ISSN 1045-6333

CROSSING THE CONTRACT-TORT BOUNDARY: AN ECONOMIC ARGUMENT FOR THE IMPOSITION OF EXTRACOMPENSATORY DAMAGES FOR OPPORTUNISTIC BREACH OF CONTRACT

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Discussion Paper No. 70

4/90

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The Program in Law and Economics is supported by a grant from the John M. Olin Foundation.

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ABSTRACT

There is currently a raging debate concerning the propriety of holding parties liable in tort for certain types of breach of contract. Doctrinally, the debate is focused on the extent to which tort damages are appropriate for breach of the implied covenant of good faith and fair dealing. Courts have discussed the issue essentially in terms of the nature of the relationship in the contract. For instance, insurance contracts have been found to contain special features, thereby making their breach deserving of tort, that is, extracompensatory, damages. Critics have opposed the expansion of the imposition of extracompensatory damages to non-insurance contexts, on the grounds that there is no principled way to contain its spread. In this paper this view is challenged. Through an inquiry into the economic purpose of contract damage measures, I show that extracompensatory damages are appropriate, and indeed needed, for certain types of contract breach, regardless of the nature of the contract relationship. In particular, extracompensatory damages are needed whenever a party manipulates information in an attempt to renege on the Pareto efficient deal that is represented by the provisions or background rules of a contract.

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Introduction

Courts are increasingly willing to cross the doctrinal demarcation between torts and contracts by allowing tort damages for bad faith breaches of contract. One striking example of this trend is the use of the well established principle that every contract contains an implied covenant of good faith and fair dealing[1] to support the imposition of tort damages in certain breach cases. While this new tort cause of action first arose in the insurance context,[2] attempts have been made to apply it to banking,[3] employment[4] and ordinary commercial[5] contexts as well. The spread of the imposition of tort damages has alarmed courts and commentators, who see it as a threat to the historical and

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1 See Restatement (Second) of Contracts s. 205 ("Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.") This duty has also been recognized by a majority of jurisdictions and by the U.C.C. See Burton, "Breach of Contract and the Common Law Duty to Perform in Good Faith, 94 Harv. L. Rev. 369, 404 app. (1980). For expository simplicity, I will sometimes use the phrase "implied covenant" as shorthand for the full term "implied covenant of good faith and fair dealing."

2 See Communale v. Traders & General Insurance Company, 50 Cal. 2d 654, 328 P.2d 198 (1958).

3 See Commercial Cotton Co., Inc. v. United Cal. Bank, 163 Cal. App. 3d 551, 209 Cal. Rptr. 551 (1985).

4 See Foley v. Interactive Data Corp., 47 Cal. 3d 654, 765 P.2d 373, 254 Cal. Rptr. 211 (1988).

5 See Seaman's Direct Buying Service, Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

well explained difference between tort[6] and contract[7] measures of damages. Contract damages are viewed as enforcing the intentions of the parties,[8] ensuring either performance or the payment of compensatory damages, with no particular preference for the former.[9] They are designed to place the victim of the breach in the position she would have been in had no breach occurred.[10] Tort damages, however, are traditionally viewed as an instrument

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[6] In this paper I will use the term tort damages to mean a damage measure which is intended not merely to compensate a victim,, but also to punish an offender. Tort damages are extracompensatory in that they include exemplary (punitive) damages.

[7] The term contract damages is used in this paper to mean full compensatory damages. The most accepted measure of compensatory damages is the victim's expectancy. It is important to keep clear that often courts, when awarding what they call expectation damages, are actually awarding something less than that. This is because traditional contract damage measure doctrine has developed in a way that leads to undercompensation of breach victims for a variety of reasons. See Note, "Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm," 86 Col. L. Rev. 377, 381 (1986); G. Gilmore, The Death of Contract 14-15 (1974). For example, contract damages do not include attorney fees. See Restatement (Second) of Contracts ch. 16 introductory note at 100 (1981). In addition, the doctrines of certainty and foreseeability of damage have led to undercompensation. See Farber, "Reassessing the Economic Efficiency of Compensatory Damages for Breach of Contract," 66 Va. L. Rev. 1443, 1443 n.2 (1980); Note, supra, at 381.

[8] See Foley, 47 Cal. 3d at 683.

[9] See Restatement (Second) of Contracts ch. 16 introductory note at 100; O. Holmes, "The Path of the Law," 10 Harv. L. Rev. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it, - and nothing else.")

[10] See Restatement (Second) of Contracts s.344 (a) & comment (a).

of social policy.[11] From this perspective, the imposition of tort damages in contract cases is seen as imposing upon certain parties duties that go beyond the purposes of the contract.[12] From an economic perspective, the imposition of tort damages is seen to threaten the principle of efficient breach, by forcing parties to perform when it is more efficient for them not to perform.[13] The opponents of the imposition of tort damages fear that once tort damages are allowed in some cases, no principle exists which can be mustered to limit their spread.[14]

In this paper, I will argue that these fears are unwarranted. Economic analysis supports the use of tort damages for contract breaches[15] in an analytically specifiable set of cases. In

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[11] See Foley, 47 Cal. 3d at 683; W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on the Law of Torts s.92 at 655 (5th ed. 1984).

[12] See Foley, 47 Cal. 3d at 690; Restatement (Second) of Contracts s.355 & comment (a).

[13] See R. Posner, Economic Analysis of Law 108 (3rd ed. 1986); Note, "Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis," 39 Stan. L. Rev. 161, 179 (1986); Note, supra note 7, at 391.

[14] See Foley 47 Cal. 3d at 6977; Oki America, Inc. v. Microtech Intern., Inc., 872 F. 2d 312, 315 (9th cir. 1989, Kosinski, J., concurring); Note, supra note 7, at 406.

[15] My argument is really that extracompensatory damages are justifiable in certain breach of contract cases. I use the term tort damages because courts and commentators tend to view things in terms of the traditional, albeit arbitrary, dichotomization of the common law into contract and tort. While a sharp division of types of disputes into contract and tort may be useful for the organization of a law school curriculum, the reification of the division in the minds of lawyers can be detrimental if it makes them lose sight of the fact that the same policies may underlie doctrines in either category. It is important to look at the particular circumstances and behavior of actors, and the

particular, tort damages are appropriate to prevent opportunistic behavior by a party to a contract. Opportunism is a term used by economists to describe efforts by individuals to achieve gains through "a lack of candor or honesty in transactions."[16] An actor is acting opportunistically when he strategically manipulates information in order to gain a larger share of a pie which already has its size determined. Opportunistic behavior is Pareto inefficient in the sense that resources are spent in an effort which, by definition, does not create any surplus. The opportunistic actor creates more value for herself, but only by taking that amount or more from others.[17]

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incentives they face when structuring policy. The use of broad categories such as contract and tort will not help this effort. See Bishop, "The Contract-Tort Boundary and the Economics of Insurance," 12 J. Legal Stud. 241, 266 (1983) ("The juridicial categories 'contract' and 'tort' ought to be our servants, not our masters. Attention to the function and purpose of various tort and contract doctrines will lead us to some intermixture of doctrines.") My use of the term tort damages should be read as being synonymous with extracompensatory damages. See supra notes 6-7.

