffs may properly recover compensatory damages for economic loss."); Gulf Atlantic Life Ins. Co. v. Barnes, 405 So. 2d 916, 925 (Ala. 1981) ("Because the violation of duty of good faith and fair dealing is tortious in nature, punitive damages as well as compensatory damages are recoverable in the *proper* case."); Nassen v. National States Ins. Co., 494 N.W.2d 231, 237-38 (Iowa 1992) (finding evidence sufficient to support economic loss resulting from premature dissipation of the plaintiff's assets); Ruwe v. Farmers Mut. United Ins. Co., 469 N.W.2d 129, 135 (Neb. 1991) (noting that economic losses may be recovered); Thomas v. State Farm Mut. Auto. Ins. Co., 383 S.E.2d 786, 788 (W. Va. 1989) (granting the insured economic damages for property damage).

6. *See, e.g.*, Troolines v. Farmers Ins. Group, Inc., 234 Cal. Rptr. 479, 481 (Ct. App. 1987) (holding that damages for negligent infliction of emotional distress were permissible in a case involving an insurer's wrongful refusal to settle a claim); Farmers Group, Inc. v. Trimble, 658 P.2d 1370, 1374-76 (Colo. Ct. App. 1982) (granting emotional distress damages for an insurer's bad faith in a personal injury claim); Gibson v. Western Fire Ins. Co., 682 P.2d 725, 738 (Mont. 1984) (granting emotional distress damages to a professional person fearing a damaged reputation); State Farm Mut. Auto. Ins. Co. v. Zubiate, 808 S.W.2d 590, 599-600 (Tex. App. 1991) (allowing recovery for mental anguish suffered as a result of the insurer's denial of a claim).

7. *See, e.g.*, Linscott v. Rainier Nat'l Life Ins. Co., 606 P.2d 958, 962-64 (Idaho 1980) (allowing punitive damages when there is an injury incurred due to an extreme deviation from reasonable standards); Hall v. SVEA Mut. Ins. Co., 493 N.E.2d 1102, 1105 (Ill. App. Ct. 1986) (granting punitive damages when the insurer refused to settle claims in a vexatious and unreasonable manner).

8. For a discussion of this effect, see Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113 (1991).

9. *See* Gibson v. Western Fire Ins. Co., 682 P.2d 725, 729-30 (Mont. 1984); Buzzard v. Farmers Ins. Co., 824 P.2d 1105, 1107-08 (Okla. 1991); Crookston v. Fire Ins. Exch., 817 P.2d 789, 793-95 (Utah 1991).

infliction of mental distress is also a significant feature of the new tort.[10] In many cases, the award for emotional distress will be sustained even where the amount of punitive damages is found to be excessive.[11]

The tort of insurance bad faith first became widely accepted during the "liability-expanding" phase of tort law development of the 1960s and 1970s.[12] It is not surprising that at the same time the courts were developing the tort of bad faith, they were also engaged in significant expansion of the general availability of emotional damages.[13] It is also not surprising that a court that took an expansive view of the availability of damages for the negligent infliction of emotional distress should make such damages available to plaintiffs in insurance bad-faith cases.[14]

In recent years, however, both the tort of negligent infliction of emotional distress[15] and the "tort" of bad faith breach of contract[16] have come under increasing critical scrutiny. For example, many courts and commentators have begun to question the general availability of damages for emotional distress caused by merely negligent conduct that neither threatens nor inflicts physical injury.[17] Also, courts and commentators have begun to question the

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10. Emotional distress damages are normally not recoverable in an action for breach of contract. *See infra* notes 217-21 and accompanying text.

11. *See* Farr v. Transamerica Occidental Life Ins. Co., 699 P.2d 376, 382 (Ariz. Ct. App. 1984); Egan v. Mutual of Omaha Ins. Co., 133 Cal. Rptr. 899, 919 (Ct. App. 1977); Farmers Group, Inc. v. Trimble, 768 P.2d 1243, 1248 (Colo. Ct. App. 1988); Anderson v. Continental Ins. Co., 271 N.W.2d 368, 378 (Wis. 1978).

12. The idea that an insurance company owed a special duty to its insured in settling a third-party claim that the insurer was defending under a liability insurance policy is actually much older. It is common to cite *Crisci v. Security Insurance Co.*, 426 P.2d 173 (Cal. 1967), as the leading case in this area, but the Texas courts, for example, had long before recognized a similar duty. *See* G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544, 546 (Tex. Comm'n App. 1929). The theoretical development of the tort as a breach of the covenant of good faith and fair dealing, and its extension to first-party cases did not get fully under way until much later. *See* Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1042 (Cal. 1973); Fletcher v. Western Nat'l Life Ins. Co., 89 Cal. Rptr. 78, 93 (Ct. App. 1970).

13. *See infra* notes 39-63 and accompanying text.

14. Merely identifying bad faith as a tort does not automatically mean that damages for emotional distress should be recoverable. *See infra* notes 75-106.

15. *See infra* notes 68-74 and accompanying text.

16. Not all courts that recognize an increased measure of damages for breach of the covenant of good faith and fair dealing by an insurance company justify the result by conceptualizing the breach as tortious. Some courts allow recovery of consequential economic loss, but not damages for emotional distress, on an ordinary breach of contract theory. *See, e.g.*, State Farm Fire & Cas. Co. v. Simpson, 477 So. 2d 242, 252 (Miss. 1985); Lawton v. Great Southwest Fire Ins. Co., 392 A.2d 576, 579 (N.H. 1978); Rova Farms Resort, Inc. v. Investors Ins. Co., 323 A.2d 495, 513 (N.J. 1974); Pickett v. Lloyds, 600 A.2d 148, 155 (N.J. Ct. App. 1991); Exum v. Ferguson, 637 P.2d 553, 555-56 (N.M. 1981); Lujan v. Gonzales, 501 P.2d 673, 678-82 (N.M. Ct. App. 1972); Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1022-23 (Or. 1978).

17. *See, e.g.*, David Crump, *Evaluating Independent Torts Based Upon "Intentional" or "Negligent" Infliction of Emotional Distress: How Can We Keep the Baby from Dissolving in the*

"tortification" of contract law by the attempted expansion of the tort of bad-faith breach of contract beyond the insurance context.[18]

For these reasons, it is instructive to examine the confluence of these two issues—the availability of emotional distress damages in suits involving insurance bad faith. It is the availability of damages for emotional distress that is often the signal that the court is treating the breach of the insurance contract as a tort subject to tort measures of damages. Yet, often little consideration is given to why the breach should be considered tortious, or if in fact tortious, that it is the type of tort for which emotional distress damages should be available.

Part II of this Article will examine the development of the tort doctrine regarding the availability of damages for the infliction of emotional distress. In particular, this part of the Article will point out the policy difficulties involved in allowing damages for emotional distress arising from merely negligent conduct that causes no physical injury. Part III of the Article will then examine the current state of the tort of insurance bad faith, focusing on the standards the courts used to determine when a refusal to pay indeed amounts to "bad faith." As will be seen, many courts allow a finding of bad faith for conduct that is, at worst, merely negligent. An analysis of the policies underlying the award of damages for emotional distress and the bad-faith breach doctrine will lead to consideration of a basic question not often directly addressed: What is "tortious" about the tort of insurance bad faith? Examination of this issue will result in the conclusion that courts should limit emotional distress damage recoveries for insurance bad faith to situations in which the insurance company was truly acting in an intentionally tortious fashion by denying claims that were clearly valid. This does not necessarily mean that breaches that do not reach this standard should only be compensated for by traditional contract damages. Other forms of consequential loss, particularly foreseeable economic loss caused by the wrongful denial, may well be recoverable in insurance bad-faith cases that do not amount to intentional torts. If such damages, however, are limited to consequential economic loss, this will provide some deterrent effect for conduct that is not intentionally tortious, without inflicting excessively severe penalties on such unintentionally wrongful conduct.

Bath Water?, 34 ARIZ. L. REV. 439, 460-61 (1992); Richard N. Pearson, *Liability for Negligently Inflicted Psychic Harm: A Response to Professor Bell*, 36 U. FLA. L. REV. 413, 435 (1984); Richard N. Pearson, *Liability to Bystanders for Negligently Inflicted Emotional Harm—A Comment on the Nature of Arbitrary Rules*, 34 U. FLA. L. REV. 477, 516 (1982) [hereinafter *Liability to Bystanders*].

18. *See, e.g.*, Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669, 671-73 (Cal. 1995) (overruling the bad-faith denial of contract tort recognized in Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 686 P.2d 1158 (Cal. 1984)); Foley v. Interactive Data Corp., 765 P.2d 373, 401-02 (Cal. 1988) (refusing a tort remedy for bad-faith discharge from employment).

II. TORT RECOVERY OF DAMAGES FOR EMOTIONAL DISTRESS

A. *Intentional and Negligent Infliction of Emotional Distress*

Tort law has never had a clear vision of whether and when to compensate in damages for the infliction of emotional distress. Beginning with a restrictive view of the ability of plaintiffs to recover damages for emotional distress,[19] tort law gradually became more accepting of the availability of such damages.[20] At present, tort law appears to be going through a process of reconsideration of emotional distress damages, with at least some courts retreating from their most expansive views.[21] It will be useful to trace the evolution of the general tort doctrine regarding the recovery of emotional distress caused by tortious conduct, in order to delineate the problems associated with awarding emotional distress damages for the bad-faith breach of an insurance contract.

The most common situation in which tort law allowed, and still allows, recovery of damages for emotional distress is when such damages are "parasitic" on some other recognized tort, usually a tort involving intentional misconduct[22] or the infliction of bodily harm.[23] Under this rule, for example, the plaintiff is allowed to recover damages for "pain and suffering" as a part of the recovery for the infliction of a physical injury.[24] In such situations, the presence of a physical injury provides the courts with clear evidence that the plaintiff endured genuine suffering.

Similarly, the common law traditionally allowed recovery for what were essentially psychic injuries caused by intentionally wrongful conduct. For example, the unpleasant mental sensation of being threatened with the infliction of a harmful or offensive physical contact was the basis for the tort of assault, and damages could be recovered for this "psychic" injury.[25] Further, the tort of false

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19. *See* RESTATEMENT OF TORTS § 46 (1934). The first Restatement did not recognize an independent cause of action even if the actor intended to cause emotional distress, if no physical injury occurred as the result of the actor's conduct. *Id.* The plaintiff could only recover damages for mental or emotional suffering if it resulted from some other, already established tort cause of action. *Id.*

20. The evolution of the Restatement position can be traced through RESTATEMENT OF TORTS § 46 (1934) to RESTATEMENT (SECOND) OF TORTS § 46 (1965).

21. *See, e.g.*, Crump, *supra* note 17, at 494-505 (commenting on recent developments regarding the negligent infliction of emotional distress tort).

22. W. PAGE KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 12, at 56-57 (5th ed. 1984).

23. *Id.* § 54, at 362-63.

24. *See* Kline v. Kline, 64 N.E. 9, 10 (Ind. 1902); Holdorf v. Holdorf, 169 N.W. 737, 737 (Iowa 1918); Nelson-Holst v. Iverson, 479 N.W.2d 759, 762 (Neb. 1992) (per curiam); Deborah S. v. Diorio, 583 N.Y.S.2d 872, 878 (Civ. Ct. 1992); Trogden v. Terry, 90 S.E. 583, 585 (N.C. 1916); Lounsbury v. Capel, 836 P.2d 188, 196 (Utah Ct. App. 1992).

25. *See* Associated Health Sys., Inc. v. Jones, 366 S.E.2d 147, 152 (Ga. Ct. App. 1988); Fisher v. Carrousel Motor Hotel, Inc., 424 S.W.2d 627, 630 (Tex. 1967); Carrell v. Richie, 697

imprisonment provided compensation for the unpleasant mental sensation of being wrongfully confined against one's will.[26] In either case, the deliberate invasion of the plaintiff's rights by the defendant was the hallmark of the tort. Given this deliberately wrongful conduct, the courts were willing to compensate the plaintiff for the unpleasant mental sensations; at the same time, these damages acted as a deterrent of such antisocial conduct by defendants.[27] These torts also included the element of personal affront that could easily escalate into a breach of the peace.[28] The legal remedy provided the plaintiff an alternative to self-help revenge.[29]

In sum, although the common law was reluctant to award damages for conduct that caused nothing more than emotional distress, it would do so when these mental injuries were accompanied by either physical injury or the invasion of certain narrowly defined interests by deliberate wrongful conduct. The notion of emotional distress damages as piggybacking upon these other factors is the germ of the idea that damages for emotional distress can be awarded against insurance companies guilty of bad faith when accompanied by an "independent tort."[30] It is important, however, to note that even such independent tort damages depended upon the presence of traditionally tortious conduct, in the sense of conduct that either produced physical injury or was the result of deliberate wrongdoing by the defendant.

