

**WHEN FAIRNESS CAN LEAD TO THE UNFAIR:  
PREVENTING THE USE OF TORT REMEDIES FOR BREACH  
OF THE DUTY OF GOOD FAITH AND FAIR DEALING FROM  
DEFEATING CONTRACTUAL TERMS AND ALLOCATIONS OF RISK.**

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INTRODUCTION

Most American jurisdictions recognize an implied duty to perform contracts in good faith and through fair dealing.<sup>2</sup>

In a few specialized areas, the common law permits a party injured by a breach of the duty of good faith and fair dealing to recover in tort. Aggressive plaintiffs attempt to expand this duty into every contractual dispute. A plaintiff may use allegations of tortious breach of good faith and fair dealing to support general jury charges on "fairness" in the transaction which ignore the terms of the transaction itself and to open up consequential and punitive damages.

The application of the tortious breach of good faith and fair dealing (hereinafter "bad faith") outside of specific special circumstances defeats contractual risk allocation and creates substantial uncertainty in commercial transactions. A broad application of bad faith increases transaction and litigation costs, makes settlement less likely as damage calculations are

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<sup>2</sup>See e.g. Tharpe v. G.E. Moore Co., 254 S.C. 196, 174 S.E.2d 397 (1970); Restatement of Contracts (Second) § 205 (A.L.I. 1981); S.C. Code Ann. § 36-1-203 (Law. Co-op 1976) (the Uniform Commercial Code implied duty of good faith and fair dealing); 1 Anderson Uniform Commercial Code § 1-203:14 (3d ed. 1989). As the author resides in South Carolina, South Carolina cases will be used to demonstrate generally applicable legal principles.

uncertain, and provides no societal advantages in return. This article will discuss how the tort of bad faith expanded from the insurance contract context into more general contract application and the trend in the courts to resist expansion of bad faith.

The implied covenant of good faith and fair dealing originated and continues as a source of contract construction used to imply terms necessary for a full performance of the parties stated terms.

Uniform Commercial Code § 1-203 (comments); 1 Anderson, Uniform Commercial Code § 1-203:14 (3d ed. 1989); Restatement of Contracts (Second) § 205 (A.L.I. 1981). The contractual duty of good faith guides the construction of explicit terms in the agreement and is an aid in furtherance of those terms. Chandler v. Hunter, 340 So. 2d 818, 821 (Ala. App. 1976); Beraha v. Baxter Health Care Corp., 956 F.2d 1436, 1443 (7th Cir. 1992) (Illinois law); Management Assistance, Inc. v. Computer Dimensions, Inc., 546 F.Supp. 666, 677 (N.D. Ga. 1982), aff'd, 747 F.2d 708 (11th Cir. 1984). The implied duty of good faith and fair dealing developed within contract law to promote parties to a contract carrying out the contract in a fair and honest manner to achieve the expressed mutual goals of the contract. Courts also based the tort of bad faith on this rule of contract interpretation, blurring the distinction between contract and tort remedies.

#### HISTORY OF THE TORT

The concept of a duty of good faith and fair dealing separate from the contract and enforceable by tort originated in liability insurance. Early in this century, most American jurisdictions recognized that when a liability insurer refused a reasonable settlement offer within the policy limits from a third-party

plaintiff, the insurer could be liable to its insured for extra-contractual damages if the underlying case is lost at trial. See, e.g., Tyger River Pine Co. v. Maryland Cas. Co., 163 S.C. 229, 161 S.E. 491 (1933); Boling v. New Amsterdam Cas. Co., 46 P. 916 (Okla. 1935). In this scenario, courts allowed plaintiff insureds to recover any excess judgment over and above the policy limits. Also, the insured may be entitled to punitive damages since the claim was based in tort.<sup>3</sup>

Courts expanded tort liability for bad faith breach of an insurance contract beginning with the seminal case of Gruenberg v. Aetna Ins. Co., 9 Cal.3d 566, 108 Cal. Rptr. 480, 510 P.2d 1032 (1973). The principles espoused in Gruenberg allowed the insured to collect consequential damages in tort when the insurer did not have a reasonable basis to reject a claim by the insured under the policy. More than thirty jurisdictions have followed this precedent.

