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COMMENTS

Bad Faith Breach of Contract: Should This Infant Tort Be Allowed to Grow in North Carolina?

I. INTRODUCTION

Direct action taken against insurance companies for breaches of their obligations to their insureds has given birth to a new tort: bad faith breach of contract.¹ The tort is committed when an insurer refuses to meet an implied contractual obligation to deal with its insured fairly and in good faith.² Recognition of bad faith breach of contract as an independent tort may be the most significant development in tort law in this century.³ The number of claims based on this infant tort likely will rival the medical malpractice and products liability explosion of recent years.⁴

Implied as a matter of law in every contract is a covenant of good faith and fair dealing.⁵ The covenant requires that neither party shall by any act impair the right of the other to receive any benefits flowing from the agreement. A breach of the covenant occurs when a promisor acts in bad faith, impairing or destroying a promisee's expected benefit in the contract.⁶ According to tort theory, the implied covenant and its bad faith breach have extra-contractual relevancy which enables the injured party to seek a remedy in tort.⁷ For example, an insurer's bad faith refusal to pay an insured's valid claim would result in a breach of the insurer's implied-in-law duty to act in good faith and to deal fairly. The insurer would then become liable in tort for all damages proximately caused by the breach.⁸ Moreover, punitive damages may be awarded

1. *See, e.g.*, *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

2. *See, e.g.*, *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

3. Minor, *Proving Bad Faith of an Insurer*, TRIAL, Aug.1980, at 17.

4. Knepper, *Review of Recent Tort Trends*, 29 DEF. L.J. 1, 2 (1980).

5. E. FARNSWORTH, CONTRACTS § 3.26, at 187, § 7.17, at 526-27 (1982).

6. 3 A. CORBIN, CORBIN ON CONTRACTS § 541, at 97 (1960); E. FARNSWORTH, *supra* note 5; 5 S. WILLISTON, A TREATISE ON THE LAW OF CONTRACTS § 670, at 159 (3d ed. 1961 & Supp. 1985).

7. W. PROSSER, R. KEETON, D. DOBBS & D. OWEN, PROSSER AND KEETON ON THE LAW OF TORTS § 83, at 597-99, § 92 (5th ed. 1984) [hereinafter cited as PROSSER & KEETON].

8. Bess & Doherty, *Survey of Bad Faith Claims in First Party and Industrial Proceedings*, 49 INS. COUNS. J. 368, 369 (1982).

where the insurer acts fraudulently, maliciously, or in flagrant disregard of its insured's rights.⁹

California pioneered the concept of the tort of bad faith,¹⁰ and many states have followed the lead.¹¹ A few states recognize the tort but only if the action is created by statute.¹² Other states refuse to recognize the action, finding that adequate remedies already exist in traditional contract theory.¹³ North Carolina is one of another group that has yet to expressly decide whether the new tort will be recognized.¹⁴

Part II of this Comment surveys the historical development of the tort of bad faith breach of contract. Part III identifies the new tort's elements and analyzes its theoretical basis. Part IV examines public policy considerations accompanying adoption of the tort. These include economic factors, impact on the courts, and the extent to which the new tort may reach beyond the insurance arena. Part V discusses the current status and future of this infant tort in North Carolina. This Comment concludes that the tort of bad faith breach of contract is evolving in response to a common need for the redress of outrageous bad faith breach of contract and that its acceptance should be encouraged.

II. HISTORICAL DEVELOPMENT OF THE TORT OF BAD FAITH BREACH OF CONTRACT

The historical development of the law of torts reflects a struggle for recognition within the common law.¹⁵ While formal acceptance of the

9. See, e.g., *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

10. Begam, *The Law of Outrage*, TRIAL, Aug. 1980, at 34, 36.

11. See, e.g., *Morgan v. American Family Life Ins. Co.*, 559 F. Supp. 477 (W.D. Va. 1983); *Chavers v. National Sec. Fire & Casualty Co.*, 405 So. 2d 1 (Ala. 1981); *Noble v. National Am. Ins. Co.*, 128 Ariz. 188, 624 P.2d 866 (1981); *Bender v. Time Ins. Co.*, 286 N.W.2d 489 (N.D. 1980); *Hoskins v. Aetna Ins. Co.*, 6 Ohio St. 3d 270, 452 N.E.2d 1315 (1983).

12. See, e.g., *Tate v. Aetna Casualty & Sur. Co.*, 149 Ga. App. 123, 253 S.E.2d 775 (1979); *First Sec. Bank v. Goddard*, 593 P.2d 1040 (Mont. 1979); *Salois v. Mutual of Omaha Ins. Co.*, 90 Wash. 2d 355, 581 P.2d 1349 (1978); *Jenkins v. J.C. Penney Casualty Ins. Co.*, 280 S.E.2d 252 (W. Va. 1981).

13. See, e.g., *Spencer v. Aetna Casualty & Sur. Co.*, 227 Kan. 914, 611 P.2d 149 (1980); *Lawton v. Great Southwestern Fire Ins. Co.*, 118 N.H. 607, 392 A.2d 576 (1978); *Santelli v. State Farm Ins. Co.*, 278 Or. 53, 562 P.2d 965 (1977).

14. See, e.g., *Escambia Treating Co. v. Aetna Casualty & Sur. Co.*, 421 F. Supp. 1367 (N.D. Fla. 1976); *Findley v. Time Ins. Co.*, 264 Ark. 647, 573 S.W.2d 908 (1978); *Stanback v. Stanback*, 297 N.C. 105, 254 S.E.2d 611 (1979); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976); *Dailey v. Integon Ins. Co.*, 57 N.C. App. 246, 291 S.E.2d 331 (1982).

15. One author on the subject has observed:

Although I can offer only a brief sketch of a large subject, I hope that it will be sufficient to remind you that the law of Torts is based on the principle that one who harms another has a duty of compensation whenever it is just that he should pay; that the question of justice involves not only justice to the persons involved but also to the state; that although justice may be colored by expediency, it always involves current ideas of economics and morality; that the specific rules are but crystallizations resulting from the meeting of competing principles in a given economic and social situation. Further, I hope to persuade you that because of the broad

law of torts as a unified body of legal principles came comparatively late in legal history,¹⁶ its essential doctrines can be traced to early Anglo-Saxon tribal law pre-dating the Norman conquest of England.¹⁷ The Norman skill of efficiency and organization led to a system of courts which administered justice to its Anglo-Saxon subjects. In order to insure peace in the kingdom, the courts necessarily sought to incorporate much of the old Anglo-Saxon tribal law to appease the conquered populace with a system of justice they could recognize and accept.¹⁸ Thus, the threads of common law were spun into the fabric of society and the law of torts became a fixed pattern within the weave of that fabric.

Our historical examination begins¹⁹ at a time when most lawyers were adroitly trying to turn every breach of contract into a tort,²⁰ thereby forcing the English courts to find some line of demarcation. The task of line drawing illustrates both the homogeneous relationship between tort and contract and their eventual separation through the centrifuge of modern legal reasoning. The tort itself—bad faith breach of contract—suggests the doctrinal overlap of the two areas of law. The distinctions are often vague and undefined. One judge referred to the tort as “a hybrid product, a cross breed of tort and contract, with no pride of ancestry, and no hope of progeny. After much examination, we are yet unable

base of the law of Torts, unrecognized through centuries but now becoming clear, the courts have succeeded in creating a workable system, with capacity for change and growth; that because of this our judges should be free, as they have been in the past, to correct mistakes where rules have proved to be unjust or unworkable and to create new rights as new interests appear.

3 W. SEAVEY, *COGITATIONS ON TORTS* § 1, at 3 (1954).

Put succinctly, “tort law is overwhelmingly common law developed in case-by-case decisionmaking by the courts.” PROSSER & KEETON, *supra* note 7, at 19.

16. The first American treatise in torts was published in 1859 by Francis Hilliard. 1 F. HILLIARD, *THE LAW OF TORTS* (1859). A major work in torts was published the following year in England. C. ADDISON, *A TREATISE ON THE LAW OF TORTS, OR WRONGS AND THEIR REMEDIES* (1860). Torts was first taught as a separate law school subject in 1870. See *THE CENTENIAL HISTORY OF THE HARVARD LAW SCHOOL* 29 (1948). The first casebook on torts was introduced in 1874. J. AMES, *A SELECTION OF CASES ON THE LAW OF TORTS* (1874). For an interesting examination of the development of tort law in the United States, see generally G. WHITE, *TORT LAW IN AMERICA: AN INTELLECTUAL HISTORY* (1980).

17. See generally F. POLLOCK, *THE EXPANSION OF THE COMMON LAW* 139-58 app. (1904); see also 2 W. HOLDSWORTH, *A HISTORY OF ENGLISH LAW* 12-34, 50-54, 82-87 (4th ed. 1936).

18. Seavey explains that:

when the conquering Normans took control their first effort necessarily was to pacify their Saxon subjects and to make a unit out of what had been a group of tribes. Their genius for organization led to the setting up of a system of King's Courts which were truly national, and a creation of a unified law of the land, for the violation of which the King's Courts would give redress. These courts did not by any means supercede the former local courts and the rules adopted were necessarily based largely upon the pre-existing Saxon customs.

3 W. SEAVEY, *supra* note 15, at 8. See also 2 W. HOLDSWORTH, *supra* note 17, at 145-74.

19. Suffice it to say that the origins of the tort of bad faith breach of contract may well be traced far into the history of the common law, in both tort and contract, in trespass-on-the-case and assumpsit. However, such an undertaking is beyond the scope of this Comment.

20. PROSSER & KEETON, *supra* note 7, at 655-62.

to determine its proper category.”²¹ The concept boils down to a residual product of the ambivalence between tort and contract principles, having its origin in the landmark case of *Hadley v. Baxendale*.²²

A. Limitation of Contract Damages

Prior to 1854, almost no rules regarding contract damages existed. The assessment and award of damages were primarily left to the unbri-dled discretion of the jury.²³ Meanwhile, England was well into its industrial revolution, a period in time where commercial activity reached new levels of complexity and the needs of businessmen engaging in such activity changed.²⁴ Excessive jury awards, which levied liability based on unforeseeable losses, were seen to impose upon a businessman or business a burden greatly disproportionate to the initial risk and to the corresponding contractual benefit.²⁵ This was the atmosphere in which *Hadley v. Baxendale* was decided.

The broad discretion previously enjoyed by juries in awarding damages was curtailed substantially when the limitation of foreseeability on damages recoverable beyond the express terms of the contract was first imposed in *Hadley*.²⁶ In *Hadley*, the plaintiffs operated a grist mill. The mill was forced to cease operations after a shaft broke in one of its machines. An employee took the broken shaft to the defendants for shipment to a manufacturing company which was to make a new shaft using the broken one as a model. The defendants unexcusably delayed shipment for several days. As a result, the mill was shut down for a longer period of time than was necessary.²⁷ A judgment was entered upon a jury verdict for the plaintiff which included an award of damages for lost profits. The verdict was reversed.