The first expansion of the common law towards more freely awarding damages for emotional distress came with the adoption of the tort known as intentional infliction of emotional distress.[31] The tort of intentional infliction of emotional distress had as its crucial element the requirement that the mental

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S.W.2d 43, 44-45 (Tex. App. 1985); National Bonding Agency v. Demeson, 648 S.W.2d 748, 750 (Tex. App. 1983).

26. *See* Reicheneder v. Skaggs Drug Ctr., 421 F.2d 307, 312-13 (5th Cir. 1970); Gibson v. J.C. Penney Co., 331 P.2d 1057, 1062 (Cal. Ct. App. 1958); Neisner Bros. v. Ramos, 326 A.2d 239, 240 (D.C. 1974); Gibson Discount Ctr., Inc. v. Cruz, 562 S.W.2d 511, 513 (Tex. App. 1978).

27. *See* Reicheneder v. Skaggs Drug Ctr., 421 F.2d at 312-13; Gibson v. J.C. Penney Co., 331 P.2d at 1062; Neisner Bros. v. Ramos, 326 A.2d at 240; Associated Health Sys., Inc. v. Jones, 366 S.E.2d at 152; Fischer v. Carrousel Motor Hotel, Inc., 424 S.W.2d at 630; Carrell v. Richie, 697 S.W.2d at 44-45; National Bonding Agency v. Demeson, 648 S.W.2d at 750; Gibson Discount Ctr., Inc. v. Cruz, 562 S.W.2d at 513.

28. *See* Reicheneder v. Skaggs Drug Ctr., 421 F.2d at 312-13; Gibson v. J.C. Penney Co., 331 P.2d at 1062; Neisner Bros. v. Ramos, 326 A.2d at 240; Associated Health Sys., Inc. v. Jones, 366 S.E.2d at 152; Fischer v. Carrousel Motor Hotel, Inc., 424 S.W.2d at 630; Carrell v. Richie, 697 S.W.2d at 44-45; National Bonding Agency v. Demeson, 648 S.W.2d at 750; Gibson Discount Ctr., Inc. v. Cruz, 562 S.W.2d at 513.

29. *See* Reicheneder v. Skaggs Drug Ctr., 421 F.2d at 312-13; Gibson v. J.C. Penney Co., 331 P.2d at 1062; Neisner Bros. v. Ramos, 326 A.2d at 240; Associated Health Sys., Inc. v. Jones, 366 S.E.2d at 152; Fischer v. Carrousel Motor Hotel, Inc., 424 S.W.2d at 630; Carrell v. Richie, 697 S.W.2d at 44-45; National Bonding Agency v. Demeson, 648 S.W.2d at 750; Gibson Discount Ctr., Inc. v. Cruz, 562 S.W.2d at 513.

30. *See infra* notes 254-57 and accompanying text.

31. *See* William L. Prosser, *Intentional Infliction of Mental Suffering: A New Tort*, 37 MICH. L. REV. 874, 874 (1939).

distress be inflicted by "extreme and outrageous conduct."[32] Although the meaning of "extreme and outrageous conduct" has never been clear,[33] the idea behind the tort was that mental distress should be compensated when it was intentionally inflicted by conduct so far outside the bounds of proper behavior that no one should be expected to endure it.[34] Like the trespassory torts of assault and battery, the tort required a mental element of intentional or reckless conduct by the defendant, as well as the element of personal affront.[35] It was also required that the intentional misconduct created *severe* emotional distress.[36] To give the tort some concreteness, the Restatement of Torts noted that outrageous conduct frequently involved the exploitation of a known emotional susceptibility of the plaintiff or the abuse of a position of power by the defendant.[37] Although the exact contours of the concept of outrageous conduct have never been clearly delineated, the courts have been able to keep the tort of intentional infliction of emotional distress within reasonable bounds.[38]

The next extension, however, would prove to be more difficult to deal with. The problem was whether or not the law of torts should recognize a cause of action for negligent conduct that inflicted only emotional distress with no accompanying personal physical injury or property damage.[39] The Restatement of Torts disallows damages for negligent conduct that causes only emotional distress, unaccompanied by bodily harm or other damage. Instead, the Restatement only allows damages for bodily harm caused by emotional distress resulting from negligent conduct by a defendant.[40] As reflected in the Restatement, the source of the reluctance, to authorize recovery for negligent conduct creating only emotional distress seems to be two-fold. First, the Restatement was at pains to define when a duty of care could exist with regard to conduct that could be deemed negligent only because it might foreseeably cause the infliction of emotional distress.[41] In response to this problem, the Restatement limited the defendant's duty of care to situations in which the conduct not only would foreseeably create emotional distress, but would also create emotional distress of

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32. *See* RESTATEMENT (SECOND) OF TORTS § 46 (1965).

33. *See id.* § 46 cmt. d; *see also* Daniel Givelber, *The Right to Minimum Social Decency and the Limits of Evenhandedness: Intentional Infliction of Emotional Distress by Outrageous Conduct*, 82 COLUM. L. REV. 42, 43 (1982).

34. *See* RESTATEMENT (SECOND) OF TORTS § 46 cmt. d.

35. *See id.* § 46(2).

36. *See id.* § 46 cmt. j.

37. *See id.* § 46 cmt. e.

38. *See* Dennis P. Duffy, *Intentional Infliction of Emotional Distress and Employment At Will: The Case Against "Tortification" of Labor and Employment Law*, 74 B.U. L. REV. 387, 394 (1994); Givelber, *supra* note 33, at 42.

39. The Restatement of Torts states that negligent conduct that results only in emotional distress by itself creates no liability. RESTATEMENT (SECOND) OF TORTS § 436A.

40. The Restatement recognizes liability in negligence for conduct that violates a duty of care to protect others from emotional distress that the actor should recognize involves unreasonable risks of causing physical harm. *Id.* § 306. On this theory, the Restatement authorizes awarding damages for the physical harm resulting from such emotional disturbance. *Id.* § 436.

41. *See id.* § 306.

such magnitude that it was foreseeable that physical harm would result from the distress.[42] Second, the Restatement was also constrained to determine the proximate consequences of negligent conduct, and having defined the duty as one involving the infliction of emotional harm that would foreseeably result in bodily injury, it then defined the proximate consequences as the resulting bodily injury and excluded the possibility that damages could be recovered solely for emotional distress.[43]

Nevertheless, the courts began to allow damages for pure emotional distress caused by negligent conduct in a limited but growing number of situations. First, emotional distress damages were recognized where the plaintiff was placed in physical danger by the tortious conduct of the defendant.[44] In these situations, plaintiff could recover so long as there was either some impact—though not sufficient impact to cause physical injury[45]—or, more broadly, when the plaintiff was at least in a zone of danger in which physical injury could result.[46] The impact/zone of danger test resolved at least one of the problems recognized by the Restatement because it dealt with conduct that was negligent in the ordinary sense of threatening the plaintiff with an unreasonable risk of actual physical harm.[47] Further, the zone of danger or impact rule created no great risk of unlimited or expansive liability for negligent conduct because it would naturally limit the plaintiffs that could recover to those in close physical proximity to the defendant's negligent conduct—persons that certainly would have been allowed to recover had physical harm resulted.[48]

A second group of cases in which courts began to allow damages for emotional distress were those involving the so-called "bystander" problem. In these cases, the plaintiff was not personally threatened with physical harm, but rather was seeking damages as a result of witnessing physical harm to some other person caused by the defendant's negligent conduct.[49] Once again, the cases

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42. *Id.*

43. *Id.* §§ 436-436A. The reasons for this scheme are set forth in comment b to section 436A, and include the familiar rationale that emotional distress not resulting in physical injury is too trivial and too uncertain to justify litigation, and that the conduct of the defendant is not sufficiently blameworthy to justify liability for mere mental disturbance. *Id.* § 436A cmt. b.

44. *See, e.g.*, Champion v. Grey, 478 So. 2d 17, 20 (Fla. 1985); Brown v. Cadillac Motor Car Div., 468 So. 2d 903, 904 (Fla. 1985); Allen v. Otis Elevator Co., 563 N.E.2d 826, 834 (Ill. App. Ct. 1990); Eakin v. Kumiega, 567 N.E.2d 150, 153 (Ind. Ct. App. 1991).

45. *See, e.g.*, Champion v. Grey, 478 So. 2d at 20; Brown v. Cadillac Motor Car Div., 468 So. 2d at 904; Allen v. Otis Elevator Co., 563 N.E.2d at 833-34; Eakin v. Kumiega, 567 N.E.2d at 152-53.

46. *See, e.g.*, Rickey v. Chicago Transit Auth., 457 N.E.2d 1, 5 (Ill. 1983); Leonard v. Kurtz, 600 N.E.2d 896, 898-99 (Ill. App. Ct. 1992); Stadler v. Cross, 295 N.W.2d 552, 554-55 (Minn. 1980); Okrina v. Midwestern Corp., 165 N.W.2d 259, 263-64 (Minn. 1969).

47. *See* RESTATEMENT (SECOND) OF TORTS § 436(2) cmts. b-e.

48. *See infra* note 49 and accompanying text.

49. *See, e.g.*, Beck v. Department of Transp. & Pub. Facilities, 837 P.2d 105, 108 (Alaska 1992); Tommy's Elbow Room, Inc. v. Kavorkian, 727 P.2d 1038, 1040 (Alaska 1968); Krouse v. Graham, 562 P.2d 1022, 1024 (Cal. 1977) (en banc); Dillon v. Legg, 441 P.2d 912, 914 (Cal. 1968) (en banc); Fineran v. Pickett, 465 N.W.2d 662, 663 (Iowa 1991).

involved traditional types of tortious conduct that inflicted physical injury on some party.[50] The cases were more difficult, however, because persons out of the zone of physical danger were allowed to recover damages for the emotional distress caused by witnessing the accident. The earliest and leading case of this type that allowed recovery of such damages is *Dillon v. Legg*,[51] in which the California Supreme Court allowed a mother to recover damages for the emotional distress caused by witnessing the death of her child, which was caused by the defendant's negligent driving.[52] By purporting to base liability for the bystander's emotional distress primarily on the grounds of foreseeability, however, the *Dillon* case raised troubling questions that have continued to plague the courts.[53] This liability was not merely an extension of the defendant's original negligent conduct towards the accident victim, which was negligent because it created foreseeable and unreasonable risks of physical injury.[54] Rather, the court found liability because this conduct also foreseeably created an unreasonable risk that a close relative of the accident victim might be nearby who would suffer emotional distress as a result of viewing the physical injury.[55] In support of this view, the opinion pointed to the close physical proximity of the emotionally distressed plaintiff to the accident and to the fact that the emotionally distressed plaintiff actually witnessed the events that caused the death of her child.[56] It was not clear, however, why those factors were significant with regard to the foreseeability of the mother suffering emotional distress because the mother would obviously suffer emotional distress whether she witnessed the death of her child or only heard about it later.[57]

Subsequently, the California Supreme Court retreated from the more expansive "foreseeability" basis of *Dillon* and reinstituted stringent limitations on emotional distress recovery, by requiring a proximity to the scene of the accident, a close family relationship with the victim, and emotional distress resulting from actual viewing of the accident.[58] As thus conceived, the bystander cases retain something of the traditional limits on the type of conduct that leads to liability, as well as traditional limitations on those plaintiffs that are able to sue for the resulting emotional distress.[59]

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50. *See, e.g.*, Dillon v. Legg, 441 P.2d at 914 (alleging negligent operation of a motor vehicle).

51. Dillon v. Legg, 441 P.2d 912 (Cal. 1968).

52. *Id.* at 914.

53. *See id.* at 919-21.

54. *Id.* at 916.

55. *Id.* at 920-21.

56. *Id.*

57. *See Liability to Bystanders*, *supra* note 17, at 490-92.

58. Thing v. La Chusa, 771 P.2d 814, 815 (Cal. 1989) (en banc); *see also* Martin v. United States, 779 F. Supp. 1242, 1246 (N.D. Cal. 1991), *rev'd in part*, 984 F.2d 1033 (9th Cir. 1993); Nugent v. Bauermeister, 489 N.W.2d 148, 149-50 (Mich. Ct. App. 1992).