Courts adopting the Gruenberg position believe that the extension of tort liability for bad faith refusal to pay insurance benefits in any context serves public policy for several reasons. First, the insurance contract is not based upon the insured seeking any commercial or monetary advantage but for protection against

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<sup>3</sup>The original "bad faith" tort described in this paragraph is known as "third-party" liability because the duty is triggered by the insurer's negotiations and defense against a claim brought by a stranger to the contract and the insured's liability to that third-party.

accidental or unavoidable loss. Nichols v. State Farm Mut. Auto. Ins. Co., 279 S.C. 336, 306 S.E.2d 616 (1983). Second, the insurance business affects the public interest. Id. Third, the insured normally has little or no bargaining power in negotiating the contract of insurance. Id. Fourth, absent the threat of extra-contractual consequential and punitive damages the insurer could deny even the most legitimate claims with economic impunity. Id. Several state legislatures also entered this arena and passed statutes providing for attorneys' fees or other extra-contractual damages to a successful plaintiff who brings a bad faith action against an insurer. See, e.g., S.C. Code Ann. § 38-59-40 (Law. Co-op. 1989); Ga. Code Ann. § 33-4-6 (Michie 1983).

A few jurisdictions extended the tort of bad faith outside insurance contracts to other contracts which have similar characteristics. Before the court will allow a suit in tort for extra-contractual damages the plaintiff must establish that the parties to the contract: (1) had inherently unequal bargaining positions in entering into the contract; and (2) the motivation for entering into the contract was non-profit, i.e., to secure peace of mind or security. See, e.g., Denholm v. Houghton Mifflin Co., 912 F.2d 357, 361-62 (9th Cir. 1990) (California law); First Security Bank & Trust of Miles City v. VZ Ranch, 247 Mont. 453, 807 P.2d 1341, 1345 (1991); Seward Yacht Sales, Ltd. v. Murray Chris-craft Cruisers, inc., 701 F. Supp. 766, 771-72 (D. Or. 1988) (Oregon law). These expansions of the bad faith tort do not encompass the vast majority of commercial and financial transactions based upon contract.

The situations recognized in these cases involve principles of adhesion and unequal bargaining position unique to individual insurance policies and other non-profit based contracts. The consumer seeking security and protection has few protections from unfair behavior by the other party to the contract unless the law provides some economic disincentive to bad faith. The parties to these contracts rarely engage in an analysis and assignment of risk and future damages, including the risk of breach, by negotiating specific contract terms.<sup>4</sup> These special circumstances do not apply in the typical commercial or financial contract.

THE TORT OF BAD FAITH IN THE COMMERCIAL OR  
FINANCIAL CONTRACTUAL CONTEXT

As one judge has noted, common consumer lending contracts, attorney-client fee contracts, or residential real estate transactions could fit within "judicial excursions into the amorphous concept of bad faith." Hinson v. Cameron, 742 P.2d 549,

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<sup>4</sup>While this article is not designed to address the basis of the Gruenberg first party insurance tort, commentators have criticized the basis for the tort particularly since state legislatures carefully dictate the terms of consumer insurance contracts and because the bad faith doctrine extends to commercial insurance agreements which do not have the special public policy concerns of adhesion and bargaining power cited by the courts. See, C. Smith, "Allis-Chalmers v. Lueck: Exposing the Fatal Flaw in the 'Christian Principle' of Tort Liability for Breach of Good Faith", 42 Okla. L. Rev. 607 (1989).

554 (Okla. 1987). A few courts began the excursion into new areas of bad faith tort liability in the 1980s.