Hadley established two rules. First, the injured party may recover those damages “as may fairly and reasonably be considered . . . [to] arise naturally, i.e., according to the usual course of things, from such breach of contract itself.”²⁸ Second, the party may recover damages “as may be reasonably [sic] in the contemplation of both parties, at the time they made the contract, as to the probable result of it.”²⁹ The court further stated that a delay of several days in the shipment of a shaft does not “in the usual course of things” result in damaging consequences.³⁰

21. *White Roofing Co. v. Wheeler*, 39 Ala. App. 662, 664, 106 So. 2d 658, 660 (1957).

22. 156 Eng. Rep. 145 (1854).

23. E. FARNSWORTH, *supra* note 5, § 12.14, at 873.

24. *Id.* at 573-74.

25. *Id.*

26. *Id.* § 12.14, at 875.

27. *Hadley*, 156 Eng. Rep. at 145-46.

28. *Id.* at 151.

29. *Id.*

30. *Id.*

Therefore, liability for damages in excess of contract value will be awarded only if such damages were in the contemplation of the parties at the time of contracting (*i.e.*, foreseeable) and were a probable consequence of the breach. Such damages have become known as "special" or "consequential."³¹

When parties bind themselves contractually, they usually look forward to performance, not breach. Theoretically, the subjective contemplation of the parties is not evidenced by the objective terms and conditions of the contract. However, courts interpret "contemplation of the parties" within the framework of the objective theory of contracts.³² For example, the first rule of *Hadley* anticipates that certain damages will quite naturally and obviously flow from the breach such that the parties will have been deemed to have contemplated them. Under the second rule, nonobvious types of damages are deemed to have been contemplated only if the promisor knew or had reason to know the special circumstances which gave rise to such damages.³³

The decision in *Hadley* evolved as a reaction to perceived excessive jury awards in breach of contract actions and as an attempt to provide acceptable rules of contract damages in an emerging industrial society.³⁴ Prior to *Hadley*, jury awards in contract disputes were often based upon what is more accurately characterized as tort damages. However, the *Hadley* court attempted to restrict damages beyond express terms of the contract while at the same time acknowledging some need for special or consequential damages.³⁵ The result of *Hadley* was to impose a more severe limitation on the recovery of damages for breach of contract than that applicable to actions in tort.³⁶ However, arguments have been advanced that this result actually expanded liability in contract by making some lost profits and other consequential damages recoverable where, at least theoretically, none had been before.³⁷ The decision likely represents a compromise between excessive jury awards or no awards at all for breach of contract. While the rules of recovery in *Hadley* were arguably based on a combination of contract breach and tort negligence, the case eventually fell victim to the divergence between tort and contract law that began developing in the late nineteenth and early twentieth centuries.³⁸

Several English cases interpreted *Hadley* in a restrictive sense and ap-

31. E. FARNSWORTH, *supra* note 5, § 12.14, at 875.

32. *Id.*

33. *Hadley*, 156 Eng. Rep. at 151; see also E. FARNSWORTH, *supra* note 5, § 12.14, at 874-75.

34. Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. LEGAL STUD. 249 (1975).

35. E. FARNSWORTH, *supra* note 5, § 12.14, at 874-75.

36. *Id.*

37. G. GILMORE, *THE DEATH OF CONTRACT* 51-52 (1974).

38. E. FARNSWORTH, *supra* note 5, § 12.14, at 874-75.

plied a more limited rule of contract damages. Those cases held that mere notice of special circumstances is an insufficient basis for imposing liability for consequential damages outside the express terms of the contract.³⁹ Those rulings required that knowledge of special circumstances "be brought home to the party to be charged under such circumstances that he accepts the contract with the special condition attached to it."⁴⁰ In other words, there must be an express or implied condition manifesting the intent to assume the risk of foreseeable consequential damages. Those damages which are wholly unforeseeable could not be within the contemplation of the parties and, therefore, are precluded from recovery on the breach of contract. Moreover, any claim that may arise in tort from the contract breach is excluded as unforeseeable unless expressly provided for and the risk is assumed by the party to be charged.

Justice Holmes, speaking for the United States Supreme Court, adopted this line of reasoning and established the "tacit agreement" test.⁴¹ According to Justice Holmes, "The extent of liability . . . should be worked out on terms which it fairly may be presumed he [the party to be charged] would have assented to if they had been presented to his mind."⁴² While this approach was generally the common law in the federal courts, the states did not always follow this lead, seeing the test as overly restrictive and doctrinally unsound.⁴³ England eventually overruled the "tacit agreement" test.⁴⁴ The *Uniform Commercial Code* explicitly rejected the test as well.⁴⁵

The pendulum eventually swung back to center in line with the rules of *Hadley*. The modern trend may be toward a strict adherence to the limitations imposed by *Hadley* by phrasing the test of limitation in terms of "foreseeability." The *Restatement (Second) of Contracts* states that "[d]amages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made."⁴⁶ A loss is foreseeable under the first rule of *Hadley* if

39. See, e.g., *British Columbia Saw-Mill Co. v. Nettleship*, 3 L.R.-C.P. 499 (1868); accord *Horne v. Midland R.R.*, 8 L.R.-C.P. 131 (1873); see PROSSER & KEETON, *supra* note 7.

40. *Horne*, 8 L.R.-C.P. at 145-46 (quoting *British Columbia Saw-Mill Co.*, 3 L.R.-C.P. at 509); see PROSSER & KEETON, *supra* note 7.

41. *Globe Refining Co. v. Landa Cotton Oil Co.*, 190 U.S. 540 (1903).

42. *Id.* at 543.

43. E. FARNSWORTH, *supra* note 5, § 12.14, at 875.

44. *Victoria Laundry (Windsor) Ltd. v. Newman Indus. Ltd.*, [1949] 2 K.B. 528, 537. This case may also be read to have somewhat liberalized the *Hadley v. Baxendale* rules in addition to rejecting the tacit agreement test. Consequential damages were allowed where the defendant had reason to know the special circumstances although they were not communicated by the plaintiff. The "reason to know" language is in essence the "foreseeability" test as set out in the RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1979).

45. U.C.C. § 2-715 comment 2 (1978) ("The tacit agreement test for recovery of consequential damages is rejected.").

46. RESTATEMENT (SECOND) OF CONTRACTS § 351 (1979).

the loss follows in "the ordinary course of events." Under the second rule, a loss is foreseeable if it follows as a "result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know."⁴⁷ The party in breach need not have consented even tacitly, to liability for the loss; he need only to have been given notice of facts that made it foreseeable.⁴⁸

B. Other Limitations

In traditional contract theory, recovery for pain and suffering and mental anguish are generally denied. The underlying rationale for denial is the avoidance of excessive jury awards.⁴⁹ Such damages also are held to be uncertain and unascertainable.⁵⁰ Where such uncertainty exists, pain and suffering and mental anguish are not foreseeable; therefore, the parties could not have contemplated them at the time of contracting. This line of thinking squares with the rules of *Hadley*, but even more so with the now-rejected tacit agreement test.⁵¹ The failure of the tacit agreement test eliminated the court's most convenient vehicle in limiting special or consequential damages, or denying them altogether.⁵² However, courts remain reluctant to impose liability on a defaulting party that seems disproportionate to the consideration received.⁵³ The *Restatement (Second) of Contracts* attempts to fill this void: "A court may limit damages for foreseeable loss by excluding recovery of lost profits, by allowing recovery only for loss incurred in reliance, or otherwise if it concludes that in the circumstances justice so requires in order to avoid disproportionate compensation."⁵⁴ The *Restatement* further provides that the remedy granted for a breach of a promise made enforceable through reliance "may be limited as justice requires."⁵⁵

Courts armed with the ability to limit damage awards arising from breach of contract have held that in certain circumstances recovery could be granted for pain and suffering so long as the injury was a foreseeable, natural and direct result of the breach.⁵⁶ In so holding, the courts have

47. *Id.* § 352 comment 2. The *Restatement* takes the first of the quoted phrases from U.C.C. § 2-714(1), and the second from U.C.C. § 2-715(a).

48. E. FARNSWORTH, *supra* note 5, § 12.14, at 876.

49. See, e.g., *Winston Cigarette Mach. Co. v. Wells-Whitehead Tobacco Co.*, 141 N.C. 284, 296, 53 S.E. 885, 889 (1906) ("The breach of a very simple contract . . . might bring ruin upon the party in default, by leaving the damages to the unbridled discretion of the jury.").

50. See generally E. FARNSWORTH, *supra* note 5, §§ 12.14-15.

51. See *supra* note 45, and accompanying text.

52. E. FARNSWORTH, *supra* note 5, § 12.17, at 892.

53. *Id.*

54. RESTATEMENT (SECOND) OF CONTRACTS § 351(3) (1979).

55. *Id.* § 90.

56. See, e.g., *Sullivan v. O'Conner*, 363 Mass. 579, 296 N.E.2d 183 (1979). This textbook case illustrates the proposition that pain and suffering are recoverable upon a breach of contract. In *Sullivan*, a surgeon had agreed to perform plastic surgery on plaintiff's nose to enhance its appear-

indirectly acknowledged the proposition that tort damages may result from a breach of contract, and those damages may be recoverable.

Recovery of damages for mental anguish or emotional distress arising from breach of contract generally is denied in traditional contract theory. The classical position may be stated as follows: Damages for mental anguish cannot be recovered because they are too remote, uncertain, and unascertainable, are not within the contemplation of the parties at the time of contracting, and cannot be said to arise as a material and natural result of a breach.⁵⁷ Even where the limitation of foreseeability may have been overcome, the denial of damages for mental distress was based on the argument that recovery is likely to result in disproportionate compensation. Such a result can be justified under the general rules of *Restatement (Second) of Contracts*.⁵⁸ Whether the actual basis for judicial reluctance in awarding damages for mental suffering rests on rules of foreseeability, certainty, reliance, or disproportionate compensation, all have their roots in the rules first laid down in *Hadley*.

The courts have not escaped the lingering need for redress in special cases. Some courts have made exceptions where either a breach resulted in actual bodily harm,⁵⁹ or where the breach was likely to have resulted in severe mental anguish.⁶⁰ Such cases illustrate the judicial recognition

ance. Instead, the surgery disfigured plaintiff's nose, requiring a third operation which caused her to endure unnecessary pain and suffering. The court bluntly stated that "an expectancy recovery may well be excessive" and the facts "suggest moderation as to the breadth of the recovery that should be permitted." The court further stated that "the fee paid by the patient to the doctor would usually be quite disproportionate to the putative expectancy recovery" and concluded that the better policy was to limit recovery to the patient's reliance interest, including her out-of-pocket expenditures, and allow damages for the worsening of her condition, and for the *pain and suffering and mental distress* involved in the third operation." *Id.* at 585-88, 296 N.E.2d at 187-89 (emphasis added).