59. Some recent decisions have expanded the classes of persons that can sue in bystander cases by liberally construing the requirement that the bystander suffer emotional distress by observing the accident. For example, recovery may be allowed where the plaintiff witnessed only the aftermath of the accident. *See, e.g.*, Tommy's Elbow Room, Inc. v. Kavorkian, 727 P.2d 1038,

The final expansion of the tort of negligent infliction of emotional distress arrived with the attempt to define a category of so-called "direct victims"[60]—plaintiffs that could recover for negligent conduct that was negligent solely because it created a foreseeable risk of inflicting emotional harm to them.[61] These cases presented most clearly the difficulties that the Second Restatement resolved by excluding recovery for negligent conduct that inflicted only emotional distress.[62] First, it was not clear what type of conduct would be considered "negligent" and therefore tortious because it involved a foreseeable and unreasonable risk of inflicting emotional distress.[63] Secondly, it was not clear who would be the victims entitled to recover for this tort.[64] It thus raised the problem of imposing liability for unspecified types of conduct to indefinable groups of potential plaintiffs.[65] The only guide that the courts seemed to be able to provide was the notion of foreseeability.[66] As commentators pointed out, however, foreseeability was utterly inadequate as a useful factor in determining the outlines of this tort.[67]

The gradual expansion of liability for the negligent infliction of emotional distress began to lead some courts and commentators to reassess the desirability of this type of tort recovery. Policy issues raised by this reassessment included a concern that liability for negligence should not be disproportionate to the fault, yet the amorphousness of the negligent infliction tort threatened, in some cases, widespread and unlimited liability.[68] In addition, there was also concern that the concept of foreseeability and the use of jury trials were inadequate to screen out frivolous or fraudulent assertions of damage from the negligent infliction of emotional distress.[69] Accordingly, this reassessment of the negligent infliction

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1043 (Alaska 1986). A plaintiff may also recover after he or she saw the victim at the hospital after the accident. *See, e.g.*, Masaki v. General Motors Corp., 780 P.2d 566, 576 (Haw. 1989) (announcing Hawaii's famous "same island" rule for bystander claims).

60. The term "direct victims" was used for the first time in *Molien v. Kaiser Foundation Hospitals*, to explain why the case was not governed by the rules of the bystander cases—the plaintiff was not a bystander but rather a direct victim. Molien v. Kaiser Found. Hosp., 616 P.2d 813, 816 (Cal. 1980) (en banc).

61. *Id.*

62. *See* RESTATEMENT (SECOND) OF TORTS § 436A (1965).

63. *Id.* Conduct that creates a foreseeable risk of inflicting emotional distress is not for that reason tortious; much otherwise acceptable behavior, such as ordinary debt collection, could otherwise lead to tort liability. *Id.*

64. *Id.* Foreseeable victims of the defendant's conduct, if defined simply as those who might foreseeably suffer emotional distress, represent another undefined and potentially expansive category of plaintiff. *Id.*

65. *Id.*

66. In *Molien*, the court rested its analysis on the "general principle of foreseeability" established in *Dillon*. Molien v. Kaiser Found. Hosp., 616 P.2d at 815-17.

67. *See* Crump, *supra* note 17, at 506 (criticizing legal rules based upon pure foreseeability when dealing with damages for emotional distress).

68. *Id.* at 472.

69. *See* Thing v. La Chusa, 771 P.2d 814, 829 (Cal. 1989); Newton v. Kaiser Hosp., 228 Cal. Rptr. 890, 893 (Ct. App. 1986).

tort led courts to search for more rigid and easily administered types of limitations on the action.[70] As already noted, some courts began to draw more rigid lines regarding the bystander type of negligent infliction.[71] Similarly, the California Supreme Court retreated somewhat from the notion of a "direct victim" type of negligent infliction of emotional distress based solely on conduct that is negligent only because it creates a risk of emotional harm.[72] In the search for a limiting principle, the California Supreme Court has focused on the existence of a pre-existing duty of care to the plaintiff based on something other than the mere foreseeability of inflicting emotional harm.[73]

Duty as a concept may be no more theoretically coherent than foreseeability, but it is more practically useful because it allows courts to define in advance the situations in which the defendant must exercise care. If this idea takes hold, damages for the negligent infliction of emotional distress would be available in a fairly limited number of situations such as: (1) where the emotional distress damages can piggyback upon already recognized and independent torts; (2) in the bystander situation, under fairly rigid limitations; and (3) in situations in which the defendant has assumed, by contract, a duty to protect the emotional well being of the plaintiff.[74]

B. *Emotional Distress Damages for Economic Torts*

The historic reluctance to award damages for emotional distress just considered is again found in the treatment of "economic" torts—those torts that directly cause only pecuniary loss.[75] Familiar examples include intentional torts such as deceit,[76] as well as such torts as attorney and accountant malpractice.[77] In these cases, indeed, the reluctance to award emotional distress damages has

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70. Thing v. La Chusa, 771 P.2d at 828-29.

71. *See, e.g., id.* at 829 (concluding that a plaintiff may recover damages for emotional distress only if the plaintiff (1) is closely related to the victim; (2) is present at the scene of injury; and (3) as result of the scene suffers emotional distress beyond that which would be normal); Freeman v. City of Pasadena, 744 S.W.2d 923, 925 (Tex. 1988) (stating that the line should be drawn to allow close family members to recover).

72. *See* Burgess v. Superior Court, 831 P.2d 1197, 1201 (Cal. 1992).

73. *Id.*

74. Crump, *supra* note 17, at 460.

75. Many courts do not allow recovery of pure economic loss under theories of ordinary negligence or strict liability. *See* Robins Dry Dock & Repair Co. v. Flint, 275 U.S. 303, 309 (1927) (holding that a third party could not bring suit for economic losses resulting from the breach owed to another that was not a party to the suit); Seely v. White Motor Co., 403 P.2d 145, 149 (Cal. 1965) (stating that the history of "the doctrine of strict liability in tort indicates that it was designed, not to undermine the warranty provisions of the sales act or of the Uniform Commercial Code but, rather, to govern the distinct problem of physical injuries"); Moorman Mfg. Co. v. National Tank Co., 435 N.E.2d 443, 448 (Ill. 1982) (rejecting utilization of a strict liability tort theory for recovery of solely economic loss). This Part will focus, however, on those tort causes of action that exist specifically to provide a remedy for various types of economic loss.

76. *See infra* notes 81-92 and accompanying text.

77. *See infra* notes 93-106 and accompanying text.

generally persisted longer, with only a few courts showing a willingness to allow such awards.[78] Both the traditional rule of nonrecovery and the recent move away from it are significant in the study of insurance bad faith.[79] Insurance bad faith is, after all, an economic tort, although it never seems to have suffered from the "no emotional distress damages" rule applied to some other economic torts.[80] A comparison of the different approaches taken to this issue in economic tort situations serves to identify the considerations that are of most significance to the courts.

1. *Deceit*

Surprising as it may seem, many courts adhere to the view that plaintiffs may not recover damages for emotional distress in cases of deceit.[81] As one recent commentator pointed out, this position seems to command a majority of treatise writers.[82] It is a rule of long standing in this country. The reason it seems surprising is that deceit, by definition, is an "intentional" tort requiring scienter.[83] Because it typically involves only loss of money or property, however, courts following this rule have asserted that the purpose of the tort is to compensate for economic loss only.[84] The great debate on damages for deceit has centered on the proper calculation of economic loss.[85]

Some courts, however, do allow emotional distress damages for deceit,[86] relying on two justifications that are familiar in the field of bad faith. First, deceit is a tort rather than a contract-based cause of action and therefore calls for the "tort" measure of recovery—all damages that result directly, naturally, and

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78. *See* John H. Bauman, *Damages for Legal Malpractice: An Appraisal of the Crumbling Dike and the Threatening Flood*, 61 TEMP. L. REV. 1127, 1165 (1988).

79. *See id.* at 1166.

80. The early leading cases of *Crisci v. Security Insurance Co.*, 426 P.2d 173, 179 (Cal. 1967) and *Gruenberg v. Aetna Insurance Co.*, 510 P.2d 1032, 1041 (Cal. 1973) both include awards of damages for emotional distress.

81. For the general rule and exceptions, see DAN B. DOBBS, LAW OF REMEDIES § 9.2(4) (2d ed. 1993).

82. *Id.*

83. Liability for deceit or fraudulent misrepresentation attaches when "one . . . fraudulently makes a misrepresentation of fact, opinion, intention or law for the purpose of inducing another to act or to refrain from action in reliance upon it." RESTATEMENT (SECOND) OF TORTS § 525 (1965).

84. *See, e.g.*, Galego v. Knudson, 573 P.2d 313, 318 (Or. 1978) (en banc) (holding that a plaintiff's recovery in an action for fraud is limited to the out-of-pocket rule).

85. Courts have used several methods of calculating damages for economic loss, including: out of pocket, loss of bargain, and flexible measures. *See* DOBBS, *supra* note 81, § 9.2(1).

86. *See, e.g.*, Rosener v. Sears Roebuck & Co., 168 Cal. Rptr. 237, 246 (Ct. App. 1980) (finding that evidence of mental suffering was convincing for damages); Trimble v. City of Denver, 697 P.2d 716, 730 (Colo. 1985) (en banc) (finding that the plaintiff was entitled to emotional suffering damages resulting from the torts of fraudulent inducement); Kilduff v. Adams, Inc., 593 A.2d 478, 484 (Conn. 1991) (finding that emotional damages can constitute consequential damages recoverable in a fraud action when emotional damages are the natural and proximate result of fraud).

proximately from the deceit, including emotional distress damages.[87] Second, expansive measures of damages are justified because of the deliberate or reckless wrongdoing of the defendant, thus sounding tort law's familiar note of moral disapproval.[88]

The first justification suffers from being somewhat question-begging—why should emotional distress be considered a harm directly resulting from the deceit? Beyond that, however, the statement is not true as a matter of observation. A number of economic loss torts do not as a rule provide compensation for accompanying emotional distress. The issue is why should tort policy allow such recovery in these particular circumstances.

The second justification—the moral culpability of one guilty of deceit—also fails to supply the answer. Moral culpability itself bears no necessary relationship to the actual injuries suffered by the plaintiff and does not automatically call for greater levels of compensation even for purposes of deterrence. One commentator sympathetic to the extension of emotional distress damages to deceit cases has argued that the focus of such recovery is properly viewed as an extension of intentional tort theory, where the aim is to protect dignitary interests of the plaintiff.[89] Viewed in this way, the damages are awarded not to compensate for the emotional distress resulting from the financial loss, but rather for the affront to dignity and self-esteem that results from the deliberate deception of another in a human—albeit a "business"—relationship.[90] Such an argument easily fits into even the restrictive view of the proper scope of emotional distress damages.[91] Under this view, courts would presumably not allow emotional distress damages for negligent or innocent misrepresentation, which do not represent a similar level of affront to personal dignity. As will be seen, this element of affront seems to be at the heart of the emotional distress award in insurance cases.[92] Those cases, however, have often lost sight of the additional factor present in the deceit cases—the existence of intentionally wrongful conduct.

2. *Professional Malpractice*

A second large category of tort cases that restricts or denies awards of emotional distress damages is professional negligence cases involving solely economic loss. Most of these cases involve attorney or accountant malpractice. The well established general rule has been that no damages for emotional distress are recoverable in a case based on professional negligence.[93] When the lawyer or

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87. Rosener v. Sears Roebuck & Co., 168 Cal. Rptr. at 246; Trimble v. City of Denver, 697 P.2d at 731; Kilduff v. Adams, Inc., 593 A.2d at 484.

88. Rosener v. Sears Roebuck & Co., 168 Cal. Rptr. at 246; Trimble v. City of Denver, 697 P.2d at 731; Kilduff v. Adams, Inc., 593 A.2d at 484.

89. Andrew L. Merritt, *Damages for Emotional Distress in Fraud Litigation: Dignitary Torts in a Commercial Society*, 42 VAND. L. REV. 1, 30 (1989).

90. *Id.* at 31-32.

91. *See supra* notes 29-37 and accompanying text.

92. *See infra* note 283 and accompanying text.

93. Bauman, *supra* note 78, at 1163.

accountant simply breached the professional standard of care, emotional distress damages are generally not allowed, even though emotional distress is foreseeable.[94] In other words, it may be perfectly predictable that poor professional judgment could cause an economic loss severe enough to also cause emotional distress.[95] Nevertheless, the general rule denies compensation for emotional distress.[96]

It is easier to describe than to justify the restrictions the courts have traditionally imposed on this recovery. First, courts have in the past shown a markedly protective attitude towards attorney defendants, imposing many barriers to recovery for legal malpractice.[97] Further, because the attorney-client relationship is based on a contract in most cases, legal malpractice actions are much influenced by contract law and its restrictive damage rules.[98] Under these rules, emotional distress damages are viewed as a type of consequential loss not within the contemplation of the parties, and therefore not recoverable.[99]

Emotional distress damages are usually recovered in malpractice actions only if the attorney's misconduct is viewed as aggravated and egregious.[100] Ordinary professional negligence involving improper judgment or advice is not sufficient.[101] Courts instead require misconduct amounting to a willful betrayal of the attorney-client relationship.[102] This rule is analogous to the contract law rule restricting recovery of emotional distress damages except where the conduct of the breaching party amounts to an independent tort.[103] The rules for recovery in this area, therefore, replicate the traditional limitation of emotional distress damages to cases involving intentional wrongdoing.

In both the law of legal malpractice and contract law generally, another exception (of uncertain scope) also permits recovery for emotional distress. When the subject matter of a contract or representation is "personal" rather than pecuniary, courts occasionally allow recovery for emotional distress, apparently on the theory that the "personal" subject matter brings these more personal injuries within the contemplation of the parties.[104] In the field of legal malpractice, for example, such damages may be available in criminal defense representation, where the subject of the representation is the client's liberty.[105] As will be seen, echoes of this approach appear in the insurance bad-faith cases as courts empha-

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94. *Id.* at 1165.