[16] Williamson, Wachter & Harris, "Understanding the Employment Relationship: The Analysis of Idiosyncratic Exchange," 6 Bell J. Econ. 250, 258 (1975). See also Shell, "Substituting Ethical Standards for Common Law Rules in Commercial Cases: An Emerging Statutory Trend," 82 Nw. U.L. Rev. 1198, 1199 n.3 (1988) ("'[O]pportunism refers to the incomplete or distorted disclosure of information, especially to calculated efforts to mislead, distort, disguise, obfuscate, or otherwise confuse'" (quoting from O. Williamson, The Economic Institutions of Capitalism 47 (1985))

[17] If the opportunist must spend resources to act opportunistically, then her rewards for opportunism will be less than what other parties give up. The amount of resources spent are sheer waste, from the viewpoint of the parties' mutual interests. In this paper, welfare judgments such as this are made in reference to the parties' mutual interests based on the principle that the purpose of contracts is to increase the surplus available to be divided by the contracting parties. See

In Part I of this paper, I will present an economic analysis of opportunism in the context of contract breach. I will argue that when a party is found to have opportunistically breached a contract, tort damages are a necessary and appropriate remedy. Tort damages can ensure that the will of the parties is fulfilled by deterring opportunism. Therefore, the critical inquiry in justifying tort damages for breach of contract is the nature of the breach. By only imposing tort damages when there is a very high level of proof that a breach is opportunistic, a limiting principle can be found upon which to base tort damages. In Part II I will analyze the development of the imposition of tort damages for breach of the implied covenant in California, the jurisdiction where the jurisprudence is most fully developed. I will show that the California courts have failed to engage in the appropriate inquiry in attempting to define when tort damages are justified for contract breach. Rather than emphasizing the nature of the breach, California courts have relied on the nature of the contract relationship as a justifying principle for tort damages. In particular, the California courts have developed a test based on the existence of a "special relationship" between the contracting parties. Only one type of contract breach - the bad faith denial of the existence of the contract - has been deemed to merit tort damages independent of the relationship between the contracting parties. An analysis of important cases will show that the California courts seemed to be using the

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<u>infra</u> note 42.

imposition of tort damages to correct for contract damage awards which are less than fully compensatory, and have not realized that tort damages are justified for opportunistic breaches whether or not the contract damage measures applied by the courts attain the goal of full compensation.[18]

I: Economic Analysis

The economic analysis of contract damage measures begins with the concept of a complete contingent contract, which "is an agreement that specifies the obligations of the contracting parties and the payments to be made under each conceivable circumstance or 'contingency.'"[19] Such an agreement can be tailored in a way that will maximize the joint interests of the contracting parties. In economic terms, it can be constructed in such a way that it will be Pareto efficient. That is, there will

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[18] Some commentators have approved the tort for breach of the implied covenant on the grounds that it allows courts to overcome the problems of undercompensation inherent in traditional contract damages doctrine. See Note, supra note 13. However, this approach to the problem seems unnecessarily indirect, confusing and expansive. See Note, supra note 7. A more appropriate approach would be to change the way that courts have approached contract damages, and make judicial calculations come closer to the theoretical ideal of full compensation. See id. at 402-06 (proposing that the flexibility of foreseeability doctrine be used to allow for more consequential damages, that the certainty rule be relaxed, and that attorney fees be awarded in some cases). In this paper, I will be proposing that tort damages are appropriate in some contract breach cases, even if full compensatory damages are available. Hence, when I refer to contract damages I will be referring to full compensatory damages, not the diluted measures that courts have found to be more practical. The difference between this true measure of contract damages and tort damages is the punitive component of the tort measure.

[19] Shavell, "Damage Measures for Breach of Contract," 11 Bell J. Econ. 466, 466 (1980).

be no action that any party can take under any of the specified conditions that will be preferred to that called for in the contract. Therefore, the Pareto efficient complete contingent contract is one which the parties will find it in their mutual interests to be bound by.[20] In fact, the contract will be self-executing if information is perfect both during the formation of the contract and through its performance.

Example 1:

Seller, a widget maker, is contacted by Buyer, who wants Seller to make for him a certain type of widget which is worth 150 to him. Seller knows that there are two ways to make the widget, and which is cheapest depends on whether the government passes a certain regulation or not. There is a known probability of 0.5 that the government will pass the regulation, in which case the cost of making the widget will be 300 (this is the Unfavorable Scenario). Should the regulation not pass, the widget will cost 50 (the Favorable Scenario). The widget should only be built if the Favorable Scenario arises. In that case there is a surplus of 100 which is created by the production of the widget (150 in value is created for an expenditure of 50). Under the Unfavorable Scenario, the manufacture of the widget costs more than the widget is worth to Buyer, so it should not be built. Knowing this, the two parties will make a contract, stating that should the Favorable Scenario arise, Seller must build the widget, and should the Unfavorable Scenario arise, the widget should not be built. The contract will also state a price which Buyer must pay to Seller. In this case, the price will fall within the range from 25 to 75. This is because Seller will accept any price that is above twenty-five[21] while Buyer will be willing to pay as much as seventy-five.[22] So, the deal will be made within this range. If we assume that Buyer and Seller are

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[20] Id. at 467.

[21] Seller faces a .5 chance of having to spend 50 to build the widget, and a .5 chance of spending nothing if the government regulation passes. Therefore, the contract's expected cost to Seller is 25. As long as he gets more than that from Buyer, Seller likes the deal.

[22] Buyer faces a .5 chance of receiving the widget, which is worth 150, and an equal chance of not receiving the widget. Thus the deal brings him an expected value of 75. As long as he pays Seller less than this amount, Buyer likes the deal.

rational, and they each have perfect information,[23] then they will always do the Pareto efficient thing under this contract. For instance, Seller is always better off building the widget under the Favorable Scenario and not building it under the Unfavorable Scenario. If he deviates from either path, Buyer will know and can withhold payment.[24] Hence, the optimal outcome is achieved even in the absence of a damage measure.

Of course, reality is never as neat and clean as the above example. Even if two parties can foresee all possible contingencies, and arrive at a Pareto efficient complete contingent contract, it is likely that during the period between the signing of the contract and the completion of performance, at least one of the parties will have the opportunity to take advantage of some imperfection in the availability of information, and this opportunism will come at the expense of the Pareto efficient deal.[25] After the contract has been formed, there are two bundles of information that are critical to the operation of the contract, and which may be exploited. First,

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23 In particular, we must assume that the Seller knows how much the widget is worth to Buyer, and Buyer knows the cost distribution facing Seller. In addition, they both must know with certainty which of the two cost scenarios actually arises.

24 I am assuming that the performances can be simultaneous. If performance is sequential, e.g. if Buyer must pay before he sees if Seller performed, then there may be costs involved in getting Seller to give the money back should he fail to perform.