57. See, e.g., *Orkin Exterminating Co. v. Thrift*, 154 Ga. 545, 269 S.E.2d 53 (1980) (recovery of damages for humiliation and embarrassment denied where jury found that the defendant exterminating company had failed to rid plaintiff's home of termites); *Hatfield v. Max Rouse & Sons*, 100 Idaho 840, 606 P.2d 944 (1980) (owner of logging equipment denied recovery for emotional distress resulting from auctioneer's sale of equipment below minimum specified price because of difficulty in imagining that the parties had contemplated the owner's mental distress upon a breach of sale agreement); *Ostrowe v. Darensbourg*, 377 So. 2d 1201 (La. 1979) (owner denied recovery for mental anguish, suffering and anxiety caused by delay in completion of house alleged to have been specially designed).

58. *RESTATEMENT (SECOND) OF CONTRACTS* § 351 (1979).

59. See, e.g., *Hawkins v. McGee*, 84 N.H. 114, 146 A. 641 (1929) (the infamous "hairy hand" case).

60. The so-called "casket cases" are illustrative. *Hirst v. Elgin Metal Casket Co.*, 438 F. Supp. 906 (D. Mont. 1977) (casket manufacturer liable for mental suffering when leakproof casket leaked); *Allen v. Jones*, 104 Cal. App. 3d 201, 163 Cal. Rptr. 445 (1980) (mortuary liable for mental distress when cremated remains were lost); *Lamm v. Shingleton*, 231 N.C. 10, 55 S.E.2d 810 (1949) (undertaker liable for mental suffering caused by improper burial which caused the casket to break the surface); cf. *B & M Homes v. Hogan*, 376 So. 2d (Ala. 1979) (plaintiff's severe emotional distress deemed foreseeable where builder constructed plaintiff's home in a blatantly irresponsible manner); *Wynn v. Monterey Club*, 111 Cal. App. 3d 794, 168 Cal. Rptr. 878 (1980) (husband not precluded from recovering damages for emotional distress due to gambling casino's breach of contract to deny wife access because she was a compulsive gambler).

that in some instances tort liability may arise from the breach of contractual obligations and that the remedy must necessarily extend beyond usual contract limitations.⁶¹

C. Expansion of Damages Recoverable In Tort

The rules of *Hadley v. Baxendale* effectively precluded any attempt by lawyers to seek tort damages in breach of contract actions. Economic losses not foreseeable at the time of the execution of the contract, punitive damages, and damages for mental distress were excluded. However, simply denying an action based on artificial rules of construction cannot dispense with the underlying need for redress.

Perhaps more than any other branch of the law, torts is an area more socially attuned to providing redress for perceived wrongs. Although many years the least favored child of the common law,⁶² the growth and development of torts continually reflects society's evolution.⁶³ The law of torts provides courts with the ability to gauge the winds of social change and public policy and set a new course, perhaps at the expense of overruling established precedent.

At the core of the tort of bad faith breach of contract is the interest in protecting a plaintiff's emotional well-being. The concept has met considerable resistance—the law of torts included. Seven years after *Hadley*, Lord Wenslydale stated in sweeping terms: "Mental pain or anxiety the law cannot value, and does not pretend to redress, when the unlawful act complained of causes that alone."⁶⁴ The venerable Justice Holmes accepted this general maxim in his treatise on the common law.⁶⁵ However, exceptions have been allowed in certain cases, particularly in the areas of assault and battery.⁶⁶ In such cases, the law of torts recognizes

61. California has led the way in recognizing and applying the tort of bad faith breach of contract beyond the "bodily harm" and "casket-type" cases. See, e.g., *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974) (insurer's bad faith refusal to settle within policy limits constituted a tort); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (insurance company's bad faith refusal to settle was a tort as well as a breach of contract); *Crisci v. Security Ins. Co.*, 66 Cal. App. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967) (damages for mental suffering recoverable where insurer refused to settle claim in good faith); cf. *Chung v. Koanohi Center Co.*, 618 P.2d 283 (Hawaii 1980) (damages for emotional distress and disappointment are recoverable where actions by shopping mall in denying a lease to a fast food kitchen amounted to wanton and reckless conduct in flagrant disregard of the promisee's rights).

62. 5 AM. L. REV. 341 (1871) ("we are inclined to think torts is not a proper subject for a law book"), cited in G. WHITE, *supra* note 16, at 1.

63. PROSSER & KEETON, *supra* note 7, § 3; see also Bohlen, *Fifty Years of Tort*, 50 HARV. L. REV. 725 (1937).

64. *Lynch v. Knight*, 9 H.L. Cas. 577, 598 (1861), cited in Magruder, *Mental and Emotional Disturbance in the Law of Torts*, 49 HARV. L. REV. 1033 (1936).

65. See generally O.W. HOLMES, *THE COMMON LAW* (1866).

66. *I de S et ux v. W de S*, Y.B. 22 Edw. III, F.99, pl. 60 (1348), quoted in *Dillon v. Legg*, 68 Cal. 2d 728, 441 P.2d 912, 69 Cal. Rptr. 71 (1967) (en banc). This famous textbook case involved the tale of the tavern-keeper's wife who, by the narrowest of margins, successfully avoided the

injury and awards damages that are not capable of exact or even approximate pecuniary measurement.⁶⁷ The key to recovery in these kinds of cases is the requirement of physical impact.⁶⁸ Aside from recovery for mental distress arising from the intentional torts of assault and battery, the courts soon found the issue presented in actions for negligence: the so-called "fright" cases.⁶⁹

Recovery for nervous shock and mental suffering caused by a defendant's negligence generally was denied in England and in America at the turn of the nineteenth century. In *Victorian Railways Commissioners v. Coultas*,⁷⁰ the English court held that a plaintiff is not entitled to recovery of damages for nervous shock caused by the defendant's negligence without proof that actual physical impact had taken place, proximately causing the plaintiff's resulting shock and other injuries.⁷¹ In the same year, the Supreme Court of New York denied recovery due to shock and fright caused by defendant's runaway horse.⁷²

In England, the rule against recovery was soon under attack.⁷³ Meanwhile, Ireland rejected *Coultas* and recovery was allowed.⁷⁴ Scotland also refused to follow *Coultas* in an almost identical case.⁷⁵ In 1915,

hatchet thrown at her by an angry customer. The action was allowed for her fright, and damages were awarded both as a reparation to the plaintiff and as a deterrent to such breaches of the King's peace.

67. See, e.g., *Beach v. Hancock*, 27 N.H. 223 (1853) (fear of personal injury when defendant aimed gun at plaintiff in an excited manner was reasonable and gave rise to cause of action for assault); *Trogden v. Terry*, 172 N.C. 540, 90 S.E. 583 (1916) (plaintiff awarded damages for humiliation and mental suffering).

68. See, e.g., *Draper v. Baker*, 61 Wis. 450, 21 N.W. 527 (1884) (physical impact requirement met when defendant spat in the face of plaintiff causing extreme outrage, humiliation and embarrassment); *Cracker v. Chicago & N.W. Ry.*, 36 Wis. 657 (1875) (physical impact requirement met when railroad conductor kissed a young school teacher causing her terror and anguish for which the court allowed compensatory damages for her outraged feelings, insulted virtue, and mental humiliation); cf. *Emmke v. DeSilva*, 293 F. 17 (8th Cir. 1923) (recovery allowed despite absence of physical impact when hotel manager entered plaintiff's room at night and, in vulgar and insulting language, accused her of being a common prostitute).

69. For an excellent discussion in this area of the law at the time of its development, see Bohlen, *Right to Recover for Injury Resulting from Negligence Without Impact*, 41 AM. L. REG. (n.s.) 141 (1902); Bohlen & Polekoff, *Liability in New York for the Physical Consequences of Emotional Disturbance*, 32 COLUM. L. REV. 409 (1932); Goodrich, *Emotional Disturbance as Legal Damage*, 20 MICH. L. REV. 497 (1922); and, Throckmorton, *Damages for Fright*, 34 HARV. L. REV. 260 (1921).

70. 13 App. Cas. 222 (1888). For a discussion of *Coultas*, see Throckmorton, *supra* note 69, at 261.

71. *Coultas*, 13 App. Cas. at 226.

72. *Lehman v. Brooklyn City R.R. Co.*, 54 N.Y. Sup. Ct. 355 (1888) (court could find neither principle nor authority, nor guidance from counsel to allow an action). For a discussion of *Lehman*, see Throckmorton, *supra* note 69, at 261.

73. See generally Throckmorton, *supra* note 69, at 261-70.

74. *Pugh v. London, Brighton and S. Coast Ry. Co.*, [1896] 2 Q.B. 248; *Delieu v. White & Sons*, [1901] 2 K.B. 669; see Throckmorton, *supra* note 69, at 261-62.

75. *Gilligan v. Robb*, 1910 1 Sess. Cas. 856 (plaintiff allowed recovery for illness due to nervous shock caused by defendant's runaway cow which bolted into her house). For a discussion of *Gilligan*, see Throckmorton, *supra* note 69, at 262.

England allowed recovery for damages due to nervous shock and fright without physical impact.⁷⁶ However, in America, the road was long for a plaintiff's recovery of damages for mental suffering or nervous shock caused by a defendant's negligence yet absent physical impact. Many jurisdictions steadfastly held to the rule of no recovery, while others overruled precedent and allowed recovery.⁷⁷ Still key to recovery in those jurisdictions that allowed damages for emotional trauma or nervous shock without physical impact was the requirement that there be some manifestation of physical illness accompanying the mental distress.⁷⁸

In the late 1920's and early 1930's, courts saw an increasing number of cases in which they could not, without obvious pretense, base recovery for mental distress on traditional concepts of liability, *i.e.*, technical assault or battery. Emerging was a need for legal protection of the plaintiff's emotional or mental well-being. In many cases, the defendant's conduct was so outrageous, exceeding all bounds of decent conduct in society, that the resulting infliction of mental distress was serious and deserving of legal protection.⁷⁹ Courts soon began to recognize intentional infliction of mental distress as a separate tort.⁸⁰ The jurisdictions, however, remained split as to whether some evidence of physical symptoms had to be shown in order to sustain a claim of intentional infliction of mental distress.⁸¹ In 1948, a section of the *Restatement of Torts* was

76. *Coyle v. Watson*, 1915 A.C. 1, 13-14 (emphasis added):

But in England, in Scotland, and in Ireland alike, the authority of *Victorian Railways Commission v. Coultas* has been questioned, and to speak quite frankly, has been denied. I am humbly of the opinion that the case can no longer be treated as decision guiding authority. . . . I should add that other cases were cited showing it to be fully established by authority—that *physical impact or lesion is not a necessary element in the case of recovery of damages in ordinary cases of tort*.

For a discussion of *Coyle*, see Throckmorton, *supra* note 69, at 263.

77. The requirement of physical impact in many jurisdictions in America was stretched to the barest minimum—to the point of absurdity—where the actual impact could not possibly have resulted in the injury complained of but served only as a technical basis upon which to award damages for mental distress. PROSSER & KEETON, *supra* note 7, § 54, at 363-64.