95. *Id.* at 1163.

96. *Id.*

97. Clients must clear at least two obstacles. *Id.* They usually must establish that the malpractice resulted in economic loss. *Id.* In addition, most courts have required proof of more than negligence before allowing the recovery of noneconomic elements of damage. *Id.*

98. *Id.* at 1164.

99. *Id.*

100. *Id.* at 1165.

101. *Id.*

102. *See* Betts v. Allstate Ins. Co., 201 Cal. Rptr. 528, 544-46 (Ct. App. 1984).

103. Bauman, *supra* note 78, at 1164.

104. *Id.* at 1166-67.

105. *Id.* at 1167 & n.237.

size that insurance is purchased, in many cases, not simply to protect property, but also to protect peace of mind.[106]

3. *Summary*

The economic torts show a familiar pattern of a gradually eroding reluctance to award emotional distress damages.[107] Like the general tort law, awards in these cases tend to be limited to situations involving intentional wrongdoing. Other recurring themes can also be identified. Because many of these cases grow out of a contractual relationship, the restrictive rules of contract damages seem to exercise a restraining effect. Pushing toward greater liability is the existence in many cases of a relationship of trust between the parties. Yet even that type of relationship is not enough by itself to persuade the courts that emotional distress damages should be generally available.[108] As the attorney malpractice cases indicate, courts have been reluctant to impose this expanded liability in cases involving only a negligent error of professional judgment.[109] Instead, it is a deliberate abuse of that relationship that leads to imposition of expanded elements of damages such as emotional distress.[110]

The cases allowing emotional distress damages for the bad-faith breach of an insurance contract can be fit within this conceptual framework. Most of these cases seem to be based on a mixture of the independent tort and contract duty concepts. To see how this mixture has been concocted, this Article will examine the development of the tort of insurance bad faith and the critical moves that allowed courts to award emotional distress damages in such cases.

III. THE "TORT" OF INSURANCE BAD FAITH

A. *Third-Party Bad Faith*

The "tort" of insurance bad faith essentially involves nothing more than the breach by the insurance company of its obligations under an insurance policy.[111] The treatment of some types of breach as a tort was justified by the notion that

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106. *See, e.g.*, Beck v. Farmers Ins. Exch., 701 P.2d 795, 802 (Utah 1985) ("[I]t is axiomatic that insurance frequently is purchased not only to provide funds in case of loss, but to provide peace of mind for the insured or his beneficiaries.").

107. John A. Sebert, Jr., *Punitive and Nonpecuniary Damages in Actions Based Upon Contract: Toward Achieving the Objective of Full Compensation*, 33 UCLA L. REV. 1565, 1585-1600 (1986) (critiquing the rule against awarding damages for emotional distress in contract actions and arguing for more general availability of such awards).

108. Bauman, *supra* note 78, at 1163.

109. *Id.* at 1164-65.

110. It is worth noting that, in both deceit and attorney-client cases, courts have long been at pains to define the contours of the relationship and what conduct will constitute a serious breach. *Id.* at 1163-64. Part of the difficulty in grappling with bad-faith cases is a lack of clear definition of the duty imposed on the insurer growing out of the relationship with the insured.

111. Other factors are involved in most theories of the bad-faith cause of action, but the breach is the common factor. *See supra* note 2 and accompanying text.

some breaches are more than a "mere breach of contract."[112] Further, the breach of the contract was evidence of such nastiness by the insurance company, was so unreasonable and unfair, that sterner remedies were called for.[113] The developments that led courts to regard these particularly egregious breaches as sounding not only in contract, but in tort as well, have often been traced.[114] It is worthwhile to briefly review this history in order to see how this tort fits neatly into the overall expansion of liability for damages resulting from emotional distress.

The tort of bad faith had its origin in the context of liability insurance—involving the improper performance by the insurance company of its obligation to provide a defense to its insured. Because an insurer that issued a policy of liability insurance became liable to pay the damages for which its insured may be found liable, the insurer naturally wished to control the conduct of the litigation on behalf of its insured.[115] Insurance companies, therefore, included in the insurance policy a provision giving them control over the litigation, including control over the decision of whether and for how much to settle the case.[116] Upon assuming control, the insurance company agreed to hire and pay an attorney to represent the insured as part of its duties.[117]

This arrangement seemed on the surface to be perfectly appropriate because the insurance company ultimately became responsible for any damages for which its insured was found liable.[118] It appeared, therefore, that the interests of the insurance company were the same as the interests of its insured. Because liability insurance policies have limits beyond which the insurer is not liable, however, it quickly became apparent that the insurer and the insured could

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112. *See, e.g.*, Reynolds v. American Hardware Mut. Ins. Co., 766 P.2d 1243, 1246 (Idaho 1988) (stating that a mere breach of contract will not support a tort cause of action but a breach of a separate duty owed to one party in contract will suffice); Transportation Ins. Co. v. Moriel, 879 S.W.2d 10, 24 (Tex. 1994) (stating that if an insurer denies coverage in bad faith, the insured will likely suffer damages not ordinarily associated with a mere breach of contract).

113. Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141, 144-47 (Cal. 1979).

114. *See* Mark G. Arnzen & Mary K. Molloy, *An Insurer's Refusal to Settle Within Policy Limits – Third-Party Bad Faith in Kentucky*, KY. BENCH & BAR, Summer 1986, at 12, 13, 40; T.H. Freeland, III & T.H. Freeland, IV, *Bad Faith Litigation: A Practical Analysis*, 53 MISS. L.J. 237, 240-45 (1983); Patrick F. Koenen, *Bad Faith and Negligence Approaches to Insurer Excess Liability for Failing to Settle Third-Party Claims: Problems and Suggestions*, 54 DEF. COUNS. J. 179, 180-81 (1987); Guy O. Kornblum, *The Current State of Bad Faith and Punitive Damages Litigation in the U.S.*, 23 TORT & INS. J. 812, 814-24 (1988); Michael Cohen, Note, *No Faith in Bad Faith*, 41 HASTINGS L.J. 201, 202-09 (1989); Richard B. Graves III, Comment, *Bad-Faith Denial of Insurance Claims: Whose Faith, Whose Punishment? An Examination of Punitive Damages and Vicarious Liability*, 65 TUL. L. REV. 395, 397-99 (1990).

115. Broyles v. Bayless, 878 F.2d 1400, 1403-04 (11th Cir. 1989).

116. *See, e.g.*, 3 WARREN FREEDMAN, RICHARDS ON INSURANCE app. O, at 478 (6th ed. 1990).

117. Nandorf, Inc. v. CNA Ins. Cos., 479 N.E.2d 988, 991 (Ill. App. Ct. 1985).

118. *Id.*

develop a divergence of interests.[119] Such divergence occurs whenever a possibility exists that a verdict against the insured might exceed policy limits.[120] In such situations, the insured has a tremendous interest in having the case settled within the limits of the policy.[121] The insurance company, on the other hand, might be more willing to gamble on a defense verdict at trial, knowing that its liability could not exceed the limits of the policy.[122] In this situation, an insurance company might be inclined to refuse a settlement demand for the limits of the policy, because the company's down-side risk is relatively small. If it refused the demand and the case resulted in a verdict in favor of the insured, the insurance company is out only the costs of the trial.[123] If, on the other hand, a verdict is brought in for an amount in excess of the policy limit, the insurance company pays up to the amount of the limit, leaving its insured to make up the rest of the judgment.[124]

Many courts quickly decided that the insurance company could not be allowed a free hand to deal with its insured in this manner.[125] Early in the twentieth century, courts began to hold insurance companies liable for amounts in excess of the policy limits, where the company had "unreasonably" refused a settlement demand within policy limits.[126] These early cases, however, limited the recovery to the amount of the excess judgment.[127]

The insured's relinquishment of control of litigation to the insurance company was the crucial point that the courts relied upon to justify an award against the insurance company in excess of its policy limits.[128] The insurer's control of

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119. *Id.* at 991-92; *see also* Broyles v. Bayless, 878 F.2d at 1403-04 (discussing the conflict of interests in making an insured a party to an action).

120. Syverud, *supra* note 8, at 1126-31.

121. *Id.* at 1131.

122. *Id.* at 1130-31. The most tempting situation would be one in which the damages could significantly exceed the policy limits but liability was doubtful.

123. *Id.* at 1142.

124. G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544, 548 (Tex. Comm'n App. 1929).

125. *See infra* notes 126-44 and accompanying text.

126. *See* Anderson v. Southern Sur. Co., 191 P. 583, 585 (Kan. 1920) (holding that the defendant insurer was negligent in not settling and in not presenting an adequate defense in a case brought by the plaintiff for balance of judgment after paying a judgment in excess of policy limits); Cavanaugh Bros. v. General Accident Fire & Life Assurance Corp., 106 A. 604, 604 (N.H. 1919) (holding that the insurer had a duty to settle the case instead of pleading a negligent defense); Wisconsin Zinc Co. v. Fidelity & Deposit Co., 155 N.W. 1081, 1084 (Wis. 1916) (finding no duty to settle or to exercise ordinary care, but the insurer may not use the power to settle for the purposes of fraud or oppression).

127. Anderson v. Southern Sur. Co., 191 P. at 584; Cavanaugh Bros. v. General Accident Fire & Life Assurance Corp., 106 A. at 604.

128. *See* Anderson v. Southern Sur. Co., 191 P. at 585. The *Anderson* court stated:

> There is nothing in the findings to show that the defendant in the present action did not take complete control of the defense in the former one. . . .
>
> The defendant had an opportunity to settle Marshall's [the plaintiff in the underlying case] claim for $4,500, but it refused to settle for that amount . . . .

settlement left the insured at the mercy of the company, which could pursue its own interests at its insured's expense. The courts, however, began to view the insurer as assuming a fiduciary-like duty[129] when it took control of the litigation, and so began to require the company to give more consideration to the protection of its insured's interests.[130] This was deemed to be part of the benefits of the contract, and the courts were in effect imposing liability for improper performance of the contractual obligation.[131]

It is clear that the insured in this situation needed some sort of protection. The courts responded by imposing on the insurance company a duty to recognize the interest of its insured in this third-party liability situation.[132] Failure to act properly to protect the insured's interests opens up the policy limits and could potentially result in liability for the insurer in excess of its limits.[133] After recognizing this duty, courts faced the difficult task of articulating exactly what the content of this duty should be.[134] No one suggested that the insurance company was somehow contractually required to accept any offer for settlement of litigation that fell within the limits of the policy.[135] Any such rule was properly viewed as an open invitation to insurance fraud. The insurance company, it was recognized, ought to have the discretion to refuse excessive settlement demands.[136] Such a rule operated to the general benefit of all insureds by

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> It could have fought successfully; through its negligence it did not, and lost, and now it must bear the consequences.

Id.; *see also* Cavanaugh Bros. v. General Accident Fire & Life Assurance Corp., 106 A. at 604 ("[W]hen the defendant assumed control of the . . . claim, it then and there became its duty to do what the average man would do in a similar situation."); Wisconsin Zinc Co. v. Fidelity & Deposit Co., 155 N.W. at 1087 ("While the [insurance company] had the right to [consider] . . . its own interest in making a settlement, it could not abuse [its] power . . . to settle if it was apparent that in all reasonable probability its conduct would not only result in damage to the plaintiff, but also in loss to itself.").

129. Crisci v. Security Ins. Co., 426 P.2d 173, 176 (Cal. 1967); Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1958). I refer to the duty as "fiduciary-like" because many courts, while imposing on the insurer the duty to consider the interests of the insured, permit the insurer to consult its own interests to some extent.

130. Crisci v. Security Ins. Co., 426 P.2d at 176. The *Crisci* court stated that "when 'there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of insured's interest requires the insurer to settle the claim.'" *Id.* (quoting Comunale v. Traders & Gen. Ins. Co., 328 P.2d at 201). The court further stated that "'the defendant did not give as much consideration to the financial interests of its said insured as it gave to its own interests.'" *Id.* at 178 (quoting the trial court).

131. *See infra* notes 225-34 and accompanying text.

132. Crisci v. Security Ins. Co., 426 P.2d at 176.

133. Syverud, *supra* note 8, at 1116-17.

134. Crisci v. Security Ins. Co., 426 P.2d at 177.

135. This is true even if the insured demands that the offer be accepted. Such a demand does not alter the insurer's standard of conduct.