25 Williamson, et. al. call such imperfections "information impactedness." This is defined as "a derivative condition" which appears in conjunction with " (1) changing economic conditions (uncertainty), (2) the inability of all the interested parties to be costlessly apprised of the changes which have occurred . . . and (3) the inclination of some of the parties opportunistically to withhold or distort the information to which they have preferential access." See Williamson, et. al., supra note 16, at 259.

the information concerning the existence of particular contingencies[26] is essential to determining what performance is called for by the contract. Second, information is required about whether performance according to the contract has actually occurred.[27]

Example 2A:

Suppose that Buyer and Seller make the deal described in Example 1, at a price of 50 (the mid-point of the bargaining range). Now suppose, unlike in Example 1, that Seller and Buyer do not have equal access to information concerning which of the two scenarios arises. In particular, assume that only Seller knows if the government regulation has passed (we can assume that it is worthwhile for Seller to find out because he deals in the area a lot, but that, for Buyer, the cost of finding out is greater than the value of the widget). If the government does not pass the regulation, Seller has an incentive to convince Buyer that the regulation passed. If he succeeds, he gets paid the contract price of 50, without expending anything. This outcome is undesirable from the viewpoint of the parties' mutual interests. No wealth is created, there is only a transfer of 50 from Buyer to Seller.[28] However, if Seller had lived up to the contract's terms, and built the widget, 100 in wealth would have been created (the widget's value of 150 minus its cost of production of 50).

Example 2B:

Now suppose that both parties have perfect information regarding which contingency has arisen, but have unequal information regarding performance. In particular, suppose that a widget can be easily forged, and that the cost of authentication is greater than the value Buyer gets from the widget. If the Favorable Scenario arises, Seller has an incentive to pretend to perform, by producing a spurious widget. For example, if the forgery costs 15 to make, then Seller can gain 35 more for himself than if he produced the real widget. However, this gain comes at Buyer's loss - the spurious widget is worth, say, only

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[26] See Williamson et al., supra note 16, at 263; Shavell, supra note 19, at 469.

[27] See Williamson, et. al., supra note 16, at 264.

[28] There may be costs involved in this transfer. In particular, Seller may expend resources in an effort to keep information from Buyer. These spent resources are a sheer loss from the viewpoint of the parties' mutual interests.

50 to Buyer. Therefore, by taking advantage of Buyer's information deficiency regarding performance, Seller enriches himself at the expense of the joint surplus (which is 65 less than it would have been if Seller had followed the terms of the contract).[29]

Seller's behavior in Examples 2A and 2B prevents the Pareto efficient contract from being carried out.[30] While ideally Pareto efficient complete contingent contracts are self-enforcing, as in Example 1, in actuality it is necessary to threaten the imposition of damages on parties that, in an effort to make opportunistic gains, do not follow the dictates of the contract. The damage measure should be set high enough that the parties will never be able to make opportunistic gains through breach.[31] This level may not be very high at all, if one assumes

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[29] The contract calls for a real widget, worth 150, to be produced at a cost of 50, creating a surplus of 100. By making a fake widget, Seller creates only 50 in value while using 15 in resources, for a surplus of 35. The difference between the two outcomes is 65.

[30] In the first example, Seller's behavior produced an inefficient outcome - the cost of producing the widget outweighs its value. In the second example, the widget is produced when it is supposed to be. However, Seller does not get paid. In a particular case, this may only be a distributional effect. However, it is likely that in order to make his opportunistic gain, Seller had to expend some resources to keep information from Buyer. These spent resources are a sheer loss from the viewpoint of the parties' mutual interests.

[31] I assume here that the cost of imposing the damage measure is not related to the size of the damage. If it were, then there may be a point where the increase in cost of imposing the penalty will outweigh the benefits of its additional incentive not to breach. However, if the penalty is set high enough, in theory it will never be imposed.

that parties to contracts have high moral standards,[32] or are altruistic, or have multi-contract relationships.[33] These types of parties may follow the dictates of the contract whether or not there are damage measures giving it compulsion.[34]

On the other hand, if one views the parties as tending towards self-interest, or self-interest with guile,[35] then damage measures are needed to rein in the tendency to take opportunistic advantage of information imperfections regarding both the existence of contingencies and the nature of performance. The existence of these imperfections enables one party to a contract to renege on the deal by manipulating information to make it appear as if he is not reneging at all. The success of this manipulation depends on there being a less than certain chance that the manipulation will be discovered and that normal compensatory damages will be imposed for the breach. If the

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[32] Some people view promises made in contracts as sacred, and not merely as a tool for arranging economic affairs efficiently. See Restatement (Second) of Contracts ch. 16 introductory note at 100; Cohen, "The Basis of Contract," 46 Harv. L. Rev. 553, 571-72 (1933).

[33] That is, if the parties deal with each other a lot, then one party may not want to take an opportunistic gain with respect to one contract because she fears that this will jeopardize other valuable contracts, present and future.

[34] There may be other extralegal institutions which prevent parties from acting opportunistically, such as accumulated custom and tradition. see G. Hodgson, Economics and Institutions 155 (1988) (criticizing Williamson's emphasis on opportunism as the central aspect of transaction costs as being too narrow in that it fails to recognize that "everyday contract is necessarily a combination of both the laws that are passed by government, and also centuries of accumulated custom and tradition.")

[35] See Williamson, et. al, supra note 16, at 258-59.

probability that the breach will be discovered and damages imposed is less than one, then the damage measure must be increased beyond the compensatory amount to counterbalance the decreased probability of it being imposed.[36] Therefore, extracompensatory damages are necessary in order to ensure that the Pareto efficient outcomes of the complete contingent contract are achieved.[37] Since we know that the greatest joint surplus is created when the complete contingent contract is adhered to, all deviations from it should be discouraged with the strongest possible sanctions.[38]

In practice, in all but the simplest situations, it is impossible to form a complete contingent contract. Defining all possible contingencies and calculating the optimal action for the parties to take under each of these contingencies is a very complex endeavour. In addition, the problems of providing for

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[36] For instance, if there is a 50 percent chance that a breach will be discovered, then the damage measure must be twice as large as the damage measure imposed when there is a 100 percent chance of discovery.

[37] In theory, competition can prevent opportunism from occurring. In a competitive environment, one actor cannot achieve opportunistic gains because other actors will exist who are willing to forgo such gains to get their "fair return." See Williamson et. al, supra note 16, at 259. In the breach context, such competition does not exist. The parties are in a situation of bilateral monopoly. See R. Posner, supra note 13, at 105 - 106. So, opportunism is likely to be a problem in any contract situation where one side has an information advantage regarding either the existence of a particular contingency or the completion of performance.

[38] Posner, in discussing opportunism in the "sequential" performance context, says that "we might as well throw the book" at the breaching party. See Posner, supra note 13, at 105.

proper identification and verification of which contingency has arisen and evaluating the nature of performance make it even more complicated to write complete contingent contracts. Because of these difficulties, Pareto efficient complete contingent contracts are impossible to attain, at least at a reasonable cost.[39] Therefore, contracts are written with lots of terms open.

Economists studying contract damage measures view them as substitutes for complete contingent contracts.[40] In deciding on an optimal damage measure, the economist uses as his benchmark where the parties would have come out had they entered into a Pareto efficient contract. That is, the ideal damage measure serves to create incentives such that parties will act exactly as they would have compelled themselves to act in a contract which was written to optimize their joint welfare.[41] Viewed in this light, damage measures are in the mutual interests of the parties to a contract.[42] While it is clear that some damage measure is a

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[39] See Williamson et. al, supra note 16, at 262-63; Shavell, supra note 19, at 468; Ayres & Gartner, "Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules," 99 Yale L. J. 87, 92-93 (listing some of the costs involved).

[40] See Shavell, supra note 19, at 468.