78. As with the requirement of physical impact, see *supra* note 77, the requirement of accompanying physical symptoms was also stretched to an absurd minimum in awarding damages for mental distress, *i.e.*, fainting, nausea, stomach pain, inability to eat and sleep, and weight loss. PROSSER & KEETON, *supra* note 7, § 54, at 363. *But see* Throckmorton, *supra* note 69, at 275-81 (supports continued recognition of an action where the physical injury complained of is shock caused by fright).

79. The roots of the law of outrage is generally credited to *Wilkinson v. Downton*, [1897] 2 Q.B. 57, where a practical joker told a woman that her husband lay seriously injured down the street and that she should go get him at once; consequently, she suffered extreme emotional distress and physical incapacity for several months. The court deemed the defendant's conduct to be so far beyond all socially acceptable norms that an award for tort damages should be granted. PROSSER & KEETON, *supra* note 7, § 12, at 60-65.

80. See, *e.g.*, *Stephens v. Waits*, 53 Ga. App. 144, 184 S.E. 781 (1936); *Gadbury v. Bleitz*, 133 Wash. 134, 233 P.2d 299 (1925).

81. See, *e.g.*, *Kirby v. Jules Chain Stores Corp.*, 210 N.C. 808, 188 S.E. 625 (1936) (physical

rewritten to exclude the necessity of showing physical illness or symptoms as evidence of mental distress.⁸² Thus, the door was opened to allow an independent action for mental distress where plaintiff's emotional injury was caused by the defendant's outrageous, reckless, or unconscionable conduct. The requirements of actual physical impact and accompanying physical symptoms were no longer necessary to maintain such an action and recover damages for mental distress.⁸³ The *Restatement (Second) of Torts* retained the 1948 supplemental note.⁸⁴

D. "Convergence Of The Twain"⁸⁵

Whereas *Hadley* and its progeny in contract law have a history of limitation, tort law has a history of expansion, culminating in the protection of a plaintiff's emotional well-being through the independent tort of negligent or intentional infliction of mental injury. The publication of *Restatement (Second) of Torts* section 46,⁸⁶ and two major California cases,⁸⁷ established that tort liability may stem from contractual obligations. Emotional injury resulting from a breach of those contractual obligations, where the breach is willful, wanton or in total disregard of a promisee's rights, constitutes an independent tort: bad faith breach of contract.

symptoms not required); but see, e.g., *Carrigan v. Henderson*, 192 Okla. 254, 135 P.2d 330 (1943) (physical symptoms required).

82. RESTATEMENT OF TORTS § 46 (Supp. 1948). This amendment was retained and incorporated into comment k of the RESTATEMENT (SECOND) OF TORTS § 46 (1964).

83. See *Dillion v. Legg*, 68 Cal. 2d 728, 733-34, 441 P.2d 912, 919, 69 Cal. Rptr. 71, 79 (1968) (en banc) (citation omitted):

In sum the application of the tort law can never be a matter of mathematical precision. In terms of characterizing conduct as tortious and matching a money award to the injury suffered as well as in fixing the extent of the injury, the process cannot be perfect. Undoubtedly, ever since the ancient case of the tavern-keeper's wife who successfully avoided the hatchet cast at her by an irate customer . . . defendant's have argued that plaintiff's claim of injury from emotional trauma might be fraudulent. Yet we cannot let the difficulties of adjudication frustrate the principle that there be a remedy for every substantial wrong.

84. RESTATEMENT (SECOND) OF TORTS § 46 (1964):

(1) One who by extreme and outrageous conduct intentionally or recklessly causes severe emotional distress to another is subject to liability for such emotional distress, and if bodily harm to the other results from it, for such bodily harm.

(2) Where such conduct is directed at a third person, the actor is subject to liability if he intentionally or recklessly causes severe emotional distress

(a) to a member of such person's immediate family who is present at the time, whether or not such distress results in bodily harm or,

(b) to any person who is present at the time, if such distress results in bodily harm.

85. T. HARDY, *THE CONVERGANCE OF THE TWAIN IN ENGLISH LITERATURE: A COLLEGE ANTHOLOGY* 909 (D. Clark ed. 1960). The title of this section is borrowed from Hardy for its metaphorical value in illustrating that opposing ideas often come together. In their convergence, a new idea is born and a new era is ushered in, leaving behind historical fragments of once separate paths.

86. RESTATEMENT (SECOND) OF TORTS § 46 (1964).

87. *Gruenburg v. Aetna Ins. Co.*, 9 Cal. 3d 556, 510 P.2d 1033, 108 Cal. Rptr. 480 (1973); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

III. THEORETICAL BASIS AND ELEMENTS OF THE TORT OF BAD FAITH BREACH OF CONTRACT

The foundation of the tort of bad faith breach of contract derives from both tort and contract theory. Under traditional contract theory, the purpose of an agreement is to secure a bargained-for exchange of goods or services. A meeting of the minds is required to seal the bargain.⁸⁸ Under tort theory, the formation of certain contracts gives rise to the element of emotional or mental well-being, in addition to the objective of the agreement. This is demonstrated where the nature of the contract induces emotional security or peace of mind. The insurance contract is the leading example of a personal contract.⁸⁹ Within our society, tort law serves to implement standards of acceptable conduct. Because tort law reflects social policy and provides a remedy where unacceptable conduct causes injury, the will or intention of contracting parties may have significance beyond the terms of the contract.⁹⁰ Thus, a promisor stands in a special relationship with the promisee. When a promisor breaches a contract without reasonable grounds, and negligently, maliciously or flagrantly disregards a promisee's rights, his conduct is in bad faith. Such conduct gives rise to tort liability.

A contract is a promise or set of promises, the breach of which the law provides a remedy, or the performance of which the law recognizes a duty.⁹¹ The duty to perform an obligation in contract is fundamental. However, a breach generally imposes no liability beyond express terms of the agreement, except where such damages were foreseeable and within the contemplation of the parties when the contract was made.⁹² A tort also may be defined so as to impose a duty, other than contract performance, that when breached provides a remedy in the form of an action and damages at law.⁹³ Tort duty is implied in law and is imposed without the consent of the parties, unlike the law of contracts which looks to the voluntary consent of the parties in the agreement, the terms and objectives having been mutually agreed upon. While not every breach of contract is willful,⁹⁴ the law of contracts provides defenses for breach where the contract has become impossible to perform or where performance has

88. See *Gruenberg*, 9 Cal. 3d at 577-78, 510 P.2d at 1040-42, 108 Cal. Rptr. at 487-88; *Crisci*, 66 Cal. 2d at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.

89. See *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

90. See generally PROSSER & KEETON, *supra* note 7.

91. RESTATEMENT (SECOND) OF CONTRACTS § 1 (1979).

92. Recall that the rules of *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854) have been adopted by the RESTATEMENT (SECOND) OF CONTRACTS. See *supra* note 47 and accompanying text.

93. See generally PROSSER & KEETON, *supra* note 7.

94. For an excellent discussion and analysis of the element of "willfulness" in breach of contract, see Marschall, *Willfulness: A Crucial Factor in Choosing Remedies for Breach of Contract*, 24 ARIZ. L. REV. 733 (1982).

otherwise been excused.⁹⁵ In tort, negligence may be defended on the grounds of last clear chance, contributory negligence, or otherwise where the limitation of proximate cause has been exceeded.⁹⁶ As for the tort of bad faith breach of contract, the plaintiff generally must establish: (1) the existence of a contract conforming to traditional contract construction, thereby creating the duty of performance and the implied-in-law duty of good faith and fair dealing; (2) the contract objective, which gives rise to the foreseeable expectation that the promisee has emotional or mental security in the performance of the contract; and (3) the promisor's breach, which, without reasonable grounds, inflicted mental distress as a direct, material, and natural result of the breach.⁹⁷

The recognition and acceptance of the interest in protecting a plaintiff's emotional well-being provides the basis for a bad faith breach of contract cause of action. Allowing recovery in tort where a party suffers mental injury as a result of another's conduct was necessary in the evolution of this cause of action. The limitations of physical impact and symptoms had to be overcome.⁹⁸ In contract, the scope of foreseeability has expanded; the concept of remoteness is narrowing; and parties to contracts dealing with special relationships or circumstances are increasingly held to have contemplated a wider range of damages.⁹⁹ The implied-in-law contract's covenant of good faith and fair dealing combined with the interest in protecting a plaintiff's emotional well-being forms the basis for tortious breach of contract.¹⁰⁰

A. *The Interest in Protecting Plaintiff's Emotional Well-Being*

The recognition in tort of both negligent and intentional infliction of emotional distress¹⁰¹ set the stage for the transition into breach of contract. In *Stewart v. Rudner*,¹⁰² the defendant physician breached an agreement to perform a Caesarean section to deliver plaintiff's child. The breach resulted in a stillbirth and caused severe emotional trauma for the mother. The court admitted that the time "had come to realize, slowly it is true, that the law protects interests in personality, as well as the physi-

95. E. FARNSWORTH, *supra* note 5, § 12.14.

96. See PROSSER & KEETON, *supra* note 7.

97. See Bolla, *Contort: New Protector of Emotional Well-Being in Contract?*, 19 WAKE FOREST L. REV. 561, 564 (1983).

98. See *supra* note 77 and accompanying text.

99. Bolla, *supra* note 97, at 565.

100. Bolla suggests six variations to the theme of tortious breach of contract, all of which may provide a remedy in tort: (1) damages for a tortious breach of contract with foreseeable emotional injury; (2) tortious breach of the covenant of good faith and fair dealing independent of the tort of intentional infliction of emotional distress; (3) extreme and outrageous conduct accompanying the contract breach; (4) actions sounding in tort yet based on contract; (5) intentional infliction of emotional distress; and (6) breach of an implied covenant. *Id.* at 567-68.

101. See PROSSER & KEETON, *supra* note 7.

102. 349 Mich. 459, 84 N.W.2d 816 (1957).

cal integrity of the person, and that emotional damage is just as real (and just as compensable) as physical damage."¹⁰³

Two lines of thought exist for jurisdictions that, like *Stewart*, allow relief for mental anguish arising from a breach of contract. Despite which line is followed, the interest in protecting a plaintiff's emotional well-being deriving from a breach of contract is still advanced. The first line of reasoning states that where a contractual duty has as its primary objective mental or emotional security, or deals in a significant way with the feelings of the party to whom the duty is owed such that a breach of the duty would reasonably and directly result in mental anguish, then recovery of tort damages is allowed.¹⁰⁴ Courts following this reasoning generally tend to adhere to traditional contract analysis, distinguishing between personal and commercial contracts.¹⁰⁵ The primary objective of the personal contract must be to give rise to tort damages upon a breach. If the contract demonstrates such an objective, the inquiry turns to the conduct of the breaching party. Due to the nature of the personal contract,¹⁰⁶ courts consider mental injury to occur as a result of the breach and that the breach was within the contemplation of the parties. When proven, the court deems the mental injury a direct and natural (*i.e.*, foreseeable) result of the breach, and the issue of tort damages may go to the jury. Where the additional element of aggravation is present, punitive damages may be awarded.¹⁰⁷

The second line of reasoning requires the recognition of a tort independent from the contract breach before allowing recovery for resulting mental anguish.¹⁰⁸ Usually, the independent tort is in the form of a bad faith breach of the implied-in-law covenant of good faith and fair dealing.¹⁰⁹ In so doing, the courts do not stretch the traditional concept of special or consequential damages in contract to include tort damages for emotional distress. Where a separate tort is committed, albeit concurrent with a contract breach, the parties need not have contemplated the tort damages. Tort duty is implied in law—without the consent of the

103. *Id.* at 467, 84 N.W.2d at 822.