The Supreme Court of Nevada found a breach of the covenant of good faith and fair dealing in dismissing a tenured employee could result in extra contractual and punitive damages in K-Mart Corp. v. Ponsock, 732 P.2d 1364 (Nev. 1987). The court looked at the employer's primary motive in discharging the employee. The court found the employer engaged in bad faith by dismissing the employee to avoid contractual retirement benefits. Id. at 1369-70. The court found that the implied covenant of good faith and fair dealing created by statute provided the legal duty which was the basis for the tort. However, the tort was outside the contract and allowed for traditional tort damages including the employee's loss of his home from inability to make payments and punitive damages. The court specified that the tort occurs "only in rare and exceptional cases ...." Id.; see also, First National Bank in Libby v. Twombly, 213 Mont. 66, 689 P.2d 1226 (1984) (allowing note debtors to counterclaim for tortious breach of the covenant of good faith and fair dealing by lender in its relationship with debtors).

A California appellate court found a "quasi-fiduciary" relationship between a bank and a commercial customer concerning the alleged wrongful honoring of a forged check in Commercial Cotton Co. v. United California Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985). The appellate court upheld an award of \$4,000.00 for negligent payment of an unauthorized check and a \$100,000.00 punitive damage award. The court based the tort award upon a bad faith imposition of non-existent legal defenses violating the implied covenant of good faith and fair dealing.

Despite these early cases expanding the tort of bad faith into non-insurance contexts, the trend in most courts is to carefully restrict the tort.

The use of an implied duty found in every contract to support tort liability and extra-contractual damages in some contracts creates an intellectual maze for legal analysis. The Supreme Court of the United States looked at this issue to determine if a Wisconsin bad faith claim arose out of a collective bargaining contract, in which case it was preempted, or existed as an independent tort in Allis-Chalmers v. Lueck, 471 U.S. 202, 216-217 (1985). The Court could find no independent element of the tort outside the contract and therefore held the action was preempted under the Labor Management Relations Act. Id.; see also, Pilot Life Insurance Co. v. Dedeau, 481 U.S. 41 (1987).

Similarly, the Court of Appeals of South Carolina rejected bad faith as a tort duty instead applying it as a breach of contract which allowed for special extra-contractual damages in Bartlett v. Nationwide Mut. Fire ins. Co., 290 S.C. 530, 348 S.E.2d 530 (Ct. App. 1986). While logically appealing, the Bartlett Court's reasoning is inconsistent with the holdings of Gruenberg and its progeny. The Supreme Court of South Carolina overruled Bartlett and stated that the bad faith doctrine represents an independent tort in South Carolina. Charleston Cty. School Dist. v. State Budget & Control Bd., \_\_\_ S.C. \_\_\_, 437 S.E.2d 6 (1993).

The inconsistency between the contract source of the duty of good faith and fair dealing and the tort remedies allowed for its breach in certain contexts leaves this area of law unsettled. The uncertainty of the roots, meaning and remedies for bad faith causes

uncertainty in a wide variety of commercial and financial contract cases. See, A. Overby, "Bondage, Domination, and the Art of the Deal: An Assessment of Judicial Strategies in Lender Liability Good Faith Litigation," 61 Fordham L. Rev. 963, 964-66 (1993). Most courts have refused to extend bad faith liability beyond the insurance context for these reasons.

Another California court specifically criticized the holding of Commercial Cotton in Price v. Wells Fargo Bank, 213 Cal. App. 3d 465, 261 Cal. Rptr. 735 (1989). There, the appellate court affirmed a summary judgment in favor of the bank holding that an arms length transaction between a bank and a commercial borrower simply could not support tort recovery for the breach of the implied covenant of good faith and fair dealing and that recent California Supreme Court decisions precluded "the sort of loose extension of tort recovery, based on quasi-fiduciary relationship, sanctioned in Commercial Cotton." Id. at 478, citing, Foley v. Interactive Data Corp., 47 Cal.3d 654, 254 Cal. Rptr. 211 (1988).