[41] See id. at 468.

[42] See id. at 489. Of course, their mutual interests may also be society's interest, though making that equation requires value judgments. Throughout this paper, whenever I make normative statements about appropriate court action, I am basing these judgments on the principle that the proper role of the courts in interpreting and enforcing contracts is to maximize the joint interests of the parties, as the parties would have done had they been able to write a complete contingent contract. This

good thing because it induces Pareto optimal breach activity by forcing the potential breacher to internalize the effects that breach would have on the promisee, there is no single damage measure which is best in all situations.[43] So, for any particular type of contract situation, it is important to first start with the construct of the complete contingent contract, and then determine which damage measure comes closest to inducing behavior in the incomplete contract context which is consonant with the complete contingent contract. In general, the expectancy measure is the one which has been identified as best serving this function.

Whatever measure is best for a particular situation, it is important to note that the measure is not going to be best for opportunistic breaches of the incomplete contract. This is the case because, as is shown above, the complete contingent contract itself may not be self-enforcing. High levels of damages are needed to prevent the exploitation of information advantages that arise after the Pareto efficient deal is worked out. The same type of damages are needed to prevent opportunistic behavior in

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approach in fact corresponds with the traditional conception of the role of contract damages as espoused by the very courts that I am criticizing. See Foley 47 Cal. 3d at 689-90 ("When a court enforces the implied covenant it is in essence acting to protect 'the interest in having promises performed' (Prosser, Law of Torts (4th ed. 1971) p. 613) - the traditional realm of a contract action. . . .")

[43] See Shavell, *supra* note 19, at 472 ("there is no damage measure which acts as a perfect substitute for complete contingent contracts.") In particular, if parties rely on the promises they make to one another, then no damage measure can induce both the proper level of reliance and breach. See *id.*

the incomplete context whenever the incomplete contract lays out performance mandates which are Pareto efficient, or alternatively, when the incomplete contract is supported by background rules, established by courts or statutes, which require certain behavior. There is no need for a subtle damage measure which can induce only proper breaches of these explicit or implicit clauses. As with the complete contingent contract, it is in the mutual interests of the contracting parties to have both the explicit dictates of the incomplete contract and those provisions implied by courts strictly enforced.[44] When a party tries to avoid the ramifications of the contract by manipulating information, as opposed to merely avoiding the burden of performance when it has become too costly from the parties' joint viewpoint, extracompensatory damages are needed to deter such manipulations. The inquiry into whether or not an actor is

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[44] If courts only imply into contracts covenants which the parties would have agreed to had they thought of it, see Katz v. Oak Industries, Inc., 508 A. 2d. 873, 880 (Del. Ch. 1986), then these implicit provisions should generally be enforced. Conventional wisdom has been that court implied default rules should be set according to what the parties would have negotiated had they been able to foresee all contingencies at a reasonable cost. See Ayres and Gartner, supra note 39, at 89 n.19; Jordan v. Duff and Phelps, Inc. 815 F. 2d 429, 438 (7th Cir. 1987) (stating that when the parties are silent on a point it is necessary to imply terms that the judges "are confident the parties would have bargained for if they had signed a written agreement.") However, in certain cases appealing to an inquiry of what the parties would have bargained for is not necessarily best because one party may avoid entering into an efficient agreement in order to avoid having to divulge valuable information in the process. See Ayres and Gartner, supra note 39, at 106-07. The best default rule in such cases should take into consideration the need to force the divulgence of information. See id. at 108-18.

acting opportunistically by breaching is not the same as the inquiry into whether the breach is efficient or not. The court must look at the particular circumstances and determine if the actor actually engaged in manipulative behavior. If so, then, as with the complete contingent contract, high levels of damages are necessary to counter the fact that the probability of detecting the opportunistic breach is less than one.

Example 3A:

Assume that Seller and Buyer enter into the contract described in Example 2. They foresee two possible states of the world at the time of the contract. Now suppose that the Favorable Scenario arises, but so does an unexpected contingency, the cost of widget material soars to 300. While the contract calls for Seller to perform, he decides not to. This is the efficient outcome, it does not make sense for him to spend 300 to create something that is worth only 150. He, instead, can be assessed 150 in damages, which makes Buyer no worse off, and saves Seller having to spend the full 300 to perform. Viewed in terms of their mutual interests, 150 in value is lost (the widget is not made), but 300 in value is saved (the cost of making the widget). So, the damage measure that Seller faces must not discourage him from breaching. In this case, a compensatory measure would do just that.

Example 3B:

Now suppose that, as in Example 2A, Seller has an information advantage regarding whether the government regulation has passed or not. If this is the case, Seller may try to avoid the 150 liability that he faces in Example 3A by convincing Buyer that he is not performing due to the explicit contract clause which excuses performance if the government passes the regulation. In this situation, the incomplete contract is working just as the complete one would - no damage measure is needed to compensate for the incompleteness of the contract. What is needed is a damage measure which will enforce the terms of the contract itself. If we assume that the probability that Buyer knows about the regulation is only 50 percent, then the damage measure must be 300 to deter Seller from acting opportunistically. This is twice the amount needed to merely compensate Buyer.

Example 3A shows that, unlike in Example 2, Seller's breach creates more value for the parties jointly than would his performance. For this reason, it is important not to discourage the breach by setting the damage measure too high. It is important to realize that some efficient breaches are nevertheless opportunistic in that one party increases his share of the economic pie without changing its size. In Example 3B, for instance, Seller's breach is efficient, but he also uses his information advantage to try to avoid paying damages to Buyer. In order to determine the correct damage measure it is therefore critical to distinguish between different types of breach. If a breach is opportunistic, high levels of damages are appropriate. However, the penalty should only be increased to the point where the deterrent effect of the incremental increase exceeds its cost, which may include the cost of court error in finding that a breach was opportunistic. It is important to note that these costs are the only bound on the level of damages. On the other hand, if a breach occurs in a situation where the performance dictates of the contract are unclear, and no manipulation of information has occurred, then the damage measure must be set so as to induce proper breach behavior. In order to avoid deterrence of efficient breaches, damages must be tightly bound to the compensatory level.

The problem of courts erring in their determination of the nature of the breach in particular cases can be severe, since the possibility of error undermines the court's ability to impose high levels of damages to deter opportunism. The fear that efficient breaches will be discouraged by the wrongful imposition of extracompensatory damages may prevent them from being applied. The way to counter this tendency is not to restrict the size of damages in appropriate cases, but to reduce the probability that tort damages will be inappropriately applied. This may mean introducing very high evidentiary burdens for showing opportunistic breach. By setting the penalty for such breach at an appropriately high level, the improbability of being caught and held accountable can be counterbalanced.[45] Whenever a court is able to find explicitly that an actor has breached in an effort to reap gains from the manipulation of information, then the only limit on the size of the appropriate penalty is the direct cost of imposing it. However, courts will not often have direct and conclusive evidence of opportunism - this is what the opportunistic actor is counting on. In these cases the level to which extracompensatory damages should rise is more tightly bound.