136. *Id.* at 177.

discouraging frivolous or extortionate litigation.[137] Given an insurance company's control over the litigation, however, it was believed that the company did owe its insured some duty to accept settlement offers within policy limits when such offers appeared to be a reasonable compromise of the litigation and a risk existed of a judgment in excess of the limits.[138]

Some courts originally phrased this duty in terms of negligence — the insurer would be liable for amounts over the policy limits where its refusal to settle was "unreasonable."[139] As the law in this area developed, other courts began to focus more on the fiduciary-like duty of the insurance company, which had assumed complete control of the litigation.[140] Because a fiduciary is required to act in the interests of another, courts that focused on this aspect of the relationship began to impose a duty on the insurance company to at least give the interests of the insured equal consideration with its own interests.[141] The common thread to both theories of liability was the view that the insurer was not liable simply for an error in judgment as to the value of a case, but only for a refusal that was obviously unreasonable given the potential for an excess verdict.[142] In addition, both theories of liability were variations of traditional types of liability—either the negligent performance of the contractual obligation to provide a defense[143] or the breach of a fiduciary duty.[144]

The innovation that threatened to bring tort liability into play in many breach of contract situations occurred when a few courts began to equate the unreasonable breach of the duty to settle with the breach of the implied contractual covenant of good faith and fair dealing.[145] Because courts had regarded the former as a type of tort, the latter also began to be seen as a type of tort.[146] But because a covenant of good faith and fair dealing is implied in every contract,[147] the recognition of this breach as sounding in tort potentially allowed the idea of bad faith to escape from its original confines in the third-party insurance situation.

Although some earlier examples of this type of analysis can be found,[148] the crucial development occurred in the California cases of *Comunale v. Traders*

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137. Syverud, *supra* note 8, at 1137-39.

138. *Id.* at 1122.

139. G.A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544, 547 (Tex. Comm'n App. 1929).

140. *See* Koppie v. Allied Mut. Ins. Co., 210 N.W.2d 844, 847 (Iowa 1973).

141. *See* Crisci v. Security Ins. Co., 426 P.2d at 176; Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1958); Ivy v. Pacific Auto. Ins. Co., 320 P.2d 140, 146 (Cal. Dist. Ct. App. 1958).

142. *See* Crisci v. Security Ins. Co., 426 P.2d at 176-77; Ivy v. Pacific Auto. Ins. Co., 320 P.2d at 145-46.

143. KEETON ET AL., *supra* note 22, § 56, at 379.

144. DOBBS, *supra* note 81, § 10.4.

145. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

146. *See infra* notes 149-50 and accompanying text.

147. RESTATEMENT (SECOND) OF CONTRACTS § 205.

148. *See supra* notes 126-28 and accompanying text.

& General Insurance Co.[149] and *Crisci v. Security Insurance Co.*[150] In these cases, the California Supreme Court identified the source of the cause of action for unreasonable failure to settle as the breach of the implied covenant of good faith and fair dealing—a breach that would sound in both tort and contract.[151] The California Supreme Court in *Crisci* clearly affirmed an award of emotional distress damages for breach of this contractual covenant.[152]

The *Comunale* and *Crisci* cases were significant in popularizing the breach of the covenant of good faith and fair dealing as the basis for the tort of insurance bad faith. The covenant of good faith and fair dealing had come to the attention of judges and legal scholars in a number of forms around the time the *Crisci* case was decided. The Uniform Commercial Code (UCC) included in its provisions a general definition of good faith.[153] This definition in turn provoked the interest of a number of scholars, who argued that the covenant of good faith had a much larger and more significant content than the UCC's simple definition of honesty in fact.[154] The commentary provoked by this debate eventually inspired the inclusion of an implied covenant of good faith and fair dealing in the Restatement (Second) of Contracts.[155] It should be pointed out, however, that the implied covenant recognized in these provisions was simply an additional implied contractual provision whose breach would be nothing more than a breach of contract. It was the innovation of the insurance bad-faith decisions that such a contract breach could be actionable as a tort.

Given its classification of insurance bad faith as a tort, it was not surprising that the *Crisci* court also decided that damages for emotional distress should be available.[156] In doing so, the *Crisci* case sounded a number of themes that have since become familiar. First, the court justified the award of damages for emotional distress by pointing out that emotional distress damages were generally available when tortious conduct causes other substantial injury.[157] In support of this proposition, the court cited a number of cases, which it said sanctioned emotional distress damages for tortious conduct that causes interference with property rights, even in the absence of personal injury.[158]

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149. Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198 (Cal. 1958).

150. Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967).

151. Crisci v. Security Ins. Co., 426 P.2d at 178; Comunale v. Traders & Gen. Ins. Co., 328 P.2d at 203.

152. *See infra* notes 153-55 and accompanying text.

153. U.C.C. § 1-201(19) (1990).

154. *See supra* note 3.

155. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

156. Crisci v. Security Ins. Co., 426 P.2d at 179.

157. *Id.* at 178-79.

158. *Id.* at 179; *see* Kornoff v. Kingsburg Cotton Oil Co., 288 P.2d 507, 508, 512-13 (Cal. 1955) (involving a trespass action by adjoining landowners against a cotton gin owner and operator for injuries to person and property due to ginning waste carried onto the plaintiff's land; where the plaintiff's discomfort constituted injury directly and proximately caused by invasion and naturally resulted from invasion, plaintiff is entitled to damages for such discomfort); Herzog v. Grosso, 259 P.2d 429, 431, 433 (Cal. 1953) (involving an action to quiet title to an easement over the defendant's land from a highway to the plaintiff's land and for damages caused by acts of the

An analysis of the cases cited by the *Crisci* court, however, shows that the court was actually creating an important extension of this rule. The causes of action involved in the cited cases were mostly based upon intentional trespass to real property[159] or nuisance.[160] The nuisance causes of action are particularly significant, because one of the elements of the nuisance tort is the interference with the quiet enjoyment of property.[161] Thus, it is quite usual in nuisance cases to award damages for the emotional distress represented by the loss of quiet enjoyment.[162] One of the other cases cited by the *Crisci* court did, in fact, involve personal injury—it was the type of negligent conduct that is negligent because it risked inflicting emotional distress of such severity that it would foreseeably cause physical injury.[163] None of these cases represent a very convincing precedent for an award of damages for emotional distress arising out of tortious conduct that causes only economic loss.

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defendant altering the road: "Once a cause of action for trespass or nuisance is established, an occupant of land may recover damages for annoyance and discomfort that would naturally ensue therefrom."); Emden v. Vitz, 198 P.2d 696, 698-99 (Cal. Ct. App. 1948) (involving an action for loss of personal property and personal injury resulting from the defendant's refusal to admit the plaintiff to her own apartment; infliction of emotional distress foreseeably resulting in physical injury is actionable).

159. *See, e.g.*, Petroleum Energy v. Mid-America Petroleum, 775 F. Supp. 1420, 1429 (D. Kan. 1991) (holding that a replacement lessee was not liable for trespass); Cullison v. Medley, 570 N.E.2d 27, 29 (Ind. 1991) (alleging that the defendant trespassed by entering the plaintiff's trailer without permission after he went to the back of the trailer to dress); McGregor v. Barton Sand & Gravel, Inc., 660 P.2d 175, 177 (Or. Ct. App. 1983) (alleging that sliding water and debris running onto the plaintiff's property from the defendant's mining operation constituted a trespass).

160. For nuisance cases, *see, e.g.*, Davis v. Shell Oil Co., 795 F. Supp. 381, 383 (W.D. Okla. 1992) (considering an allegation that the operation of an oil company pollutes and contaminates a private owner's surface and ground water); Crawford v. National Lead Co., 784 F. Supp. 439, 441 (S.D. Ohio 1989) (plaintiffs allege the operation of a federally-owned uranium metals production plant emits harmful materials and has diminished their property values and resulted in emotional distress); Rice v. Merritt, 549 So. 2d 508, 509 (Ala. Civ. App. 1989) (action against a neighboring fuel distributor by a private homeowner alleging that the operation of the property interfered with the quiet enjoyment of his home, decreased the value of his property, and subjected him to fear and danger); Smith v. County of Los Angeles, 262 Cal. Rptr. 754, 757 (Ct. App. 1989) (action brought by homeowners to recover for losses to their property from a landslide and for emotional distress); Bowers v. Westvaco Corp., 419 S.E.2d 661, 663 (Va. 1992) (considering what acts constitute actionable private nuisances and the amount of recoverable damages appropriate to those acts); Arnoldt v. Ashland Oil, Inc., 412 S.E.2d 795, 799 (W. Va. 1991) (considering plaintiffs' allegation that air emissions from a refinery interfered with their use and enjoyment of their property).

161. KEETON ET AL., *supra* note 22, § 87, at 619-22.

162. *Id.* § 89, at 638-40.

163. Crisci v. Security Ins. Co., 426 P.2d at 179 (citing Hanke v. Global Van Lines, Inc., 533 F.2d 396 (8th Cir. 1976); Emden v. Vitz, 198 P.2d 696 (Cal. Ct. App. 1948); Vicnire v. Ford Motor Credit Co., 401 A.2d 148 (Me. 1979); 49 Prospect Street Tenants Assoc. v. Sheva Gardens, Inc., 547 A.2d 1146 (N.J. Super. Ct. App. Div. 1988); RESTATEMENT (SECOND) OF TORTS § 313 (1965)); *see also* RESTATEMENT (SECOND) OF TORTS § 436 (1965).

In addition, the *Crisci* court put forward the rationale that the purchaser of insurance is not attempting to obtain a commercial advantage, but rather sought only to protect herself against the risks of accidental losses and thereby to obtain some sort of peace of mind in knowing that insurance protection was available.[164] Given this view of the purposes of the insurance purchaser, the court found that it was foreseeable that unreasonable denial of benefits under the contract could lead to the very emotional distress that the insured sought to avoid by purchasing insurance in the first place.[165]

If one assesses the status of the cause of action for third-party bad faith at this point, it would appear that the courts, although using the innovation of breach of the covenant of good faith and fair dealing, were nevertheless still dealing with what had begun as a cause of action sounding recognizably in tort. The assumption of the responsibility to conduct the defense, whether viewed as a fiduciary-like duty or simply as a contractual obligation that had to be performed with due care, gave rise, when breached, to a tort cause of action that permitted the recovery of damages beyond the contractual limits in the policy. The innovation of the *Crisci* case, then, was to transfer this familiar tort doctrine to a new basis—the breach of the implied covenant of good faith and fair dealing—and to recognize that in addition to the traditional contract remedy, the plaintiff could also recover damages for emotional distress.

The next innovation, however, was much more startling. The analysis of the third-party cases was transferred wholesale to the so-called first-party cases in which the insurance company simply refused to perform its contractual obligation to pay money directly to its own insured. Although some courts purported to find the two situations indistinguishable, it is quite clear that the first-party situation lacked the fiduciary-like assumption of duty involved in the third-party case, which provided the justification for tort treatment in that context.

B. *First-Party Bad Faith*

First-party bad faith involves the insurance company's refusal to pay a claim owed directly to its insured under "first-party" insurance—life, health, disability, property, and fire insurance are the most common examples of this sort of coverage.[166] The refusal to pay is, of course, based upon the insurance company's position that the loss is not covered by the terms of the policy.[167] The tort of bad faith, therefore, focuses upon the propriety of the insurer's determination that the claim is not covered.[168] The origin of first-party bad faith as a tort action distinct from breach of contract can be traced directly to the landmark California

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164. Crisci v. Security Ins. Co., 426 P.2d at 179.

165. *Id.*

166. *See* Pablo E. Carrillo, Manuel v. Louisiana Sheriff's Risa Management Fund: *The Louisiana Supreme Court Clarifies Jurisprudential Confusion Regarding the Nonretroactivity Principle in the Context of Third-Party "Bad Faith" Actions*, 71 TUL. L. REV. 325, 327 n.18 (1996).

167. 2 FREEDMAN, *supra* note 116, § 9:2.

168. *Id.*

case of *Gruenberg v. Aetna Insurance Co.*[169] In that case, the Supreme Court of California imported the concepts of third-party bad faith wholesale into this new context.