The Supreme Court of Alabama refused "to extend to the area of general contract law the tort of bad faith that we have recognized in the context of insurance policy cases." Government Street Lumber Co., Inc. v. AmSouth Bank, N.A., 553 So. 2d 68, 72 (1989). In that case, the plaintiff contended that AmSouth monitored the plaintiff's accounts receivable, required deposits from accounts receivable into a blocked account to pay the lender, disqualified certain accounts from the lending base, refused to lend more than was required under the financing agreement, and dishonored checks drawn on insufficient funds. Id. at 73. The court found that all these actions were justified under the loan agreement between the

parties, and even if they had not been, would not extend tort liability for breach of the covenant of good faith and fair dealing to the lender/borrower relationship. Id. at 72-73; see also Quinn Companies, Inc. v. Herring-Marathon Group, Inc., 299 Ark. 431, 773 S.W.2d 94, 95 (1989) (refusing to extend a claim for the tort of bad faith to the breach of contracts outside of the insurance context).

Courts are reluctant to extend the concept of tortious bad faith to breach of contract generally because it would supersede all contractual law and eliminate the standards and restrictions developed for breach of contract actions over the years. Note, Contracts: Allis-Chalmers v. Lueck - Exposing the Fatal Flaw in the 'Christian Principle' of Tort Liability for Breach of Good Faith, 42 Okla. L. Rev. 607 (1989). Thus, one federal district court stated in recognizing that neither Ohio nor Illinois recognize a general tort of bad faith that "care must be taken to prevent the transmutation of every breach of contract into an independent tort action through bootstrapping of the general contract principle of good faith and fair dealing." Highway Equipment Co. v. Caterpillar, Inc., 707 F.Supp. 954, 958 (S.D. Ohio 1989)(quoting Martin v. Federal Life Ins. Co., 109 Ill. App. 3d 596, 65 Ill. Dec. 143, 150, 440 N.E.2d 998, 1006 (1982)); see also Carlson v. Carlson, 147 Ill. App. 3d 610, 101 Ill. Dec. 384, 498 N.E.2d 708, 711 (1986); Richie Enterprises v. Honeywell Bull, Inc., 730 F.Supp. 1041, 1052 (D. Kan. 1990) (applying Kansas law).

Oklahoma specifically refused to extend the tort of bad faith to the commercial lending setting in Rogers v. Tecumseh Bank, 756 P.2d 1223, 1226-27 (Okla. 1988). The court found that none of the

compelling reasons for a deviation from standard contract law present in the insurer/insured context existed in the context of the borrower/lender relationship. Id. Oklahoma reaffirmed its position in Coble v. Bowers, 809 P.2d 69, 72 (Okla. App. 1990). See also Radloff v. First Am. Nat'l Bank of St. Cloud, N.A., 470 N.W.2d 154, 158 (Minn. App. 1991) (imposing sanctions on plaintiff for submitting a claim on tort theory of breach of duty of good faith and fair dealing, a cause of action not recognized in Minnesota).

A federal district court refused to extend Pennsylvania law to apply a tortious breach of good faith and fair dealing in the lender/borrower relationship in Temp-way Corp. v. Continental Bank, 139 B.R. 299 (E.D. Pa. 1992). A corporation and its putative shareholders sued its primary lender in an amended complaint containing seven counts. One of the causes of action claimed tort damages for the breach of the covenant of good faith and fair dealing. Id. at 319-20. Applying Pennsylvania law, the court held that "a borrower does not have a legally cognizable tort action against a lending institution for failure to deal with its borrower in good faith.... [W]here a duty of good faith arises, it arises under the law of contracts, and there is no need to create a separate tort for breach of a duty of good faith." Id. at 320; see also Creeger Brick and Building Supply, Inc. v. Mid-State Bank and Trust Co., 385 Pa. Super. 30, 560 A.2d 151, 154 (1989).<sup>5</sup>

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<sup>5</sup>See also, Keeton v. Bank of Red Bay, 466 So. 2d 937 (Ala. 1985); In re Cannco Contractor, Inc., 135 B.R. 608 (Bkrtcy. E. D. Ark. 1991) (Arkansas law); Betterton v. First Interstate Bank of Arizona, N.A., 800 F.2d 732, 736 (8th Cir. 1986) (Arizona law); North Central Kansas Production Credit Ass'n v. Hansen, 240 Kan. 671, 732 P.2d 726 (1987); Radloff v. First Am. Nat'l Bank of St.