In this section I have shown that tort damages are appropriate and necessary to combat opportunistic breaches of contract. In imposing tort damages, it is critical that courts

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[45] This point can be illustrated with an example. Suppose that 10 out of 100 breaches are opportunistic. However, courts will only have evidence to find opportunism in one out of the ten, and there is no systematic way to know which of those ten cases will be found. (This assumption will be valid if the evidence of opportunism arises by chance, and there is little way for an actor to control the possibility that his opportunism will be exposed.) In order to deter opportunism, the penalty in the one detected case must be ten times what it would be if all of the cases would be detected. This is because any one breacher will face only a 10% chance of having the penalty imposed. (I am assuming that the breacher is risk neutral.)

actually find that opportunistic behavior has occurred, that is, that there has been manipulation of information designed to increase one party's gains to a contract while not increasing the total surplus available. In the next section I will look at the state of doctrine regarding tort damages for breach of the implied covenant of good faith and fair dealing to see how courts are justifying the imposition of tort damages.

II: Doctrine

Courts have grappled with the idea that, despite traditional doctrine which separates torts from contracts, sometimes tort damages are appropriate in cases involving breach of contract. This idea has been most fully developed in California,[46] where the courts have injected tort remedies into breach cases through the doctrine of bad faith breach of the implied covenant of good faith and fair dealing. In California, the idea that there is an implied covenant of good faith and fair dealing in every contract has existed for some time.[47] Courts have generally recognized that it is appropriate to imply in every contract a covenant of good faith and fair dealing that "neither party will do anything which will injure the right of the other to receive the benefits

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[46] Since the state of California has gone the furthest in suggesting that high levels of damages may be appropriate for certain types of contract breaches, I will concentrate on the development of law in that jurisdiction. Since my intention here is merely to illustrate the problems that arise in this area, I do not think much is lost by not exhaustively reviewing the caselaw of all jurisdictions.

[47] See Communale v. Traders & General Insurance Co., 50 Cal. 2d 654, 328 P.2d 198, 200 (1958) (citing Brown v. Superior Ct. 34 Cal. 2d 559, 212 P 2d 878).

of the agreement."[48] Initially, the doctrine was used to read into contracts performance requirements which seemed to be implied by the explicit provisions of the contract and its context. In other words, the implied covenant of good faith and fair dealing is breached whenever a party does something that the parties, if they had thought of it, would have negotiated as proscribed.[49] Only recently, however, have California courts decided to also use the doctrine as a means of imposing tort damages for failure to perform, regardless of whether the performance requirement is explicit[50] or implicit in the contract. For our purposes, we want to investigate whether the tort damages are being imposed appropriately. An appropriate use would entail a determination of the nature of the breach in any particular case, and the imposition of tort damages only if the breach behavior can be characterized as opportunistic. Absent evidence of opportunism which meets a high threshold, compensatory damages should be used. In this section, I will describe the evolution of bad faith breach of the implied covenant doctrine in California. I will show that the California courts have tended to emphasize the nature of the contract at issue, in terms of its purpose and the relationship of the

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48 Communale 328 P.2d at 200.

49 See Katz v. Oak Industries, Inc. 508 A 2d 873, 880 (Del. Ch. 1986).

50 See Diamond, "The Tort of Bad Faith Breach of Contract: When If at All, Should It Be Extended Beyond Insurance Transactions?" 64 Marq. L. Rev. 425, 428 n.9 (1981).

parties to it, rather than looking to the nature of the breach. I will look at several cases, more or less in chronological order.

A. The beginnings - third party liability insurance.

The first case to imply that a breach of the covenant of good faith and fair dealing may be more than just a regular contract breach was Communale v. Traders & General Insurance Company,[51], which involved a third party insurance contract. Third party liability insurance contracts are those in which the insurer agrees to pay for liability which the insured incurs with third parties. For example, a truck driver will purchase insurance which covers him should he injure people with his truck. Communale involved a trucker, Sloan, who struck two pedestrians (Mr. and Mrs. Communale) with his vehicle. They suffered injuries and sued him. Sloan had a liability insurance policy with Traders & General Insurance Company (T & G) which covered him for up to $10,000 for each person injured, and $20,000 for each accident. In addition, the insurance contract called for T & G to defend the insured should he be sued for an accident covered by the policy. When the Communales sued Sloan, T & G refused to defend him. Sloan hired his own counsel, and received a settlement offer of $4000 on the second day of trial. He informed T & G of the offer, but the insurers refused to defend Sloan, or pay the settlement. The trial proceeded, and

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[51] 50 Cal. 2d 654, 328 P.2d 198 (1958).

Sloan was found liable for $26,250.[52]

Sloan did not pay, and the Communales sued T & G as the insurance contract allowed. T & G was found liable for the policy limits, in this case $11,250, and paid. However, the Communales, who were assigned Sloan's rights under the contract, sued for the remainder of their award, claiming that Sloan had a cause of action for breach of the implied covenant of good faith and fair dealing. In particular, they argued that T & G's unreasonable refusal to settle the case at $4000, when Sloan was facing the possibility of much higher liability, was a breach of the insurance contract. The California Supreme Court agreed with this, holding that the implied covenant requires an insurer to settle in appropriate cases even though the insurance contract does not expressly require this.[53] In finding that T & G unreasonably refused to settle in this case, the court held that the insurer was liable for the full $26,250 award, and not just the policy limit.[54] Though the court did not actually impose tort damages in the case, it did hold that the cause of action

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52 $25,000 of which was for Mr. Communale's injuries.

53 The court stated that, "The insurer, in deciding whether a claim should be compromised, must take into account the interest of the insured and give it at least as much consideration as it does its own interest." Communale 328 P.2d at 201 (citing Ivy v. Pacific Automobile Ins. Co., 156 Cal. App. 2d 652, 320 P. 2d 140 (1958).

54 The court reasoned that the policy limit applies only when the insurer pays in performance of the contract, but that when the insurer breaches, there is no contractual limit on the amount of damages that are recoverable. See Communale 328 P.2d at 201.

sounded in tort, as well as contract.[55]

The Communale case illustrates a fundamental tension that exists in third party insurance contracts where the insurer is obligated to defend suits on behalf of the insured. When a settlement offer is made, if the policy has a liability limit which is below the potential liability in the suit, the insurer and the insured may have different interests in the settlement process. For instance, in Communale, the insurer was on the line for only $11,500, while the insured was subject to much greater liability (the trial award was $26,250 and presumably could have been higher). To illustrate the general problem, let us assume that the Communales suffered damages of $26,500 which are undisputed. Suppose that the issue is whether the truckdriver was the cause of their injuries. For the truckdriver to prefer a $4000 settlement to going to trial (assume that he is risk neutral to this decision), he would have to perceive the chances of losing at trial to be at least 15%. (15 percent times 26250 is 4000). The insurance company, however, only faces a loss at trial of its liability limit of 11,500. Therefore, it will want to settle only if it perceives the probability of losing at trial to be at least 35 percent. So, if the insured and insurer each perceive the actual probability to be between 15 and 35, they will have different interests in settling.[56]

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[55] See Communale 328 P.2d at 203.

[56] This situation is even more exaggerated when the fact that the truckdriver is more risk averse than the insurer is taken into account. This factor increases his willingness to

In drawing up a Pareto optimal contract, parties that could foresee these contingencies at a reasonable cost would contract for the insurer to settle the case in certain cases, and not in others. But, absent such contingent arrangements, contract damages for breach must be used to induce the insurer to act in a way that would maximize the mutual interests of the parties.[57] This can be done through a contract provision which says that the insurer breaches whenever it refuses to settle when the settlement is preferred to trial from the viewpoint of the insured's and insurer's joint interests (this is the optimal definition of unreasonable refusal to settle). Alternatively, the same thing can be achieved if courts develop a background rule which embodies the same performance requirement.