The plaintiff in *Gruenberg* was the owner of a restaurant that was destroyed by fire.[170] During the investigation of the fire by the fire department, the insurance adjusters employed by the defendant insurance companies informed the arson investigators that the plaintiff had excessive coverage on the premises.[171] The authorities then arrested Gruenberg and charged him with arson.[172] While the criminal charges were pending, the insurance companies insisted that Gruenberg submit to an examination under oath,[173] as they were entitled to under the terms of the insurance policy.[174] Gruenberg's attorney informed the insurance companies that his client would not appear for this examination until the criminal proceedings were concluded.[175] The representatives of the insurance companies warned that failure to appear for the examination would be a breach of the contract by the insured and would forfeit coverage.[176]

At the preliminary hearing, the court threw out the arson charges against Gruenberg on the basis of lack of probable cause.[177] Although Gruenberg now indicated his willingness to submit to the required examination, the insurance companies at this point insisted that Gruenberg was in breach of his obligations under the policy and therefore denied the claim.[178] Gruenberg then filed suit against the insurers.[179] The California court held that Gruenberg had stated a claim against the insurers for breach of the covenant of good faith and fair dealing.[180] The court identified the duty imposed by the covenant in the first-party insurance context as "a duty not to withhold unreasonably payments due under a policy."[181] The court further held that a tort action for breach of the covenant of good faith and fair dealing existed whenever the insurance company refused, "without proper cause, to compensate its insured for a loss covered by the policy."[182]

The *Gruenberg* case, although an early example of the transfer of the tort duty of good faith and fair dealing to the first-party insurance context, nevertheless presents at least two features that would become common in this area. First, the insurance companies in *Gruenberg* probably had good reason at least to

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169. Gruenberg v. Aetna Ins. Co., 510 P.2d 1032 (Cal. 1973).
170. *Id.* at 1034.
171. *Id.*
172. *Id.*
173. *Id.*
174. *Id.* at 1034 n.2.
175. *Id.* at 1035.
176. *Id.*
177. *Id.*
178. *Id.*
179. *Id.* at 1034.
180. *Id.* at 1036.
181. *Id.* at 1037.
182. *Id.*

question the claim. When a fire appears to be of a suspicious origin and the owner of the premises is overinsured, a prudent insurer would at least investigate the possibility that the fire was deliberately set by the insured in order to collect on the policy. As in many such situations, however, the insurers had no actual evidence that the insured had set the fire. In response, therefore, the insurance companies attempted to play games with their insured by demanding an immediate examination under oath at a time when criminal charges were pending. This would predictably place the insured in the impossible position of either furnishing evidence that could possibly be used in the criminal prosecution, or else refuse the examination and losing insurance coverage. Such game playing, by which the insurance company attempts to take advantage of the vulnerability of its insured, is typical of the types of insurance company conduct that have led to findings of bad faith.[183]

Also typical in *Gruenberg* is the extraordinary vagueness of the standard of culpability that will lead to this type of tort recovery. The court did not go so far as to say that any refusal to pay that ultimately turned out to be incorrect would lead to tort liability, but rather placed it in terms of the "unreasonableness"[184] or lack of "proper cause"[185] for the denial. Neither formulation clarified in advance how far the insurance company is entitled to go in pursuing what appear to be legitimate questions about the coverage of the loss.

Many other state courts followed the *Gruenberg* case in adopting tort liability in the first-party bad faith context.[186] Many of these courts attempted to define more carefully the conduct that would lead to a finding of bad faith. One of the earliest and most influential examples of this attempt at a definition was the decision of the Wisconsin Supreme Court in *Anderson v. Continental Insurance Co.*[187]

In *Anderson*, the Wisconsin Supreme Court held that the tort of first-party bad faith required the plaintiff to show the "absence of a reasonable basis for denying benefits of the policy," plus the insurance company's "knowledge or reckless disregard of the lack of a reasonable basis for denying the claim."[188] The court's addition of this formulation made it clear the tort being claimed was an intentional one.[189] The court indicated that this test would allow an insurance company to challenge claims which are "fairly debatable," with liability for bad faith resulting only when the insurance company lacked a reasonable basis for its denial.[190] Many jurisdictions have adopted the *Anderson* test, but they apply it with varying degrees of strictness.[191] Although this formulation seems to have been intended to excuse the insurer from tort liability when its denial, although

183. *See infra* notes 239-45 and accompanying text.
184. Gruenberg v. Aetna Ins. Co., 510 P.2d at 1037.
185. *Id.* at 1036.
186. 1 JOHN C. MCCARTHY, RECOVERY OF DAMAGES FOR BAD FAITH § 1.33 (5th ed. 1990).
187. Anderson v. Continental Ins. Co., 271 N.W.2d 368 (Wis. 1978).
188. *Id.* at 376-77.
189. *Id.* at 374, 377-78.
190. *Id.*
191. *See infra* notes 193-98 and accompanying text.

ultimately incorrect, was reasonable, in practice, the test can vary greatly in effect depending on how the burden of proof on this issue is allocated.[192]

At one extreme is the "directed verdict test" set forth in *National Savings Life Insurance Co. v. Dutton*.[193] In that case, the Alabama Supreme Court held that to make out a prima facie case of bad-faith refusal to pay an insurance claim, the proof offered must show that the plaintiff is entitled to a directed verdict on the contractual issue, that is, on the issue of the duty of the insurer to pay the claim under the policy.[194] If the plaintiff cannot do so, the claim would be deemed "fairly debatable" and the insurer would not be acting in bad faith, that is, with no reasonable basis, in denying the claim.[195] The Texas Supreme Court takes what appears to be an intermediate position, holding that the plaintiff must demonstrate no reasonable basis for the denial of the claim.[196] Under this test, which focuses more on the conduct of the insurer than the directed verdict test, the existence of uncontroverted evidence of a reasonable basis for denial will defeat the bad-faith claim as a matter of law.[197] At the other extreme is the approach of the Arizona courts, which would apparently allow the issue of bad faith to go to the jury so long as there was some evidence of reckless conduct on the part of the insurer in handling the claim.[198]

Another way that jurisdictions tend to vary greatly in their application of the *Anderson* test is in the treatment of the insurance company's investigation of the claim.[199] Without some attention paid to this element, the standard would place a premium on an insurer remaining ignorant of facts supporting the claim. The insurer might argue, for example, that while plenty of evidence existed to support the claim, the insurer was unaware of it, and therefore, did not deny the claim with knowledge of a lack of reasonable basis for denial. The *Anderson* court itself acknowledged the need to impose some sort of duty of investigation.[200] The result, however, is that as soon as a court imposes a "duty," it naturally needs an enforcement mechanism; insurers now face bad-faith liability for improper investigation.[201]

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192. *See* Roger C. Henderson, *The Tort of Bad Faith in First Party Insurance Transactions After Two Decades*, 37 ARIZ. L. REV. 1153, 1158-59 (1995).

193. National Sav. Life Ins. Co. v. Dutton, 419 So. 2d 1357 (Ala. 1982).

194. *Id.* at 1362.

195. *Id.*; *cf. Ex parte* Blue Cross & Blue Shield, 590 So. 2d 270, 276-77 (Ala. 1991) (applying the directed verdict test, but noting that the numerous cases that created exceptions to the rule calling for an application of the test, mainly involving situations in which the factual issue preventing a directed verdict, related to the adequacy of the claims investigation performed by the insurer).

196. *See, e.g.*, National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d 373, 376 (Tex. 1994); Lyons v. Millers Cas. Ins. Co., 866 S.W.2d 597, 599 (Tex. 1993).

197. National Union Fire Ins. Co. v. Dominguez, 873 S.W.2d at 376-77.

198. Deese v. State Farm Mut. Auto. Ins. Co., 838 P.2d 1265, 1270 (Ariz. 1992) (en banc).

199. *See* Aetna Life Ins. Co. v. Lavoie, 505 So. 2d 1050, 1052-53 (Ala. 1987); Continental Assurance Co. v. Kountz, 461 So. 2d 802, 805 (Ala. 1984).

200. Anderson v. Continental Ins. Co., 271 N.W.2d 368, 377 (Wis. 1978).

201. Of course, this standard is often difficult in application. How far must the insurer go in seeking evidence to support the claim? Some courts require that at least some investigation be per-

Once the standard for first-party bad faith is determined, there remains the issue of whether to allow damages for emotional distress.[202] The *Gruenberg* case is again significant not only for introducing the tort of first-party bad faith, but also for making it clear that this was a tort that would support an award of damages for emotional distress.[203] The *Gruenberg* court justified the award for emotional distress based upon the economic loss suffered by the plaintiff, and further indicated the plaintiff did not need to make a showing that the emotional distress was severe.[204] Thus, the California court once again accepted the equation that categorizing the breach as a property tort must automatically mean that emotional distress damages were recoverable if proven.[205]

In the translation from third-party to first-party bad faith, however, several factors were lost. The first-party bad-faith situation presents neither of the traditional tort bases of recovery that justified the treatment of third-party bad faith as a tort—a fiduciary-like duty in which the insurance company assumes control of the negotiation of a settlement on behalf of the insured,[206] or the assumption of a duty to act on behalf of another party combined with negligent performance.[207] Rather, the first-party bad-faith situation appears to be no more than a refusal to perform at all—a straightforward breach of contract. The California court did not explain convincingly why this situation must be treated in the same fashion as the third-party bad-faith situation and regarded as a tort. Why, in other words, is a simple breach of contract suit not a sufficient remedy for the insured in this context?

The California court attempted to provide the necessary justification in several cases developing the first-party bad-faith tort.[208] First, in *Gruenberg*, the California Supreme Court argued that the breach of the covenant of good faith and fair dealing was the same whether it appeared in the context of third-party bad faith or first-party bad faith.[209] What this argument ignored, however, was that in most contractual situations, the breach of the covenant of good faith and fair dealing is no more than a mere breach of contract.[210] This argument does not identify the peculiar features of the insurance contract that require an otherwise ordinary breach to be treated as a tort. In later cases, the California Court of

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formed in order to fairly determine whether a basis for denial exists. *See* Aetna Life Ins. Co. v. Lavoie, 505 So. 2d at 1053; Continental Assurance Co. v. Kountz, 461 So. 2d at 803. The real difficulty, however, may lie in assessing the effect of the improper investigation; would a better investigation have required a different decision? Is the insurer required to ignore evidence supporting a denial if some evidence exists supporting the insured's claim? Is the insurer permitted to even consider evidence supporting denial in that case? Even if some evidence would support the insured's position, the insurer may still have a reasonable basis for denial of the claim.

202. Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1040-41 (Cal. 1973).

203. *Id.* at 1041.

204. *Id.*

205. *Id.*

206. *See supra* text accompanying note 143.

207. *See supra* text accompanying note 144.

208. Gruenberg v. Aetna Ins. Co., 510 P.2d at 1040.

209. *Id.* at 1037-38.

210. *See* RESTATEMENT (SECOND) OF CONTRACTS § 205 (1979).

Appeals bolstered this argument with the further claim that the insurer in the first-party bad-faith situation was also in a fiduciary like position.[211] This position, however, would require viewing the payment of the claim as a type of fiduciary duty rather than as a contractual duty. The money in question is not held by the insurance company for the beneficial use of the insured in the same way that trust proceeds would be. The insured is not obligated to pay unless the claim is covered, and the failure to pay a claim covered by the policy is no more than a breach of contract. The court in *Egan* also believed that tort treatment was necessary in order to improve the insured's bargaining position, so that the insurer would have more at stake in the event it was mistaken in denying the claim rather than merely the amount owed under the policy.[212] Again, a similar result can be reached even under traditional contract doctrine. For example, if the denial of the claim leads to further consequential losses, it may be that these additional economic losses would be recoverable if it was within the contemplation of the parties at the time of contracting.[213] This could be the case in a situation such as that in *Gruenberg*, where the insured would predictably face the loss of a business if the insurance proceeds were not paid because he would not be able to rebuild his restaurant.[214]

Indeed, some courts have found insurance companies liable for additional consequential damages even under a straight contract treatment of the first-party bad-faith situation.[215] For example, the Utah Supreme Court in *Beck v. Farmers Insurance Exchange*[216] refused to treat the first-party bad-faith situation as a tort, but nevertheless found that the insurer could be liable for damages in excess of those owing under the policy on the grounds that these were consequential losses that were foreseeable at the time of contract.[217] The court even suggested that this award could include damages for emotional distress.[218] Following up the suggestion that insurance is often purchased in order to obtain peace of mind

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211. *See, e.g.*, Egan v. Mutual of Omaha Ins. Co., 133 Cal. Rptr. 899, 909 (Ct. App. 1976) (imposing a duty based on the reasonable expectation of the insured).

212. *Id.* at 907-08.

213. *See* Hadley v. Baxendale, 156 Eng. Rep. 145, 151 (1854).

214. Gruenberg v. Aetna Ins. Co., 510 P.2d at 1040-41.

215. *See, e.g.*, Cook v. Jackson Nat'l Life Ins. Co., 885 F. Supp. 221, 224 (D. Colo. 1995) (stating that under Colorado law, an insurer can be liable for consequential damages in a breach of contract action if the plaintiff establishes that the insurer had reason to foresee such damages at the time the contract was made); Indiana Ins. Co. v. Plummer Power Mower & Tool Rental, Inc., 590 N.E.2d 1085, 1090 (Ind. Ct. App. 1992) (holding that consequential damages awarded to the insureds in a first-party insurance bad-faith action for a breach of policy contract would exceed the policy limits); Adams v. Fidelity & Cas. Co., 591 So. 2d 929, 930 (Fla. 1992) (stating that the damages recoverable in a first-party insurance bad-faith suit are those damages that are the natural, proximate, probable, or direct consequences of the insurer's bad-faith actions and may exceed the limits of the policy); Pickett v. Lloyd's, 621 A.2d 445, 458 (N.J. 1993) (finding that breach of contract liability, for the insurer's bad-faith denial paying first-party benefits to the insured, may be imposed for consequential economic losses that are fairly within the contemplation of the insurer).

216. Beck v. Farmers Ins. Exch., 701 P.2d 795 (Utah 1985).

217. *Id.* at 801-02.