Ascribing tort remedies for the breach of an implied contract term upsets the expectations of parties to commercial and financial transactions. Contract law governs every day commercial activity and two of its greatest goals are to further the independent, legal terms negotiated between responsible parties and to provide predictable results when a contract is not performed. See, e.g., Uniform Commercial Code, Introduction and section 1-102. The tort of bad faith conflicts with these goals of contract law. It aims at compensating plaintiffs for extra-contractual damages not foreseeable at the time of contracting, consequential damages often excluded by contract law, and awarding punitive damages and attorneys' fees as punishment.

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Cloud, N.A., 470 N.W.2d 154 (Minn. App. 1991); Coble v. Bowers, 809 P.2d 69 (Okla. App. 1990).

While contract law is based upon the clear meaning of the contract terms and the objectively expressed intentions of the parties<sup>6</sup>, bad faith law is based on a subjective analysis by the jury of whether a party to the contract acted in good faith and dealt fairly with the other party.<sup>7</sup> A party to a contract cannot accurately forecast the potential risk of loss if a breach occurs when bad faith is interjected. Oki Am., Inc. v. Microtech Int'l, Inc., 872 F.2d 312, 315 (9th Cir. 1989) (Kozinski, J. concurring). Increased risk leads to fewer transactions and increased transaction costs. Id. A party to a lending or other commercial agreement must be careful to specify more terms more tightly in order to avoid the looming threat of bad faith. Once litigation commences, the damages sought are indeterminate making settlement more difficult. Id.

Whatever the merits of allowing bad faith tort liability in the context of individual insurance policies and similar non-profit

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<sup>6</sup> Kruse v. Todd, 260 Ga. 63, 389 S.E.2d 488 (1990); Martin v. Ray Lackey Enterprises, Inc., 100 N.C. App. 349, 396 S.E.2d 327 (1990); Warner v. Weader, 280 S.C. 81, 311 S.E.2d 78 (1983).

<sup>7</sup>There are limitations on this doctrine. For example, many courts have held it cannot be "bad faith" to exercise a right specifically permitted a party under the terms of the contract. See, e.g., First Fed. Sav. & Loan Ass'n v. Dangerfield, 307 S.C. 260, 414 S.E.2d 590, 594 (Ct. App. 1992); Waller v. Maryland Nat'l Bank, 95 Md. App. 197, 211-12, 620 A.2d 381, 388 (1993).

based contracts with bargaining power concerns, the same public policy concerns do not apply to arms length commercial, real estate, financing and sale transactions. There is no overriding social concern that justifies upsetting the negotiated terms and risk allocations between the parties to these contracts. Social policies favoring freedom to contract, commercial certainty, and decreasing litigation support refusal to extend bad faith outside the traditional insurance context. To the extent a party uses gaps in a contract to render imperfect performance or defeat the express purposes of the contract, contractual construction using the implied duty of good faith and fair dealing will avoid unjust results without engrafting tort remedies onto the contract. See, I. Ayres & R. Gertner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules," 99 Yale L.J. 87 (1989).

#### CONCLUSION

The concept of tortious breach of the covenant of good faith and fair dealing is inconsistent with established principles of contract law. The tort of bad faith inappropriately complicates commercial and financial contractual relationships and unfairly exposes contracting parties to extra-contractual liability. The courts should untangle the intellectual roots of the bad faith doctrine and recognize it for what it is: a very limited special exception of insurance law not applicable to contracts generally and only applied when an insurer acts unreasonably. Clarification would decrease litigation and increase certainty in commercial and financial transactions.