Thus, economic analysis supports the Communale court's conclusion that a third party insurance contract which mandates that the insurer have control over the defense and settlement process, to make sense, must include an implied promise by the insurer that it will settle cases whenever there is a settlement proposal that the insurer would accept were it fully liable at trial. However, the court does not discuss in any detail any

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settle when they would not want to.

[57] In this case, assume that the actual probability of losing the case is 25 percent. The expected cost of the trial outcome is thus 6625. However, the insurance company's expected share of the cost is only 2875, while the trucker's expected share is 3750. If they settle, the joint liability is only 4000, but the insurance company pays it all, with certainty. The optimal action is for the case to settle, the insurer to pay 4000, and for the price of the contract to be set ex ante taking this into account.

factors which are necessary to support a claim that breach of this implied covenant should sound in tort. In fact, the problem that the court is concerned about is one for which compensatory damages may be perfectly well suited.[58] Extracompensatory damages should only be imposed if the insurer is refusing to settle because he is taking advantage of information imperfections which make the unreasonableness of his actions hard to detect.[59]

Another important third party insurance case is Crisci v. Security Insurance Co. of New Haven, Conn..[60] Mrs. Crisci was the landlady of an apartment building in which the Dimares lived. One day Mrs. DiMare fell through the stairs of the building, and was suspended fifteen feet above the ground. She suffered physical injuries and allegedly developed a psychosis as a result of the accident. The DiMares sued Mrs. Crisci, who had a $10,000 liability insurance policy with Security Insurance. The insurance company and Mrs. Crisci's lawyer both agreed that should the jury find that the psychosis was caused by the accident, they would award at least $100,000 in damages. Both

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[58] The compensatory damages in this case are what the insured must pay at trial after the insurer has unreasonably refused to settle. The insurer facing this damage measure internalizes the insured's costs of not settling.

[59] Suppose, for example, that the insurer has sole access to a settlement offer which is reasonable (the parties would have agreed, ex ante, to contract for its acceptance). If the insurer can prevent the insured from finding out about the offer, then it may reject it and take its chances at trial, even though this is not the Pareto efficient outcome.

[60] 66 Cal. 2d 425, 426 P.2d 173 (1967).

sides gathered psychiatrists to espouse their respective positions on the cause of Mrs. Dimare's psychosis. At one point, the DiMare's offered to settle the case for $10,000, $3,000 of which represented compensation for her physical injuries. The insurance company refused to settle the case, and later rejected a $9,000 settlement even though Mrs. Crisci volunteered to chip in $2,500 of her own money. The case went to trial, and the court awarded Mrs. DiMare $100,000 (and her husband $1,000). The insurance company paid $10,000, the limit of Mrs. Crisci's policy. The court points out that Mrs. Crisci, an immigrant widow, was impoverished making up the rest of the settlement. As part of her payment, she assigned her rights against Security to the DiMare's.

The DiMare's sued Security for breaching its contract with Mrs. Crisci, and the court relied on Communale in holding that Security breached the implied covenant of good faith by not accepting a reasonable settlement offer. The court recognized the conflicting interests of insured and insurer in cases where there is a policy limit which is much lower than the potential liability. The court concluded that Security was not properly taking into consideration the interests of its insured when it refused to settle for $9,000 a case which it recognized faced a "considerable risk" of an award of at least $100,000. This result fits well with Communale, and its underlying justifications.

However, in some forceful dicta, the court argued that a performance rule for settlement different from the Communale reasonableness rule should be implied into third party insurance contracts. The proposed rule would consider the insurer to have breached the contract whenever it refuses to settle for an amount which is within the policy limit. The court pointed out that it "will always be in the insured's interest to settle within the policy limits when there is any danger, however slight, of a judgment in excess of those limits."[61] This is undeniably true when viewed from the insured's perspective after an accident has occurred, since the insured pays nothing when a settlement within the limit is accepted, but risks having to pay something if the settlement is rejected and the plaintiff wins in court.

However, this *ex post* analysis is inappropriate to the task before the court because it may not reflect what the parties would have agreed to had they bothered to explicitly write out the insurer's performance duties.[62] Viewed properly, in light of the *ex ante* positions of the parties, it is clear that the insured would not contract for the acceptance of all settlements that are below the policy limit. For a potential insured negotiating an insurance contract, there is a cost involved in requiring the acceptance of all such settlement offers - increased premiums. The insured will not always be willing to pay these extra premiums. In fact, the existence of the policy

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[61] Crisci 426 P.2d at 177.

[62] For a discussion of the problem of *ex ante* versus *ex post* analysis, see Ayres and Gartner, *supra* note 39, at 89 n.18.

limit itself indicates that the insured is not willing to pay the extra premium to insure against liability in excess of the limit.[63] The court cannot avoid an inquiry into whether the settlement offer was reasonable, that is, whether it properly balanced the insured's level of risk aversion with the probability distribution she faced at trial. In other words, a settlement is reasonable if it is less than or equal to the amount which makes the insured indifferent between paying the settlement and facing the probability distribution of liability associated with the facts of the accident at issue. If the refusal to settle is found to be unreasonable, then a proper damage measure must be applied, that is, compensatory damages which make the insurer internalize the insured's costs which arise through a non-settlement.

The Communale and Crisci holdings can be described in the terms of this paper as follows. The parties entered into an incomplete contingent contract, one term of which is that the insurer agrees to accept any reasonable settlement offer. While this term is not explicit in the contract, this makes no difference, legally[64] or economically.[65] They could obviously

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[63] This assumes that the policy limit was not a result of the insurer refusing to cover the excess liability at the actuarially fair amount.

[64] "The promise which the law implies as an element of the contract is as much a part of the instrument as if it were written out." Communale 328 P.2d at 203 (citations omitted).

[65] The implied covenant is not used to change the nature of the contractual deal, but rather it is a means for the court to assess exactly what the duties of the parties is under the deal,

not anticipate all contingencies efficiently, so the term's requirements under various contingencies are left open. When a particular unanticipated contingency arises in the form of particular lawsuits and settlement proposals, the insurance company must decide whether to settle or not. The Crisci court held that in order to make this decision properly, the insurer must face the prospect of damages for emotional distress suffered by the insured. Whether this measure of damages is needed to ensure proper breach and make the incomplete contingent contract act like a Pareto efficient complete contract is an interesting question, but not one which I wish to discuss here since it really only involves determining what full compensatory damages in this context would be. Other commentators have dealt with this issue.[66] I am interested in exploring whether courts have recognized that tort damages may be necessary even if traditional contract damages are fully compensatory. It is apparent that the Crisci did not, at least not explicitly. Nowhere did the court offer any cognizable economic justifications, specifically, evidence of opportunism, for the imposition of tort damages. Rather, the court used tort damages to effectuate a case-specific adjustment to traditional contract damages.[67]

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and to gauge their performances against those duties. See Note, supra note 7, at 394.