104. Bolla, *supra* note 97, at 566.

105. A personal contract is one that adds mental and emotional security to its primary objective of economic protection. See, e.g., *F. Becker Asphaltum Co. v. Murphy*, 224 Ala. 655, 141 So. 630 (1932); *Stewart v. Rudner*, 349 Mich. 459, 84 N.W.2d 816 (1957); *Stanback v. Stanback*, 297 N.C. 181, 254 S.E.2d 611 (1979). See generally Louderback, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F.L. REV. 187 (1982).

106. See *supra* discussion at p. 39-41.

107. See, e.g., *Stanback v. Stanback*, 297 N.C. 181, 254 S.E.2d 611 (1979); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976); *Oestreicher v. American Nat'l Stores Inc.*, 290 N.C. 118, 225 S.E.2d 797 (1976); see also Comment, "Extra-Contractual" Remedies for Breach of Contract in North Carolina, 55 N.C.L. REV. 1125 (1977).

108. See, e.g., *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

109. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

parties—and all proximately caused damages are recoverable. Similarly, tort damages need not be “foreseeable,” the limitation in tort being that of proximate cause. If the conduct of the party in breach was indeed tortious, he becomes liable for all injuries proximately caused by the conduct.¹¹⁰ Punitive damages may be awarded upon a showing of aggravating factors accompanying the commission of a tort.¹¹¹

B. *The Bad Faith Insurer*

In dealing with the tort of bad faith breach of contract, a “tortious” breach must be distinguished from an innocent breach. An innocent breach may arise from either a misunderstanding of the scope of the obligation or a valid inability to perform. However, when a promisor induces a promisee to rely on his promise, one he never intended to perform, the promisor acted fraudulently or misrepresented his promise. Hence, a tortious breach occurs. A further problem exists where the promisor’s failure or refusal to perform is based upon the promisor’s own interests, rather than upon fraud, honest mistake, or inability. His intention, nonetheless, was not to fulfill his obligations under the contract. This is the area of the tort of bad faith breach of contract.¹¹²

Many jurisdictions, most notably California,¹¹³ have allowed recovery based upon bad faith breach of contract in the field of insurance. As previously stated, the insurance policy is a personal contract creating a special relationship between the insurer and the insured. The insured has secured no “real” commercial advantage in the contract because the very purpose of the agreement is to provide coverage against the economic loss he would suffer had he not purchased the policy. An inference may be made that the loss which occurs as a result of an insurer’s bad faith refusal to pay a valid claim is the very loss that was *contemplated* by the parties to the contract.

The nature of the insurance contract makes such a contract suitable for recognizing that a bad faith breach should be actionable in tort. Insurance contracts are, for the most part, contracts of adhesion. The insured is offered a policy full of fine print and must either take or leave the policy as is. To the extent he has bargained at all, the policyholder contracts for financial security and the peace of mind and emotional well-being that a bad faith breach would deny him.¹¹⁴ Loss of the policyholder’s peace of mind and mental security is deemed to have been clearly within the contemplation of the parties at the time the agreement

110. See generally PROSSER & KEETON, *supra* note 7.

111. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

112. See generally Bolla, *supra* note 97.

113. See, e.g., Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

114. Crisci, 66 Cal. 2d at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19.

was made.¹¹⁵ One way to avoid the “contemplation of the parties” issue as raised by *Hadley* is to recognize that a covenant of good faith and fair dealing exists between insurer and insured which requires that neither party impair the contractual rights or benefits of the other. In *Gruenberg v. Aetna Insurance Company*,¹¹⁶ the court explained this duty:

It is the obligation, deemed to be imposed by law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.¹¹⁷

Application of this reasoning to a bad faith breach amounts to an intentional tort, separate and apart from the contract, resulting from a breach of an implied-in-law duty created by the nature of the contract and the special relationship of the parties to the contract.

The distinction between bad faith in tort and contract turns on the nature of the duty breached. An intentional contract breach is a violation of a promise to complete the contracted-for performance. The duty to act in good faith and to deal fairly is implied in law and its breach gives rise to tort damages.¹¹⁸ The parties contract voluntarily and exchange mutual promises to perform their contractual obligations. The duty of good faith and fair dealing is implied without the consent of the parties and in this sense, is involuntary. A contract places the parties in a special relationship for the performance of certain obligations; the disregard or violation of the duty imposed by law as a result of the contractually established relationship is a separate intentional wrong—the tort of bad faith breach of contract.¹¹⁹

IV. PUBLIC POLICY CONSIDERATIONS IN ADOPTION OF THE TORT OF BAD FAITH BREACH OF CONTRACT

Economic self-interest is a factor inherent in business and commercial activity.¹²⁰ Judicial reluctance to impose tort liability for breach of con-

115. See *Stewart v. Rudner*, 349 Mich. 459, 465, 84 N.W.2d 816, 824 (1957):

When we have a contract concerned not with trade and commerce but with life and death, not with profit but with elements of personality, not with pecuniary aggrandizement but with matters of mental concern and solicitude, then a breach of duty with respect to such contracts will inevitably and necessarily result in mental anguish, pain and suffering. In such cases the parties may reasonably be said to have contracted with reference to the payment of damages therefor in event of breach. Far from being outside the contemplation of the parties, they are an integral and inseparable part of it.

116. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

117. *Id.* at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485.

118. *Hart v. Ludwig*, 347 Mich. 559, 79 N.W.2d 895 (1956).

119. *Bolla*, *supra* note 97, at 575.

120. C. AMMER & D. AMMER, *DICTIONARY OF BUSINESS AND ECONOMICS* 379-80 (1977). See

tract stems from an unofficial acceptance that economic factors motivate breach.¹²¹ The remedies available under traditional contract theory, whether involving intentional breach or not, do not substantially deter a bad faith breach.¹²²

A. Allocation of Risk

If contract breaches are too harshly sanctioned, the result not only would deter breaches but also would curtail execution of contracts. Such sanctions are not in keeping with classical economic theory and may not be a desirable social policy.¹²³ If courts routinely allowed legal liability to exceed the promisee's actual pecuniary losses, efficient reallocation of resources would be interrupted and the cost ultimately would be paid by society. The law of contracts evolved within this system of risk allocation.¹²⁴

Allowing tort recovery for a bad faith breach of contract has been at odds with the theoretical basis of contract. Defining bad faith as an intentional, willful, selfishly motivated breach of contract is only to acknowledge the covert rationale: the bad faith breach is often anticipated and encouraged by economic efficiency. The freedom of parties to contract, to agree to buy and sell, or to provide services, is fundamental to commercial enterprise. An associated policy concern, as stated by one court, is that:

When two or more persons competent for that purpose upon a sufficient consideration, voluntarily agree to do or not to do a particular thing which may be lawfully done or omitted, they should be held to the consequences of their bargain. It is elementary that public policy requires that such contracts be held sacred and shall be enforced by the courts of justice unless some other overpowering rule of public policy intervenes which renders such agreement illegal or unenforceable. This rule imposes upon the court a duty to give contracts of that character effect especially when they have been acted upon by the parties. Without such a rule the commerce of the world would soon lapse into a chaotic state.¹²⁵

generally A. ALCHIAN & W. ALLEN, UNIVERSITY ECONOMICS: ELEMENTS OF INQUIRY 24-25 (3d ed. 1972).

121. Diamond, *The Tort of Bad Faith Breach of Contract: When, if at all, Should it Extend Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425, 429 (1981).

122. *Id.* at 435.

123. It is in society's interest that each individual reallocate his resources whenever it makes him better off without making some other unit worse off. Since reallocation through breach will not make the injured party worse off if his expectations are protected by preserving his planned allocation of resources, and will, by hypothesis, make the party in breach better off, it is in society's interest that the contract be broken and the resources be reallocated. *Id.* at 437 (citing E. FARNSWORTH & W. YOUNG, CASES AND MATERIALS ON CONTRACTS 20 (1980)).

124. See generally E. FARNSWORTH, *supra* note 5.

125. *Bliss v. Southern Pac. Co.*, 212 Or. 634, 646, 321 P.2d 324, 330 (1958).

Judicial reluctance in accepting the tort of bad faith breach of contract is valid where purely commercial contracts are involved. Still, exceptions to the general rule have been allowed where the nature of the contract relates to matters other than strictly pecuniary interest.¹²⁶

B. *Distinguishing Personal and Commercial Contracts*

The majority of jurisdictions that either recognize the tort of bad faith or allow damages based on some other tort (*i.e.*, fraud, misrepresentation, or infliction of emotional distress) distinguish between personal and commercial contracts, allowing damages in tort for the former but limiting damages in contract for the latter.¹²⁷ The policy concerns associated with personal contracts are viewed somewhat differently than those with commercial contracts. The personal contract usually creates a special relationship between the promisor and the promisee. This relationship may be characterized along the lines of "quasi-fiduciary."¹²⁸

Public policy considerations become paramount once the nature of an insurance contract is examined. The insured contracts for certain protection against loss for which the insurer agrees to indemnify. Should the insurer in bad faith refuse to pay a valid claim, the insured is left with added expenses and mental anxiety. The insured seeks no commercial advantage in purchasing insurance and in most cases is compelled to do so by law (*e.g.* automobile insurance). He is usually subject to less-than-equal bargaining power; insurance contracts are in essence contracts of adhesion. Furthermore, the insurance industry is regulated and, a legitimate policy concern exists for protecting the public from unfair practices.¹²⁹ Therefore, policy considerations that rely on the fear of interference with commercial activity are misplaced when personal contracts are involved. The inverse, however, rings true. Public policy dictates that bad faith breach of personal contracts should be enforced through the awarding of tort damages, not only to compensate the injured party but to serve as a general deterrent against bad faith breach.¹³⁰

126. *Stanback v. Stanback*, 297 N.C. 181, 254 S.E.2d 611 (1979) (separation agreement held to be a personal contract involving more than mere pecuniary gain).

127. See generally *Louderback*, *supra* note 105.

128. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 52, 157 Cal. Rptr. 482 (1979) (A personal contract carries with it certain obligations by the promisor that he will abide by the contract to insure that the promisee's expected benefits are protected; thus, the promisor stands almost in a fiduciaries' shoes when dealing with the promisee.).

129. See generally *Best, Statutes and Regulations Controlling Life and Health Insurance Claim Practices*, 29 DEF. L.J. 115 (1982). For an in-depth analysis of whether the tort of bad faith breach of contract should extend beyond insurance or personal contracts, see *Louderback*, *supra* note 105, and *Diamond*, *supra* note 121.