218. *Id.* at 802.

rather than commercial advantage, the court opined that recovery for emotional distress caused by the insurer's bad faith might be within the contemplation of the parties according to the rule of *Hadley v. Baxendale*.[219] A later case made clear, however, that the award of emotional distress damages required more than mere breach of contract.[220] Emotional distress damages would be awarded only for breach of the covenant of good faith and fair dealing, which required a showing of unreasonable conduct on the part of the insurer.[221] Although contract law would determine the question of foreseeability of the emotional distress damages as of the time of contracting,[222] this theory still focuses on whether breach was reasonable or unreasonable, and rather artificially views emotional distress as the foreseeable outcome of only unreasonable breaches.[223]

The courts in first-party bad-faith cases, therefore, have created a new species of tort liability of a potentially expansive nature.[224] The problem, however, is that the standard of conduct that would distinguish a mere breach of contract from a tortious breach of contract was, from the beginning, vague and undefined. Recent efforts by the courts to clarify the standards for bad-faith liability may also assist in defining the proper cases in which emotional distress damages should be awarded.

IV. A TORT LIKE OTHER TORTS? BAD FAITH AS A BASIS FOR AN AWARD OF EMOTIONAL DISTRESS DAMAGES

At this point it may be appropriate to ask just what is tortious about insurance bad faith? To put the question another way, at what point does insurance company behavior merit treatment as a tort, with tort law's potentially more expansive categories of damages? A further question is whether this is the type of tort that merits the award of damages for emotional distress? Part IV attempts to address these issues, beginning with the cause of action for third-party bad faith.

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219. Hadley v. Baxendale, 156 Eng. Rep. 145 (1854).

220. *See* Billings v. Union Bankers Ins. Co., 918 P.2d 461, 467-68 (Utah 1996).

221. *Id.* at 465-66.

222. David Tartaglio, Note, *The Expectation of Peace of Mind: A Basis for Recovery of Damages for Mental Suffering Resulting from Breach of First Party Insurance Contracts*, 56 S. CAL. L. REV. 1345, 1362-63 (1983).

223. The *Billings* case does allow a greater recovery of consequential damages for a good faith but erroneous denial of benefits. For example, the insured can recover attorney's fees expended in litigating the validity of the denial. Billings v. Union Bankers Ins. Co., 918 P.2d at 468.

224. The leading case for the "tortification" of contract law was *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, which created the tort of bad-faith denial of the existence of a contract, also known as the stonewalling tort. Seaman's Direct Buying Serv. Inc. v. Standard Oil Co., 686 P.2d 1158, 1164 (Cal. 1984), *overruled by* Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669 (1995).

A. *Third-Party Bad Faith as a Tort Justifying the Award of Emotional Distress Damages*

Although third-party bad faith in many ways presents a more "tort-like" facade, damages for emotional distress in fact seem to play a much smaller role than they do in first-party bad faith.[225] This may be because courts have articulated a fairly clear standard of insurer behavior, with well-understood results if the standard is violated.[226] As a result, damages for emotional distress are rendered unnecessary.[227]

Third-party bad faith, as noted above, occurs when the insurer unreasonably refuses to accept an offer of settlement within the policy limits.[228] The result of such a refusal is to force a case to trial and to expose the insured to the risk of a judgment in excess of policy limits. Certainly, in this situation, there are foreseeable risks of emotional distress to the insured, who may be forced to endure the inconvenience and anxiety of a trial, followed by the possibility of financial ruin if the insurer guessed wrong about the value of the case. Further, courts have justified treating this situation as a tort because of the fiduciary nature of the duty assumed by the insurer to take over the defense of its insured.[229] In spite of these elements, which point to emotional distress liability, however, such damages have less of a role to play in this setting. The whole structure of the system has evolved to lessen the need for such an award.

The imposition on the insurer of a duty to give the interests of the insured at least as much consideration as its own and to treat offers of settlement as if the policy had no limits has resulted in an almost ritualized treatment of excess judgment cases. Knowledgeable plaintiff attorneys understand the need to "set up" the liability insurer by making a policy limits demand, thereby triggering the insurer's duty to consider the interests of its insured.[230] This demand can create a potential divergence of interests between the insurer and the insured.[231] Once the policy limits offer is made and refused, the insurer and insured have potentially conflicting interests, which are worked out in well-programmed steps. If an excess judgment is in fact entered and upheld against the insured, the insured has a potentially valuable claim against the insurer for violation of the duty to settle. This claim is often assigned to the victorious plaintiff in exchange for a covenant

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225. Relatively few cases have approved an award of emotional distress damages for third-party bad faith. *Cf.* Syverud, *supra* note 8, at 1121 n.16. Professor Syverud's careful analysis of the benefits and costs of prescribing settlement behavior by insurers barely mentions the threat of emotional distress damages, and hardly considers it as a factor affecting the behavior of the insured and insurer. *See id.*

226. *Id.* at 1121 n.18.

227. A number of courts have flatly rejected such damages. *See* 1 MCCARTHY, *supra* note 186, § 2.69.

228. Reedy v. White Consol. Indus., 890 F. Supp. 1417, 1435 n.9 (N.D. Iowa 1995).

229. *See* Henry v. Associated Indem. Corp., 266 Cal. Rptr. 578, 586 (Ct. App. 1990); Spindle v. Chubb/Pacific Indem. Group, 152 Cal. Rptr. 776, 779-80 (Ct. App. 1979); Florida Farm Bureau Mut. Ins. Co. v. Rice, 393 So. 2d 552, 555-56 (Fla. Dist. Ct. App. 1980).

230. 2 MCCARTHY, *supra* note 186, § 5.1.

231. *Id.*

not to execute on the judgment.[232] The plaintiff in the underlying action then pursues the bad-faith claim against the insurer, trying to collect the amount of the excess.[233]

The ability to assign the third-party bad-faith claim to the holder of the excess judgment in exchange for a release from the threat of excess liability cuts against the notion that the insured is necessarily being made to suffer great emotional torment. Indeed, a properly counseled insured might actually be reassured once the plaintiff makes a policy limits demand. The effect will be to give the insured a strong possibility of avoiding excess liability, either because the case in fact settles or because the insured now has a potentially valuable bad-faith claim.

The assignment of the bad-faith claim also tends to limit emotional distress claims for purely procedural reasons. A claim of damages for emotional distress is a personal claim that in many jurisdictions cannot be assigned.[234] It is therefore not uncommon to have the plaintiff in the underlying action pursue the excess judgment claim while the insured breathes a sigh of relief and drops further action. While it would be possible for both the plaintiff and the insured to sue,[235] allowing the insured to pursue any emotional distress claim, the structure of the third-party action may discourage the assertion of the emotional distress claim.

It is certainly true, nevertheless, that in many cases emotional distress is a foreseeable result of the insurer's refusal to accept a settlement offer within the policy limits. It will cause concern to many insureds who will face the uncertainty and anxiety of trial with no assurance that an excess judgment claim can be assigned. Yet this is one of those situations where foreseeability of emotional distress is not by itself a sufficient justification for awarding damages. No state imposes strict liability for refusal to accept a policy limits demand, and if the refusal was justifiable, the insured must face the excess judgment alone. In this situation, the insured faces both the excess judgment and uncompensated emotional distress. In the event the refusal was wrongful, the insurer pays the excess judgment, which goes a long way towards alleviating any emotional distress that the insured may have suffered. If we agree that an insurer may justifiably refuse a limits demand, then we have a situation of the type in which emotional distress is foreseeable but not actionable. The insurer is under no duty to accept every offer of settlement solely to avoid a risk of emotional distress to its insured. The concern is that any such rule would create too much of an incentive for insurers to settle unmeritorious cases.[236]

It does appear, however, that emotional distress damages are awarded when the insurer goes beyond merely refusing to settle and in fact tries to exploit

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232. 1 *id.* § 2.59.

233. STEPHEN S. ASHLEY, BAD FAITH ACTIONS § 10.39-.41 (1996) (giving directions for "setting up" the third-party bad-faith claim).

234. *See, e.g.*, Murphy v. Allstate Ins. Co., 553 P.2d 584, 587 (Cal. 1976) (stating that punitive, emotional, and personal injury claims are not assignable).

235. 1 MCCARTHY, *supra* note 186, § 2.60.

236. *Cf.* Syverud, *supra* note 8, at 1169-70 (discussing the drawbacks of a strict liability rule for failure to settle).

and betray the fiduciary-like relationship it enjoys with its insured. In the early days of the development of the duty to settle, for example, the exposure of the insured to liability for an excess judgment frequently had devastating effects. Here again the *Crisci v. Security Insurance Co.*[237] is illustrative. As a result of the failure to settle, the insured became indigent, declined in health, and became suicidal.[238] This financial and personal disaster was at least in part the predictable result of the failure to consider the insured's interests at a time when it was not clear that the insurer could be liable in excess of policy limits for this conduct.

Although the duty owed to the insured is now more clearly established, insurers can still abuse their insureds by misleading them. A prime example of such behavior is *Betts v. Allstate Insurance Co.*[239] In *Betts*, the evidence showed that Allstate and the counsel it appointed to defend the insured did not inform her about the weight of the evidence against her,[240] delayed in informing her about settlement demands made by the plaintiff within policy limits,[241] did not inform her about her rights and the potential conflict with her insurer once such a demand had been received,[242] and after entry of an excess judgment, still failed to advise her to seek independent counsel.[243] The court described the insured as living "on the edge of a financial volcano."[244] This conduct by the insurer and the appointed defense counsel resulted in an award of emotional distress damages against both.[245]

This "betrayal of trust" fact pattern is one that often leads to the imposition of emotional distress damages when they might otherwise be unavailable.[246] Situations in which the insurer does go beyond merely exercising its judgment to refuse a settlement demand and attempts to compromise its insured's rights with tactics such as those described in the *Betts* case are justifiably treated as tortious and subject to tort measures of damages, including damages for emotional distress.[247] These cases combine intentionally wrongful conduct with the element of personal affront that results from the betrayal of a trust relationship.[248] They are also analogous to the legal malpractice cases, in which the courts are reluctant to award emotional distress damages for errors, even negligent errors in professional judgment, but view betrayal of the attorney-client relationship as a wrong justifying a more expansive recovery. Viewed in this way, emotional distress damages play a limited but significant role in third-party bad-faith cases. Emotional distress damages mark the point at which the insurer's conduct crosses the

237. Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967).
238. *See id.* at 176.
239. Betts v. Allstate Ins. Co., 201 Cal. Rptr. 528 (Ct. App. 1984).
240. *Id.* at 536.
241. *Id.*
242. *Id.*
243. *Id.* at 537.
244. *Id.* at 546.
245. *Id.*
246. Bauman, *supra* note 78, at 1127, 1163-68.
247. Betts v. Allstate Ins. Co., 201 Cal. Rptr. at 533-37.
248. *See id.* at 539-40.

line from the negligent error in judgment as to the settlement value of the case to the more egregious and intentionally wrongful betrayal of the rights of the insured.

B. *First-Party Bad Faith as a Tort Justifying the Award of Emotional Distress Damages*

The cause of action for first-party bad faith was born of an uncertain analogy to third-party bad faith.[249] But because it lacked the elements of trust and fiduciary duty, this cause of action's justification for transforming a breach of contract into a tort based on the implied covenant of good faith and fair dealing was potentially far reaching. Because the implied covenant existed in all contracts, the rationale could be generalized to all contract breaches, resulting in a major displacement of contract with tort concepts.[250] The displacement did not progress very far, however, before something of a backlash developed, questioning the justification for first-party bad faith.[251] Part of that scrutiny involves the proper role that emotional distress damages should play in these cases.

1. *"Independent Tort" Jurisdictions*

Some jurisdictions completely reject the bad-faith revolution and do not regard even unjustified refusal to pay claims as a tort.[252] Instead, these jurisdictions treat such claims as ordinary breaches of contract, with strictly limited contract measures of damages, unless the insured can show that the conduct of the insurer amounted to an "independent tort."[253] Usually this means that the insured must plead and prove a cause of action for an established intentional tort such as deceit or intentional infliction of emotional distress. This is a significant obstacle to recovery and generally rules out most emotional distress recoveries in these states.[254]

The jurisdictions that adopted this position also resisted attempts to evade the rule by grounding recovery for emotional distress damages on contract theories.[255] Some insureds have attempted to argue that because insurance companies advertise and attempt to sell "peace of mind," they can contemplate, at the for-

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249. *See supra* notes 166-214 and accompanying text.

250. *See* Seaman's Direct Buying Serv., Inc. v. Standard Oil Co., 206 Cal. Rptr. 354 (1984), *overruled by* Freeman & Mills, Inc. v. Belcher Oil Co., 900 P.2d 669 (Cal. 1995).

251. 1 MCCARTHY, *supra* note 186, § 1.44-.45.

252. Many jurisdictions adopt this position on the ground that a statutory remedy for insurance claim denial preempts any common law tort remedy. *See* Spencer v. Aetna Life & Cas. Ins. Co., 611 P.2d 149, 158 (Kan. 1980); Marquis v. Family Farm Mut. Ins. Co., 628 A.2d 644, 652 (Me. 1993); Shafer v. Auto Club Inter-Ins. Exch., 778 S.W.2d 395, 400 (Mo. Ct. App. 1989).