66 See Note, supra note 13, at 168-70.

67 In fact, much of the literature advocating the use of tort damages for breach of the implied covenant justifies the tort damages on the inadequacy of the contract damages that courts are willing to award. The complaint is not that

B. Extending the tort - first party insurance contracts

The California Supreme Court extended the remedy for breach of the implied covenant of good faith and fair dealing beyond compensatory damages in Egan v. Mutual of Omaha Ins. Co..[68] Egan involved a dispute over claims under a health and disability insurance policy purchased by Egan from Mutual. The policy called for lifetime benefits of $200 per month to be paid if the "insured became totally disabled as a result of either an accidental injury 'independent of sickness and other causes' or sickness sufficiently severe to cause confinement of the insured to his residence. Benefits for a non-confining illness were payable for a period not to exceed three months."[69] The insured successfully made several claims under the policy between 1963 and 1970. In late 1970 he made a fourth claim, stating that he could no longer work due to a back injury. As part of his claim, he included a letter from his doctor stating that the current injury was 50 percent due to a work-related injury, and 50

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compensatory damages are inappropriate for such breaches, but merely that the courts are not awarding the full compensatory amount. This justification, then, does not support the imposition of full tort damages, including exemplary damages. Hence, commentators often argue that there should be a tortious breach of the implied covenant, but that the "tort" should not be remedied with punitive damages. See Foley 254 Cal. Rptr. at 237 n.35; Note, supra note 13. In this paper, on the other hand, the argument is that full tort damages are justified for opportunistic breach whether or not courts are willing to award full compensatory damages.

[68] 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979), cert. denied 445 U.S. 912, 100 S.Ct. 1271 (1980).

[69] Egan 620 P.2d at 143.

percent to the natural progression of a pre-existing pathology of the spine. The insurance company offered the plaintiff three months of benefits, plus medical costs, the policy maximum for non-confining illness. The insured refused the payment and sued. At trial, the judge directed a verdict that the insurer violated the implied covenant of good faith and fair dealing by not adequately investigating the plaintiff's claim under the policy. The jury at trial awarded the plaintiff $45,600 in general compensatory damages, $78,000 for emotional distress, and $5 million in punitive damages.

On appeal, the insurance company claimed that it would only be violating the implied covenant if it denies a claim knowing that the claim is valid. The court disagreed, holding that the insurer also violates the implied covenant if it fails to properly investigate the validity of a claim. In so doing, the court read into first party insurance contracts a performance requirement. There may be very good reason for doing so. In particular, the parties, if they had thought about it, may have included in their agreement such a provision because it serves to maximize their mutual interests. For instance, it may be the case that the insurer can more cheaply and efficiently determine the validity of awards, and therefore should be contractually obligated to do so, thereby saving the insured from having to do so less efficiently. Having read this performance requirement into the contract, the court must grapple with the issue of what damage measure is appropriate to enforce it.

The main damage issue in Egan was the propriety of punitive damages. The court held that public policy considerations did support the use of exemplary damages in cases where the evidence "is undisputed" that an insurer fails to properly investigate a plaintiff's claim. The court based its decisions on two features of the insurance contract. First, it held that insurers owe fiduciary duties to their insureds, and therefore they must honor their obligations with "decency and humanity."[70] Second, the court argued that the inherent imbalance in the insurer-insured relationship could be rectified by a rule that allowed punitive damages in cases such as the one at hand. While approving the principle of punitive damages, the court found that the facts in this case indicated that the jury award, which was "40 times larger than the not insubstantial assessment of $123,600 in compensatory damages" was the result of "passion and prejudice on the part of the jurors."[71]

The Egan court based the imposition of punitive damages on two aspects of the nature of the contractual relationship. It should have, however, determined if the breach was opportunistic, and deserving of tort damages. Let us look at two different scenarios. First suppose that the insurer, regardless of the fiduciary or other nature of his contract, is truly unsure as to whether Egan's disability is due to an injury or an illness. The insurer is faced with the decision of how much it should spend on

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[70] Egan 620 P.2d at 146.

[71] Egan 620 P.2d at 149.

investigating the merits of the claim. In theory, we would like the insurer to spend an amount which maximizes the joint interests of the parties to the contract, an amount that they would arrive at with perfect foresight. The insurer must be given proper incentives through a damage measure to only investigate when the parties, ex ante, would have agreed that investigation would be in their joint interests. The measure must encourage investigation when it is cheap enough, but discourage investigation when it is too expensive. Compensatory damages would do this, whereas punitive damages would lead to excessive investigation.

Punitive damages may, however, be appropriate in Egan under an alternative fact situation. Suppose that Mutual knows or suspects that Egan's disability is due to an injury. However, it also knows that the current state of information available to Egan and a court is ambiguous. There is no evidence in the case that this is so, but assume hypothetically that Mutual has a doctor who can always determine the exact causes of disabilities, at very low cost. Further suppose that the possibility of anyone finding out that this doctor exists is 10 percent. In this case, while it is optimal for the secret doctor to determine which contingency has arisen so the Pareto optimal outcome can be achieved under the contract, Mutual will not send him into action unless the penalty for not doing so is high enough.[72]

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[72] Suppose that the probability of a court determining that Egan's disability was injury related is 50 percent, in which case Egan receives $200 a month for life. Otherwise, he receives $200

The Egan court failed to show that the type of opportunistic circumstances necessary to justify punitive damages existed, because it failed to distinguish between the two types of breach described above. Rather, they relied on abstract notions of unfairness, inequity and loyalty. In his dissent, Justice Clark criticized this approach, arguing that, "Although [the] plaintiff may have stated he needed money for the approaching Christmas season, an insurer is not Santa Claus."[73] More concretely, the dissent had alternate objections to the majority opinion. First, the dissent argued that the imposition of punitive damages will only result in higher premiums paid by all insureds. Since the receipt of punitive damages is a windfall to the insured, he will be made worse off by having to pay these high premiums. Essentially, this is an argument for the court imposing damages with the goal of producing outcomes which the parties would have agreed to themselves. Since the insured would not have been willing to pay higher premiums to receive punitive damages for normal breach of the contract, they should not be imposed by the court. Second, the dissent suggested that even if punitive

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for 3 months. Suppose that Mutual, however, knows that the disability is injury related, but can hide its knowledge in 90 percent of the cases. If in the particular case the court finds that Mutual actually had hid its knowledge, it would be appropriate to impose punitive damages. Compensatory damages will not be enough since there is a probability of 90 percent that they will be avoided. In addition, as long as the insurer is confident that courts will only find opportunistic behavior when it actually exists, the only activity that will be deterred is opportunistic activity.

[73] Egan 620 P.2d at 153.

damages are appropriate, there is not enough evidence in this case to hold the insurer liable for them. The dissent seemed to be aware that it is very important to find that the necessary type of behavior has actually occurred before tort damages are applied against that behavior.