130. See *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 462, 521 P.2d 1103, 1109, 113 Cal. Rptr. 711, 717 (1974) ("Defendant's failure to afford relief to its insured against the very eventuality insured against . . . amounts to a violation as a matter of law of its duty of good faith and fair dealing implied in every policy.").

C. *Litigation in the Courts*

The fear of spurious litigation has historically affected the development of tort doctrine, and has occasionally been a determinative factor in refusing to expand tort liability though such expansion may have been warranted.¹³¹ The same fears were espoused when consequential damages were permitted in contract and when strict liability and infliction of emotional distress were recognized in torts.¹³² So too, have similar fears surrounded the recognition of the tort of bad faith breach of contract.¹³³

Assuming sanctions imposed for bad faith breach are sufficient to induce an injured promisee to sue, the sanctions, at least theoretically, should be sufficient to induce a promisor not to act in bad faith and breach a contract.¹³⁴ Those who would breach a contract at the promisee's expense are discouraged from engaging in the tortious conduct lest the penalty of tort liability be levied upon them. Where a tortious breach does occur, the promisee should be allowed to seek a tort remedy for the promisor's tortious conduct. To the extent that tort principles deter wrongful conduct,¹³⁵ the need for litigation traditionally decreases after the initial surge of complaints.¹³⁶

V. SHOULD THIS INFANT TORT BE ALLOWED TO GROW IN NORTH CAROLINA?

As of this writing, the question titling this section has yet to be definitively answered in North Carolina. However, a discernable trend suggests the answer will be in the affirmative. The recognition and acceptance of the tort of bad faith breach of contract has been a primary issue in four North Carolina cases.¹³⁷ Prior to the first of these cases, *Oestreicher v. American National Stores, Inc.*,¹³⁸ North Carolina held fast to the traditional maxim: "Punitive (tort) damages are not awarded for breach of contract."¹³⁹ However, courts have ruled that certain behavior, once surpassing the bounds of decent conduct, is tortious and should be deterred. In such cases, some courts have gone to great lengths to

131. See generally PROSSER & KEETON, *supra* note 7, §§ 1-12.

132. See generally E. FARNSWORTH, *supra* note 5; PROSSER & KEETON, *supra* note 7.

133. Diamond, *supra* note 121, at 429.

134. *Id.* at 449-50.

135. The foremost examples are the products and strict liability cases. Products liability spurred industry to insure the safety of their products before presenting them to the public for sale. Strict liability stands for the proposition that all persons engaging in ultra-hazardous activities would be held strictly liable for resulting damages. See PROSSER & KEETON, *supra* note 7.

136. Diamond, *supra* note 121, at 449.

137. Stanback v. Stanback, 297 N.C. 181, 254 S.E.2d 611 (1979); Newton v. Standard Fire Ins. Co, 291 N.C. 105, 229 S.E.2d 297 (1976); Oestreicher v. American Nat'l Stores, Inc., 290 N.C. 118, 225 S.E.2d 797 (1976); Dailey v. Integon Gen. Ins. Corp., 75 N.C. App. 387, 331 S.E.2d 148 (1985).

138. 290 N.C. 118, 225 S.E.2d 797 (1976).

139. See, e.g., King v. Insurance Co., 273 N.C. 396, 398, 159 S.E.2d 891, 893 (1968).

separate and identify an independent tort so as to be actionable outside the contract.¹⁴⁰ Also pre-dating *Oestreicher*, North Carolina adhered to the idea that "aggravating factors" must accompany the tortious conduct. Alternatively, the conduct, though tortious in nature, would be deemed dependent upon and limited to the contract action, thereby subjecting the claim to the traditional elements of foreseeability, contemplation of the parties, remoteness, and certainty.¹⁴¹

A. *Oestreicher v. American National Stores, Inc.*¹⁴²

Oestreicher involved a commercial lease agreement between two business enterprises. The defendant leased a building from the plaintiff for the purpose of operating a retail furniture business. The lease provided that the defendant was to pay minimal rent plus five percent of its net sales income above a stated amount.¹⁴³ Thirteen years later, plaintiff sued, alleging that defendant fraudulently misrepresented its net sales for nine years, depriving the plaintiff of \$11,233.20 due under the lease.¹⁴⁴ Plaintiff claimed that the fraudulent reporting of sales breached the lease agreement. Plaintiff further requested an award of punitive damages based on fraud and misrepresentation.¹⁴⁵

The trial court granted summary judgment for the defendant on the issue of punitive damages.¹⁴⁶ The North Carolina Court of Appeals dismissed plaintiff's appeal as improperly interlocutory,¹⁴⁷ and after granting discretionary review, the supreme court held that the breach of contract and punitive damages claims were improperly severed.¹⁴⁸ The court would not allow the tort (punitive damages) action to be severed from the breach of contract action because the plaintiff has a substantial right to have both causes heard before the same judge and jury. The court ordered the issue of punitive damages returned to the jury for determination, stating that while this was a "type of contract case," the case nonetheless contained "substantial tort overtones emanating from

140. See, e.g., *Binder v. GMAC*, 222 N.C. 512, 23 S.E.2d 894 (1943); *Woody v. First Nat'l Bank*, 194 N.C. 549, 140 S.E. 150 (1927); *Carmichael v. Southern Bell Tel. & Tel. Co.*, 157 N.C. 21, 72 S.E. 619 (1911). Notable among the exceptions are the breach of contract to marry, carrier cases, and the casket cases. See cases cited *supra* note 60.

141. Comment, *supra* note 107, at 1134.

142. 290 N.C. 118, 225 S.E.2d 797 (1976).

143. *Id.* at 120, 225 S.E.2d at 799.

144. *Id.* at 132-33, 225 S.E.2d at 806-07.

145. *Id.* at 132, 225 S.E.2d at 806-07.

146. *Id.* at 121, 225 S.E.2d at 800.

147. *Oestreicher v. American Nat'l Stores, Inc.*, 27 N.C. App. 330, 330, 219 S.E.2d 303, 304 (1975).

148. *Oestreicher*, 290 N.C. at 130, 225 S.E.2d at 805 ("The causes of action that the plaintiff alleges are related to each other. He seeks punitive damages in the second cause because of the alleged misconduct of defendant in the first cause of action.").

the fraud and deceit."¹⁴⁹

The *Oestreicher* court struggled with precedent that denied recovery for tort damages as a result of a breach of contract. A large hurdle was presented by *Swinton v. Savoy Realty Company*,¹⁵⁰ a 1953 case that involved fraud. In *Swinton*, the court reversed a jury award for punitive damages based on the theory that "there must be an element of aggravation accompanying the tortious conduct which causes the injury,"¹⁵¹ concluding that "[f]raud is not an accompanying element of an independent tort but the particular tort alleged."¹⁵² Therefore, *Swinton* stands for the proposition that upon a breach of contract, in order to take the issue of punitive damages to the jury, an independent tort with attendant aggravating circumstances must be present.¹⁵³

The court in *Oestreicher* characterized the issue to be decided as one dealing with "damages for fraud arising from a contract agreement."¹⁵⁴ Another issue was whether defendant's tortious conduct demonstrated sufficient bad intent to award punitive damages to the plaintiff, or whether additional aggravating factors were needed.¹⁵⁵ First, the court read *Swinton* to mean that in breach of contract actions where tort damages are alleged, the issue may reach the jury upon a showing of an independent tort actionable outside the contract.¹⁵⁶ Second, finding that the fraud perpetrated by the defendant upon the plaintiff was an independent tort, the court decided that the fraud itself was sufficient aggravation to warrant punitive damages and that additional aggravating factors were unnecessary.¹⁵⁷

The majority in *Oestreicher* did not clearly state whether a distinct, independent tort must be found in a breach of contract action before the issue of tort damages could go to the jury. When the court says punitive damages may be recovered where "breach of contract actions . . . smack of tort" and have "substantial tort overtones,"¹⁵⁸ uncertainty is created

149. *Id.*

150. 236 N.C. 723, 73 S.E.2d 785 (1953). *Swinton* involved a fraudulent sale of land. The plaintiffs were uneducated blacks who had paid \$2000 for land that the seller had said was a larger tract than it actually was. After paying for the land, the plaintiffs received a deed that was one-tenth the size that it was represented to be by the seller at the time they contracted to purchase. The plaintiffs sought contract damages and punitive damages for the fraud. The court denied the claim for punitive damages. *Id.* at 724-25, 73 S.E.2d at 785-88.

151. *Id.* at 725, 73 S.E.2d at 786.

152. *Id.*

153. *Id.* at 726, 73 S.E.2d at 786. Note that the "aggravating factors" test generally has been applied to all tort cases where punitive damages were sought. Application of this test seems a logical extension to breach of contract actions where tort damages are sought. See Comment, *supra* note 107, at 1134.

154. *Oestreicher*, 290 N.C. at 133, 225 S.E.2d at 807.

155. *Id.*

156. *Id.* at 135, 225 S.E.2d at 808.

157. *Id.* at 136, 225 S.E.2d at 808.

158. *Id.*

as to exactly what standard is to be applied.¹⁵⁹ Nonetheless, the decision opened the door to allow victims of contract breach arising from a defendant's tortious conduct (fraud) to reach the jury with a claim for punitive damages.

B. *Newton v. Standard Fire Insurance Company*¹⁶⁰

Decided the same year as *Oestreicher*, *Newton* differed substantially on its facts. Plaintiff, owner-operator of a retail business, purchased an insurance policy from the defendant which provided theft coverage. Plaintiff filed a claim for losses under the policy when his store was burglarized. Defendant refused to pay the claim.¹⁶¹ The plaintiff sought compensatory and punitive damages alleging that defendant's conduct was "heedless, wanton and oppressive" in refusing to "properly settle" the claim.¹⁶²

Once again, the trial court disallowed the claim for punitive damages on the stated ground that North Carolina law did not permit punitive damages in breach of contract actions.¹⁶³ On appeal, the supreme court stated that a party claiming punitive damages in a breach of contract action did have a substantive right to be heard on both issues by the same trial court and jury.¹⁶⁴

The majority in *Newton* upheld the rule that punitive damages may be awarded where an independent tort exists separate and apart from the breach of contract claim.¹⁶⁵ The court specifically overruled *Swinton*, distinguishing simple from aggravated fraud, and permitted punitive damages for the latter but not the former.¹⁶⁶ The plaintiff argued that the defendant's conduct amounted to a separate tort for which punitive damages should be awarded. The *Newton* court responded by affirming the dismissal of punitive damages, stating that the circumstances in the case fell short of proving the required tort. However, the court indicated that punitive damages would have been proper had either of three cir-

159. Chief Justice Sharp dissented in *Oestreicher*, implying that the majority was taking a radical departure from traditional contract theory and was in effect creating a new rule distinguishable from *Swinton* which the majority purportedly followed. The chief justice insisted that plaintiff's only rights were those for which plaintiff contracted, and any recovery beyond those terms unjustly enriched the plaintiff. Moreover, Chief Justice Sharp argued that if the plaintiff had an action in tort for fraud, the fraud was not proven sufficiently to cause separation from the breach of contract action. *Oestreicher*, 290 N.C. at 146, 225 S.E.2d at 814 (Sharp, C.J., dissenting in part and concurring in part).