253. Spencer v. Aetna Life & Cas. Ins. Co., 611 P.2d at 153-58; Marquis v. Family Farm Mut. Ins. Co., 628 A.2d at 652; Shafer v. Auto Club Inter. Ins. Exch., 778 S.W.2d at 399-400.

254. *See, e.g.*, Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d 50, 54-55 (Mich. 1980); Lawton v. Great Southwest Fire Ins. Co., 392 A.2d 576, 581 (N.H. 1978).

255. *See* Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d at 53-55; Lawton v. Great Southwest Fire Ins. Co., 392 A.2d at 578-81.

mation of the contract, that wrongful refusal to pay claims will result in destruction of peace of mind.[256] Under this argument, such emotional distress meets the consequential damages requirements of *Hadley v. Baxendale*[257] and so should be recoverable. The argument can be bolstered by claims that at least some types of insurance, such as medical or disability insurance, are "personal" in nature or subject matter, and therefore, support an award of emotional distress damages for their breach.

These arguments were considered and rejected by the Michigan Supreme Court in *Kewin v. Massachusetts Mutual Life Insurance Co.*,[258] the leading decision which leaves Michigan firmly in the "independent tort" camp. In that case, the insured sued for breach of a disability income protection policy, and argued that emotional distress damages should be available under a special exception for contracts that are "personal" in nature.[259] The insured persuaded the lower courts that a contract for disability income protection involved matters of mental concern and solicitude, and therefore, fell within this exception.[260] The Michigan Supreme Court, however, held that the policy was "commercial" in nature, so that its breach did not naturally give rise to damages for emotional distress.[261] Nor, in the court's view, had the plaintiff showed that these damages were within the contemplation of the parties.[262] The court rejected the arguments of the dissenting judge that the contract was primarily "personal" and therefore within the exception to the general rule denying damages for emotional distress.[263]

The result is not surprising given the skepticism with which these courts view expanded tort liability for first-party bad faith.[264] Treating damages for emotional distress as the expected consequence of breach of an insurance contract results in recovery even in cases where a tort rule might not.[265] Because liability in contract is strict, no consideration need be given to the "reasonable basis" for the denial of benefits. If the denial turned out to be erroneous, and therefore, a breach of the contract, emotional distress damages would be recoverable.

Independent tort jurisdictions do not have to grapple with whether unjustified refusal to pay claims is independently "tortious," and therefore, merits an award of emotional distress damages. They have defined the issue out of existence by requiring proof of traditional tort causes of action. The problem with

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256. *See* Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d at 57 (William, J., dissenting in part); Stewart v. Rudner, 84 N.W.2d 816, 822 (Mich. 1957).

257. Hadley v. Baxendale, 156 Eng. Rep. 145 (1854).

258. Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d 50 (Mich. 1980).

259. *Id.* at 53 (citing Stewart v. Rudner, 84 N.W.2d at 823).

260. *Id.* at 52.

261. *Id.* at 53-54.

262. *Id.* at 55.

263. *Id.* at 57.

264. *Id.* at 56.

265. The dissent in *Kewin* noted that the nature of the breach, whether simple, negligent, or in bad faith, was irrelevant to the recovery of emotional distress damages once they were found to be either the natural or contemplated result of a breach. *Id.* (Williams, J., dissenting in part).

these decisions is the failure to recognize that insurer behavior that does not satisfy the elements of a traditional cause of action may, nevertheless, contain sufficient elements of tortious wrongfulness to be treated as such. It is possible to formulate such a standard without treating every refusal as an opportunity for open-ended damage awards.

2. *Expanded Contract Damages*

An intermediate position on bad-faith damages is represented by those jurisdictions that treat wrongful refusal as a breach of contract but more readily allow recovery of consequential damages than is the case under strict contract doctrine. In some of these jurisdictions, the expansion of the available contract remedies is premised on a showing of a breach of the covenant of good faith and fair dealing, and not simply a breach of the terms of the insurance contract itself.

A leading example of this approach is *Beck v. Farmers Insurance Exchange*.[266] In that case, the Utah Supreme Court directly confronted the issue of whether first-party bad faith is better treated under a tort or a contract analysis.[267] In the court's view, the absence of the distinctive features that gave the third-party cases their fiduciary-like character allowed for the treatment of the first-party cases as breaches of contract.[268] At the same time, however, the court signaled its willingness to accept a broader reading of the compensatory damages available, suggesting in dictum that the availability of a variety of consequential damages,[269] including damages for emotional distress in "unusual cases."[270]

Commentators who praised the *Beck* analysis seemed pleased by the notion that it represented a kind of golden mean between the tort and strict contract approaches to first-party bad faith.[271] In practice, however, its meaning was unclear because the Utah court gave little guidance regarding what kind of case would justify emotional distress damages for breach of contract. It was unclear whether the court endorsed the view of the dissenting judge in the *Kewin* case that emotional distress damages should be available regardless of the nature of the breach.[272] Under that view, expanded damages would be available even if the decision of the insurer was reasonable. Allowing such damages might provide an excessive penalty for the conduct of the insurer that was merely erroneous but not wrongful.

Such awards are not, however, unheard of in contract law, particularly in recent years.[273] Courts have awarded emotional distress damages for breach of contract based upon the "personal" nature of the subject matter of the contract, apparently meaning that the subject matter of the contract was sufficient to bring

266. Beck v. Farmers Ins. Exch., 701 P.2d 795 (Utah 1985).

267. *Id.* at 798.

268. *Id.* at 799.

269. *Id.* at 801-02.

270. *Id.* at 802.

271. *See, e.g.*, ASHLEY, *supra* note 233, § 2.14.

272. *See* Beck v. Farmers Ins. Exch., 701 P.2d at 802 (citing Kewin v. Massachusetts Mut. Life Ins. Co., 295 N.W.2d 50, 57 (Mich. 1979) (Williams, J., dissenting in part)).

273. Sebert, *supra* note 107, at 1585-600.

emotional distress at its breach within the contemplation of the parties.[274] Under this view, a court might regard personal insurance, such as health, life, and disability insurance, as sufficiently personal to bring emotional distress within the consequences contemplated by the parties in the event of breach. As noted above, one of the arguments put forward for treating bad faith as a tort is that insurance is purchased not for commercial advantage but rather to secure peace of mind.

The jurisdictions adopting the "expanded contract damages" approach have not been consistent with regard to awards of emotional distress damages for breach of contract. The Utah court recently refined the approach set forth in the *Beck* case by limiting recovery of emotional distress to cases involving unreasonable conduct by the insurer.[275] Delaware permits recovery of punitive damages but not emotional distress damages for a malicious breach of contract.[276] Other courts adhere to the traditional rule denying recovery of emotional distress damages for breach of contract.[277]

Jurisdictions that take the contract approach could still provide an incentive not to breach without justification by expanding the types of economic consequential damages that can be recovered. Once it is accepted that breach of an insurance contract can lead to catastrophic economic consequences that may well be within the contemplation of the parties at the time of contracting, insurers will potentially have a substantial extracontractual liability exposure which should encourage more thoughtful decisionmaking.

One remaining issue that needs resolution is the scope of these expanded consequential economic losses. Just what losses should be considered within the contemplation of the insurer at the time of contracting? In a regime of private ordering, such as the contract approach ostensibly adopted in these jurisdictions, the rule of *Hadley v. Baxendale* acts as a protection against one contracting party being made responsible for losses whose nature it had no reason to expect, and whose extent is limited only by tort concepts of proximate cause. An insurer may therefore be expected to anticipate some type of consequential losses, while others should be found to be outside even this liberalized rule. For example, an insurer of business property against loss by fire is not writing business interruption insurance, but nevertheless probably has a good deal of information about the size and type of operation occupying the property. If the insurer wrongfully withholds insurance benefits after the fire, delaying the insured from resuming normal business operations, the insurer can probably anticipate an ensuing loss of profits. If the delay causes the loss of an extraordinary and unusual business opportunity of which the insurer had no notice, that loss should not be considered to be within the contemplation of the insurer. This approach expands the potential liability of insurers while retaining a realistic contract approach that does not open the insurer to an undefinable exposure for economic loss.

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274. *Id.* at 1588-89.

275. *See* Billings v. Union Bankers Ins. Co., 918 P.2d 461, 465 (Utah 1996). The Utah court allowed the insured to recover attorney's fees expended in pursuing the claim even for a reasonable but erroneous claim denial. *Id.* at 468-69.

276. *See* Pierce v. International Ins. Co., 671 A.2d 1361, 1367 (Del. 1996).

277. *See* Farris v. United States Fidelity & Guar. Co., 587 P.2d 1015, 1023 (Or. 1978).

In the same way, an insurer withholding from an individual the benefits of disability or health insurance can anticipate the withholding will cause some economic disruption, the extent of the loss would depend on the insurer's knowledge of the insured's situation and the amount of the claim that is being denied. Extraordinary and unforeseeable consequential losses should not be recoverable. Under this approach, the insured need only prove the breach and the amount of damages within the contemplation of the parties. The reasonableness of the denial is not a defense to the contract-based approach.[278]

3. *Bad-Faith Breach as a Tort*

In contrast to the contract-based approach in the preceding section, the tort based approach to first-party bad faith usually requires the insured to prove not only that the denial of benefits was a breach of contract, but also that it was wrongful. In other words, the insured must show that the insurer lacked a sufficient basis for the denial, allowing the inference that the denial was made in bad faith and was therefore tortious. The major difference in the decisions of the courts adopting the tort approach relates to the burden and standard of proof required of the insured in making this showing.

Some jurisdictions use the "no reasonable basis" test, placing on the plaintiff the burden of showing that the insurer knew or should have known that it had no reasonable basis for the denial.[279] This allocation of the burden means that if the insurer can show some sort of reasonable basis for the denial, the bad-faith portion of the plaintiff's claim will be defeated.[280] As previously noted, the reasonable basis test is derived from the *Anderson v. Continental Insurance Co.*[281] opinion of the Wisconsin Supreme Court.[282] In operation, the test looks for tortious conduct by focusing on the insurer's knowledge of the lack of a reasonable basis for denying the claim. Recall that the *Anderson* court emphasized that the tort was an intentional one.[283] If this standard is taken seriously as a threshold to bad-faith liability, then the "tort" that this test defines satisfies most of the traditional elements for an emotional distress recovery. In addition to a knowing breach of contract, the insurer's breach contains the elements of oppression and knowing exploitation of another's vulnerability that are frequently the components of other emotional distress cases.

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278. This approach is consistent with Utah's recent opinion in *Billings*, which allowed recovery of attorney's fees without requiring a showing of unreasonable conduct. Billings v. Union Bankers Ins. Co., 918 P.2d at 468-69.

279. *See, e.g.*, Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 213 (Tex. 1988) (holding that the claimant must establish (1) absence of a reasonable basis for denying claim and (2) that the carrier knew or should have known no reasonable basis existed).

280. Some courts go so far as to hold that the insurer is entitled to a directed verdict on the bad-faith claim unless the insured is entitled to a directed verdict on the breach of the insurance contract claim. *See* National Sav. Life Ins. Co. v. Dutton, 419 So. 2d 1357, 1362 (Ala. 1982).

281. Anderson v. Continental Ins. Co., 271 N.W.2d 368 (Wis. 1978).

282. *See supra* note 188-92 and accompanying text.

283. Unfortunately, the exact content of the required "intent" was left uncertain. *See* Henderson, *supra* note 192, at 1157.

Because the standard for liability in this area is still evolving,[284] it is not surprising to find that some jurisdictions have adopted rules that seem to move the standard of liability from intent to recklessness, to gross negligence, to even ordinary negligence.[285] As the threshold standard is lowered, however, it does not follow that damages for emotional distress should automatically continue to be awarded. When only the negligent conduct is involved, the earlier analysis has shown that foreseeability by itself has not proved to be an adequate limiting standard.[286] Something more should be required before liability for emotional distress is triggered.

Supporting this conclusion is the practical understanding that a negligent denial of a claim can often be transformed, with a little effort and follow-up, into either an approval or a more deliberate and calculated denial. In the former case it would be unnecessary and unhelpful, given the costs of litigation, to allow an independent emotional distress claim for the aggravation of dealing with the insurer. In the latter case, battle can be joined on the issue of the justification for the denial, with liability for emotional distress based on well-established principles where the insurer lacked a sound reason for the refusal to pay.

V. CONCLUSION

Liability for damages of emotional distress does not, as a matter of course, necessarily follow the labeling of a cause of action as "tortious." In the case of the tort of insurance bad faith, there is a good reason for courts to distinguish situations in which such an award falls within the accepted norms for recovery of emotional distress from those situations in which it is unwarranted. Yet, even where damages for emotional distress are denied, courts can still allow the bad-faith tort to perform its dual functions of providing more compensation and deterring wrongful conduct by allowing recovery of consequential economic loss. Such awards can be made under either a tort or contract theory of recovery, and can allow courts to reserve the emotional distress recovery for situations involving more serious insurance company misconduct.

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284. *Id.* at 1159.

285. *Id.* at 1158-59.

286. *See supra* notes 60-73 and accompanying text.