160. 291 N.C. 105, 229 S.E.2d 297 (1976).

161. *Id.* at 109, 229 S.E.2d at 300.

162. *Id.* at 110, 229 S.E.2d at 300. Plaintiff sought \$5500 in compensatory damages and \$50,000 in punitive damages. *Id.*

163. *Newton v. Standard Fire Ins. Co.*, 27 N.C. App. 168, 218 S.E.2d 232 (1975).

164. *Newton*, 291 N.C. at 168, 218 S.E.2d at 232.

165. *Id.* at 111, 229 S.E.2d at 301.

166. *Id.* at 113-14, 229 S.E.2d at 302.

cumstances been proven: (1) fraud; (2) that the insurer had refused to investigate the claim; or, (3) that after investigating the insurer found the claim to be valid but still refused to settle with the intention of causing further harm to the plaintiff.¹⁶⁷

Newton is important for its conceptual analysis of the tort of bad faith by Justice Exum in dictum.¹⁶⁸ Phrased differently, the question before the court may have been whether the alleged oppressive conduct of the defendant insurer amounted to bad faith and, thus, an independent tort sufficient to warrant tort damages. Recognizing that California pioneered the concept of bad faith breach as a tort,¹⁶⁹ Justice Exum looked to several California cases for a definition of the tort.¹⁷⁰ The court subsequently concluded:

Because of the great disparity of financial resources which generally exists between insurer and insured and the fact that insurance companies, like common carriers and utilities, are regulated and clearly affected with a public interest, we recognize the wisdom of a rule which would deter refusals on the part of insurers to pay valid claims when the refusals are both unjustified and in bad faith.¹⁷¹

Although *Newton* may indicate that the court was carefully treading its way into recognizing the tort of bad faith breach of contract, this the court would not do:

Insurer's knowledge that plaintiff was in a precarious financial position in view of his loss does not in itself show bad faith on the part of the insurer in refusing to pay the claim, or for that matter, that the refusal was unjustified. . . . Had plaintiff claimed that after due investigation by defendant that the claim was valid and defendant nevertheless refused to pay or that defendant refused to make any investigation at all, and that defendant's refusals were in bad faith with an intent to cause further damages to plaintiff, a different question would be presented.¹⁷²

Without explicitly approving the California definition of "bad faith," the *Newton* court nevertheless used the term without providing a definition of its own, leaving future courts uncertain as to whether the tort of bad faith should be recognized in North Carolina. Moreover, courts are still without guidelines as to the actionable elements of the tort. The court sent plaintiff *Newton* away with only his contract rights intact. He

167. *Id.* at 115-16, 229 S.E.2d at 303. Justice Exum went to great lengths in the *Newton* opinion to outline the policy in North Carolina in awarding punitive damages. This discussion may have been in response to Chief Justice Sharp's dissenting opinion in *Oestreicher*. *Id.* at 113, 229 S.E.2d at 302. See Comment, *supra* note 107, at 1142.

168. 291 N.C. at 114-15, 229 S.E.2d at 303.

169. *Id.*

170. *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

171. *Newton*, 291 N.C. at 116, 229 S.E.2d at 303.

172. *Id.* at 115-16, 229 S.E.2d at 303.

had failed to show the necessary aggravation vis-a-vis fraud to give rise to punitive damages, and the court refused to recognize any other action in tort.¹⁷³ Clinging to a dichotomy between contract and tort, and unable to reconcile its differences, the court in *Newton* held that claims for relief must fall within one or the other, and denied the introduction of bad faith breach of contract in North Carolina.

C. *Stanback v. Stanback*¹⁷⁴

In *Stanback*, the plaintiff-wife sued defendant-husband for alleged breach of a separation agreement seeking recovery of actual, compensatory, and punitive damages. The trial court dismissed all claims except that of actual damages. The North Carolina Court of Appeals affirmed.¹⁷⁵ On discretionary review,¹⁷⁶ the North Carolina Supreme Court held that the complaint failed to state a claim for consequential damages but sufficiently stated a claim for punitive damages for intentional infliction of emotional distress.¹⁷⁷

The court in *Stanback* began its analysis by stating the problem in contract terms: "[The] limitation on the recovery of damages for breach of contract was first enunciated in the famous English case of *Hadley v. Baxendale*."¹⁷⁸ The court outlined the general theory of recovery in traditional contract construction.¹⁷⁹ The court noted that when recovery is sought for mental anguish as a result of the breach, the general rule is that of denial based on policy concerns of limiting contractual risk with or without the formal application of the *Hadley* test.¹⁸⁰ However, the court pointed out a line of cases that excepted to the general rule¹⁸¹ and more recent attempts to formulate a standard test for allowing recovery for mental anguish in a wider range of cases.¹⁸² The court quoted a

173. *Id.* at 114, 229 S.E.2d at 302 ("This case involves no tort.").

174. 297 N.C. 181, 254 S.E.2d 611 (1979).

175. *Stanback v. Stanback*, 37 N.C. App. 324, 246 S.E.2d 74 (1978).

176. *Stanback v. Stanback*, 295 N.C. 649, 248 S.E.2d 253 (1978).

177. *Stanback*, 297 N.C. at 194, 198-99, 254 S.E.2d at 620, 622-23.

178. *Id.* at 187, 254 S.E.2d at 616 (citing *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854)).

179. According to the court, damages are recoverable upon breach if they are foreseeable, and are such that they will follow in the ordinary course of events and were within the contemplation of the parties at the time of contracting. Whether special or consequential damages are recoverable upon breach depends "upon the information communicated to or [within] the knowledge of the breaching party at the time of contracting." *Id.*

180. *Id.* at 188, 254 S.E.2d at 617.

181. *Id.* at 188-89, 254 S.E.2d at 617-20. Among the exceptions noted by the court are the now familiar breach of a promise to marry, the carrier and telegraph cases, and the "casket cases." See cases cited *supra* note 60.

182. *Id.* at 189-201, 254 S.E.2d at 618-20. The court apparently accepted the proposition that some contracts have as their objective, personal rather than pecuniary purposes. Thus any breach may necessarily include mental anguish as damages. An insurance contract is the foremost example of a personal contract. Recovery for mental anguish could extend to any contract where a special

North Carolina case, *Lamm v. Shingleton*,¹⁸³:

The tenderest feelings of the human heart center around the remains of the dead. When the defendants contracted with the plaintiff to enter the body of the deceased husband in a workmanlike manner they did so with the knowledge that she was the widow and would naturally and probably suffer mental anguish if they failed to fulfill their contractual obligations in the manner to be charged. The contract was predominantly personal in nature and no substantial pecuniary loss would follow its breach. . . . It cannot be said, therefore, that such damages were not within the contemplation of the parties at the time the contract was made.¹⁸⁴

The court cited other jurisdictions¹⁸⁵ and distinguished between personal and commercial contracts.¹⁸⁶

With two provisos, the court concluded that a plaintiff could recover consequential damages for mental anguish arising from a breach of contract. The first proviso required that the contract be personal in nature. Second, the court required that the benefits contracted for (1) not have pecuniary interest as their primary objective, (2) relate *directly* to matters of dignity, mental concern, or the sensibilities of the party to whom the duty is owed, and (3) *directly* involve interests and emotions recognized by all as involving great probability of resulting mental anguish if not respected.¹⁸⁷ Although the court in *Stanback* established that consequential damages for mental anguish resulting from a breach of contract could be awarded, the court held that in this case, the plaintiff had failed to prove the elements set out above and affirmed the appeals court.¹⁸⁸

The second issue confronted by the court in *Stanback* was whether the plaintiff had stated a sufficient claim for relief so as to ask the jury for an

relationship exists between promisor-promisee giving rise to mental or emotional well-being and security in its performance. See Bolla, *supra* note 97, at 565-67.

183. 231 N.C. 10, 55 S.E.2d 810 (1949) (breach of a burial contract where the plaintiff's husband's casket rose to the surface several months after interment, causing severe shock and mental anguish to the plaintiff. An inspection revealed that the vault either had been improperly secured or not locked at all to begin with. The court said the action was for breach of contract to bury husband's body properly and not an action in tort.)

184. 297 N.C. at 191, 254 S.E.2d at 619 (quoting *Lamm v. Shingleton*, 231 N.C. 10, 15, 55 S.E.2d 810, 813-14 (1949)).

185. *F. Becker Asphaltum Co. v. Murphy*, 224 Ala. 655, 657, 141 So. 630, 631 (1932) ("[W]here the contractual duty or obligation is so coupled with matters of mental concern or solicitude, or with the feelings of the party to whom the duty is owed, that a breach of that duty will necessarily or reasonably result in mental anguish or suffering, it is just that damages therefore be taken into consideration and awarded."); *Stewart v. Rudner*, 349 Mich. 459, 84 N.W.2d 816 (1957) (physician's failure to carry out agreement to perform Caesarian section delivery resulted in a stillbirth of the child, causing mother severe emotional trauma).

186. *Stanback*, 297 N.C. at 192, 254 S.E.2d at 619.

187. *Id.* at 194, 254 S.E.2d at 621.

188. There is an ongoing debate as to whether breach of contract resulting in emotional distress in contract is really distinguishable from negligent or intentional infliction of emotional distress in tort. In each case, the determination and award of damages are left to the discretion of the jury. While emotional harm may result from a contract breach, the actual conduct that causes the breach stems from tort duty. See generally Bolla, *supra* note 97.

award of punitive damages.¹⁸⁹ Relying on *Newton* and *Oestreicher*, the court concluded that when a "breach of contract also constitutes or is accompanied by an identifiable tortious act, the tort committed may be grounds for recovery of punitive damages."¹⁹⁰ However, identifying the tort is not enough: "Even where sufficient facts are alleged to make out an identifiable tort . . . the tortious conduct must be accompanied by or partake of some element of aggravation before punitive damages will be allowed."¹⁹¹ Unlike *Newton*, the *Stanback* court held that the trial court erred in dismissing plaintiff's allegations which were "sufficient to state a claim for what has become essentially the tort of intentional infliction of emotional distress."¹⁹² The court reasoned that plaintiff's allegation of great mental anguish and anxiety as a result of defendant's willful, malicious, and calculated conduct was a sufficient allegation of "other emotional disturbance" to state a claim for relief.¹⁹³ In addition, by alleging that defendant "acted with full knowledge of the consequences of his actions she has sufficiently indicated that the harm she suffered was a foreseeable result of his conduct."¹⁹⁴ Furthermore, the plaintiff met the requirement that some element of aggravation accompany the tortious conduct in order to seek punitive damages.

Stanback must be appreciated for recognizing that a tort action exists for intentional infliction of emotional distress. Moreover, basing this upon a breach of contract was a significant step toward allowing recovery for punitive damages without a further showing of aggravated circumstances. However, the court did not address the issue of bad faith breach and whether tortious conduct causing a breach, may in and of itself, be compensable without regard to actual contract damages or punitive damages.¹⁹⁵

189. *Stanback*, 297 N.C. at 196, 254 S.E.2d at 621.

190. *Id.*

191. *Id.*

192. *Id.* at 198, 254 S.E.2d at 621-22.

193. *Id.* at 197-98, 254 S.E.2d at 622-23 (citing *Kirby v. Jules Chain Store Corp.*, 210 N.C. 808, 188 S.E.2d 625) (1936) (damages for fright are recoverable when some physical injury contemporaneously, naturally, and proximately results from the fright caused by the defendant's negligent and wilful misconduct)).

194. *Stanback*, 297 N.C. at 198, 254 S.E.2d at 623 (citing *Slaughter v. Slaughter*, 264 N.C. 732, 142 S.E.2d 683 (1955)). The *Stanback* court additionally stated that "plaintiff must show some physical injury resulting from the emotional disturbance caused by defendant's alleged conduct," but noted that "given the broad interpretation of 'physical injury' in our case law, we think her allegation that she suffered great mental anguish and anxiety is sufficient to go to trial" *Id.* The courts' tenacious reliance on the pretense of physical impact or attendant physical symptoms before allowing damages for mental distress illustrates the preferred judicial reluctance in matters of this nature.

195. Tort damages may include all proximately caused injury, including economic loss, attorneys fees, and mental anguish above and beyond actual contract and punitive damages. More importantly, the element of aggravation need not be shown since the commission of the tort is aggravation enough. However, in North Carolina, the exact status of this position is unclear. The element of aggravation may still have to be shown for an independent tort. For an award of punitive

D. *Dailey v. Integon General Insurance Corp.*¹⁹⁶

In *Dailey*, the plaintiff sued defendant-insurer for failing to settle or pay plaintiff's claim under a policy insuring plaintiff's house and personal property against loss by fire.¹⁹⁷ The complaint sought relief from the insurer (1) for breach of contract in failing to pay the losses covered under the policy, (2) for bad faith failure to settle the policy obligations,¹⁹⁸ and (3) for bad faith refusal to settle the insurance claim.¹⁹⁹ Plaintiff further alleged that defendant's conduct was willful, wanton, malicious and intentional, the purpose being to pressure plaintiff into accepting an unfair settlement and, therefore, was a breach of its implied covenant of good faith and fair dealing.²⁰⁰

The defendant moved to dismiss all claims at trial. The trial court dismissed plaintiff's second and third claims but allowed the first claim to stand.²⁰¹ On appeal, the court reversed the trial court's order of dismissal on the second and third claims holding them justiciable claims for relief.²⁰² At the close of plaintiff's evidence at trial, the trial court directed a verdict against plaintiff's second claim but allowed the first and third claims to go to the jury. On the first claim, the jury awarded plaintiff \$105,000 for fire damage done to the house, \$37,000 for fire damage done to the house's contents, and \$15,000 for living expenses during the thirty months that the premises had remained uninhabitable.²⁰³ On the third claim, the jury awarded punitive damages in the amount of \$20,000 based on the malicious conduct of defendant's agent and \$100,000 for defendant's wrongful failure to settle the claim in good faith.²⁰⁴ On defendant's motion, the trial court entered a judgment notwithstanding the verdict on both awards for punitive damages. The trial court noted that plaintiff's allegations were supported by the evidence, but stated that North Carolina law simply did not permit punitive damages in a case based on a breach of contract and to allow the issues to go to the jury was error.²⁰⁵ Plaintiff appealed.

Dailey presented two main issues on appeal: (1) whether punitive damages are recoverable in North Carolina where the basic, underlying

damages, aggravating factors need to be shown. See *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976).

196. 75 N.C. App. 387, 331 S.E.2d 148, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985).

197. *Id.* at 389, 331 S.E.2d at 150.

198. On this claim plaintiff sought compensatory damages for expenses incurred and time lost in pursuing the claim. *Id.*

199. On this claim plaintiff sought punitive damages. *Id.*

200. *Id.* at 390-93, 331 S.E.2d at 151-53.

201. *Id.* at 389, 331 S.E.2d at 151.

202. *Dailey v. Integon Gen. Ins. Corp.*, 57 N.C. App. 346, 350, 291 S.E.2d 331, 333 (1982).

203. *Dailey*, 75 N.C. App. 387, 390, 331 S.E.2d 148, 151 (1985).

204. *Id.*

205. *Id.*

claim is for breach of contract; and (2) whether compensatory damages for mental anguish resulting from a bad faith breach of a contract states a claim sufficient to present to the jury.²⁰⁶ The *Dailey* court immediately acknowledged the general rule denying recovery for punitive damages based on a breach of contract but also recognized the more recent cases which allowed recovery.²⁰⁷ The court of appeals noted that because *Newton* was decided by the supreme court, the trial court had relied on the exception to the general rule in holding that in some cases a breach of contract action had also stated a claim for which punitive damages could be awarded. On each issue, the court of appeals held that the trial court had erroneously dismissed plaintiff's claim for punitive damages.²⁰⁸ Therefore, the court concluded that North Carolina law now permits the recovery of punitive damages on claims for tortious, bad faith refusals to settle under insurance policies, though the refusal to settle also constitutes a breach of contract.²⁰⁹ The court stated: "In this case, according to the evidence, the identifiable tort alleged — defendant's bad faith refusal to settle — not only accompanied the breach of contract, it was also a breach of the contract that was accomplished by some element of aggravation."²¹⁰ The jury's finding of accompanying aggravation was sufficient to find that the defendant tortiously refused in bad faith to settle plaintiff's claim. The record revealed that the defendant acted maliciously, oppressively, wilfully and with reckless indifference to consequences.²¹¹ The court of appeals reinstated the jury verdict awarding punitive damages for bad faith refusal to settle a valid claim.²¹²

On the second issue, the court concluded that an allegation of mental suffering resulting from a bad faith breach of contract states a claim for relief sufficient to go to the jury. The court relied on *Stanback*²¹³ to support its conclusion.²¹⁴ Because *Stanback* also recognized the tort of intentional infliction of emotional distress where a claim of this nature

206. *Id.* at 394, 400, 331 S.E.2d at 153, 157.

207. *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 111, 229 S.E.2d 297, 301 (1976) ("Nevertheless, when there is an identifiable tort even though the tort constitutes, or accompanies, a breach of contract, the tort itself may give rise to a claim for punitive damages."); *Oestreicher v. American Nat'l Stores, Inc.*, 290 N.C. 118, 136, 225 S.E.2d 797, 809 (1976) (Punitive damages may be appropriate in breach of contract actions that "smack of tort because of the fraud and deceit involved" or those actions "with substantial tort overtones emanating from the fraud and deceit.").

208. *Stanback v. Stanback*, 297 N.C. 181, 196, 254 S.E.2d 611, 621 (1979); *Payne v. North Carolina Farm Bureau Mut. Ins. Co.*, 67 N.C. App. 692, 696, 313 S.E.2d 912, 915 (1984); *Dailey v. Integon Gen. Ins. Corp.*, 57 N.C. App. 346, 350, 291 S.E.2d 331, 333 (1982).

209. *Dailey*, 75 N.C. App. at 394-99, 331 S.E.2d at 153-56.

210. *Id.* at 396, 331 S.E.2d at 154.

211. *Id.* at 396, 331 S.E.2d at 155.

212. *Id.* at 397-98, 331 S.E.2d at 155-56.

213. 297 N.C. 181, 198, 254 S.E.2d 611, 622-23 (1979) (defendant's "willful, malicious, calculated, deliberate and purposeful" conduct in breaching a separation agreement stated a claim for relief).

214. *Dailey*, 75 N.C. App. at 400-01, 331 S.E.2d at 157.

arises from a breach of contract, a sufficient allegation may go to the jury for a determination.

In *Dailey*, the court of appeals held that a claim based on a bad faith breach of contract that results in the intentional infliction of emotional distress may be presented to the jury. However, the court affirmed the dismissal of the claim stating that absent from the record was any testimony whatsoever to indicate that plaintiff suffered emotional distress, compensable or otherwise, because of defendant's bad faith refusal to settle the claim. Such injury may not be assumed and must be proven by evidence.²¹⁵ The court did not discuss how the mental injury may be proved or whether compensatory damages may be awarded absent the element of aggravation. Reading *Oestreicher*, *Newton*, and *Stanback* leads to an inference requiring that the element of aggravation be present. Yet, a more aggravating factor than the tort itself is unimaginable. And if proven, why should compensatory damages not be awarded based on the tort alone, independent of actual contract or punitive damages? Such would be the case upon recognition and acceptance of the independent tort duty of good faith and fair dealing — the tort of bad faith breach of contract.²¹⁶

VI. CONCLUSION

A strong judicial reluctance to recognize the tort of bad faith breach of contract permeates the courtroom. Perhaps such a reluctance is due to the inability of the courts to resolve doctrinal uncertainties that exist between tort and contract. These difficulties may be overcome by realizing two points. First, every contract contains an implied-in-law covenant of good faith and fair dealing. Second, breach of the implied covenant provides an injured party with an actionable tort of bad faith, regardless of whether the acts complained of also constitute a breach of contract. Like other intentional torts, bad faith can be proven by circumstantial as well as direct evidence. Once proven, recoverable damages would include mental distress and economic loss. In addition, punitive damages have provided a stumbling block to recovery in tort for bad faith. Nevertheless, the tort should be actionable without regard to either actual contract or punitive damages. However, where sufficiently outrageous conduct accompanies the bad faith breach, punitive damages also should be awarded.

215. *Id.* at 401, 331 S.E.2d at 158.

216. The tort duty of good faith and fair dealing was suggested in *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976) to arise in instances of insurance, or where there is a personal contract, see *supra* p. 45. However, this was dictum, and the issue was left open as to whether the tort of bad faith breach of contract would be recognized in North Carolina as an independent tort.

North Carolina's appellate courts have opened the door to recovery for breaches of personal contracts that are accompanied by identifiable tortious conduct. However, the courts have pulled up short of recognizing the full-blown tort of bad faith breach of contract—a tort actionable on its own grounds. Because the last word in North Carolina on this subject, *Dailey v. Integon General Insurance Corp.*,²¹⁷ stands without a definition of the tort of bad faith breach of contract, and is equally deceptive as to whether such a tort, once defined, is actionable without regard to a claim of punitive damages, the tort remains in limbo in this state.

Concurrent with the rapid development of tort law, which has been predisposed to deriving rules dealing with mental and emotional suffering, many courts are coming full circle to acknowledge that tort liability may result from a breach of contract. North Carolina should likewise square its position on the tort of bad faith breach of contract and join the growing circle. If further injury, especially in the insurance industry, is to be avoided, tort and contract in North Carolina should best arrive at their point of departure which began universally with *Hadley v. Baxendale*.²¹⁸

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217. 75 N.C. App. 387, 331 S.E.2d 148, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985).

218. 156 Eng. Rep. 145 (1854).