C. Grappling with the tort's expansion - Seaman's and its progeny

The distinction between an analysis which distinguishes breach cases for the purpose of imposing tort damages on the nature of the contract, and that which distinguishes cases on the nature of the breach was clearly raised in the controversial case Seaman's Direct Buying Service, Inc. v. Standard Oil Company of California.[74] Seaman's was interested in leasing area, part of which would be used as a fuel dealership, from a municipality in a new marina. The city requested, as a condition for signing the lease, that Seaman's provide proof that it had entered into a binding agreement with an oil supplier. Seaman's had been negotiating with two oil companies, and reached a tentative agreement with Standard. Seaman's then "requested evidence of that agreement - 'something that would be binding on the parties' - to show to the city."[75] Standard sent a letter of intent, however, it explicitly stated that it was not binding. Seaman's continued negotiating with a second supplier, until Standard agreed to final terms in late 1972. Standard wrote a letter to

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[74] 36 Cal. 3d 752; 206 Cal. Rptr. 354; 686 P. 2d 1158 (1984).

[75] Seaman's 36 Cal. 3d at 759.

Seaman's setting forth these terms, and concluding that the offer therein was subject to mutual agreement of the parties on the actual wording of the contract to be drawn. The letter asked for Seaman's to sign and return two copies of the letter if the terms were agreeable. The letter was signed with a Standard representative present, and with some pomp and excitement. Seaman's signed the lease with the city, and ended negotiations with the other potential supplier.

Soon afterward, in 1973, the supply of oil became very tight. Standard adopted a restrictive policy on new business, but did sign a temporary supply agreement with Seaman's. The agreement contemplated in the letter of intent was never drawn up. A few months later, the federal government instituted a program which required oil suppliers to allocate their supply to existing customers as of 1972. Standard told Seaman's that the program prohibited it from supplying Seaman's, but that it otherwise would be willing to. Standard suggested that Seaman's appeal to the government for an exception to the program. Seaman's was successful, and received a supply order. Standard refused to supply oil, now claiming that no binding agreement was ever reached during 1972. Standard appealed to the federal government, and had the supply order overturned. Seaman's appealed this decision, and had it reversed. The new decision authorized the issuance of a new supply order if Seaman's could produce a court decree saying that a valid contract existed in 1972. Seaman's requested that Standard stipulate to the existence of the contract, because it was afraid that it could not survive waiting for a trial to be held. Standard refused, and Seaman's went out of business. Seaman's sued Standard on several theories, including breach of the implied covenant of good faith and fair dealing. The jury found a tortious breach, and awarded $397,050 in compensatory damages and $11,058,810 in punitives. The judge ordered a new trial unless Seaman's agreed to a reduction of the punitive damages to $1 million, which Seaman's did. Standard appealed to the California Supreme Court.

The Supreme Court was faced with the issue of deciding whether, as in this case, a commercial contract can be the subject of a tortious breach of the implied covenant of good faith and fair dealing. The court saw the problem in this way:

> While the proposition that the law implies a covenant of good faith and fair dealing in all contracts is well established, the proposition advanced by Seaman's -that breach of the covenant always gives rise to an action in tort - is not so clear. In holding that a tort action is available for breach of the covenant in an insurance contract, we have emphasized the 'special relationship' between insurer and insured, characterized by elements of public interest, adhesion, and fiduciary responsibility. (cites Egan) No doubt there are other relationships with similar characteristics and deserving of similar legal treatment. (footnote omitted)
>
> When we move from such special relationships to consideration of the tort remedy in the context of the ordinary commercial contract, we move into largely uncharted and potentially dangerous waters. . . . In such contracts, it may be difficult to distinguish between breach of the covenant and breach of contract, and there is the risk that interjecting tort remedies will intrude upon the expectations of the parties. This is not to say that tort remedies have no place in such a commercial context, but that it is wise to proceed with caution in determining their scope and

application.[76]

Rather than defining a principle with which to interject tort remedies into the commercial context, the court held that Seaman's could be decided by appealing to a theory of liability separate from the implied covenant. The court then defined a new tort - bad faith denial of the existence of a contract. The court wrote, "It is sufficient to recognize that a party to a contract may incur tort remedies when, in addition to breaching the contract, it seeks to shield itself from liability by denying, in bad faith and without probable cause, that the contract exists."[77]

For the first time, the court found that tort remedies were justified by analyzing the nature of the breach, in a case where the nature of the contract was ordinary. However, the court limited this type of analysis to one particular type of breach - denial of the existence of the contract. This behavior is a paradigmatic case of opportunism,[78] and is appropriately remedied

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[76] Seaman's 36 Cal. 3d at 768-69.

[77] Seaman's 36 Cal. 3d at 769.

[78] Suppose that two parties enter into a contract. Subsequently, one party denies the existence of the contract in order to avoid both performance under it and the payment of damages for non-performance. The party denying the existence of the contract may have good reason for breaching the contract, that is, the breach may be efficient, however, the attempt to avoid paying compensatory damages by manipulating information regarding the existence of the contract is opportunism similar to the behavior in Example 3B. The facts of the Seaman's case indicate that a contract did exist between the parties. Part of the information that the contract existed is Standard's acknowledgment of the contract (often, when there is no writing or witness, the parties' acknowledgments are the only evidence).

with tort damages. Unfortunately, however, the court, in finding the new and separate tort, kept alive the old doctrine which states that for all other types of breach behavior, tort damages are only appropriate if a "special relationship"[79] exists between the parties.[80]

In a partial dissent, Justice Bird criticized the Seaman's court's avoidance of the full consequences of the questions it posed. She argued that the imposition of tort remedies for bad faith denial of the existence of a contract is not a new doctrine, but rather is compelled by the line of breach of the implied covenant cases beginning with Communale. She prayed for the court to "forthrightly recognize the principle that, under certain circumstances, a breach of contract may support a tort cause of action for breach of implied covenant."[81] Justice Bird proposed and defended a definition of what the "certain circumstances" are under which tort remedies are appropriate. She relied on looking at the parties' reasonable expectations, arguing that actions which are unreasonable in light of the

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The strategic withholding of this information is rightfully remedied by tort damages.

[79] See Seaman's 36 Cal. 3d at 768.

[80] While the Seaman's decision contained some ambiguity as to whether it was actually creating a new, limited tort, subsequent courts have interpreted the case in that way. See Elxsi v. Kukje America, Inc. 672 F. Supp. 1294, 1298 (N.D. Cal. 1987); Oki America, Inc. v. Microtech Int'l, Inc., 872 F.2d 312 (1989). But see Kittredge Sports Co. v. Superior Court 213 Cal. App. 3d 1045, 261 Cal. Rptr. 857 (Cal App 4 Dist. 1989).

[81] Seaman's 36 Cal. 3d at 775 (Bird, J. concurring and dissenting).

parties' expectations would be subject to tort liability. She wrote, "Certain expectations derive from assumptions so basic to the very notion of a contract that they are shared by virtually all contracting parties. Foremost among these is the expectation that a breaching party will compensate the other party for losses caused by the breaching party's failure to perform. The availability of contract damages, in turn, supports the equally fundamental assumption that breach is a foreseeable and, in most situations, acceptable possibility." Justice Bird argued that any activity which a party undertakes in order to avoid paying these damages, when they are due, is activity which should be punished with tort remedies. In essence, she identified a form of opportunism as the principle which divides tortious from non-tortious breaches. She rationalized her choice further by arguing that not punishing such bad faith behavior will undermine "the acceptance of the possibility of breach" by contracting parties.[82]

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[82] Justice Bird went on to state that a second class of cases require the imposition of tort damages - those in which the parties do not accept or reasonably expect that the contract will be breached. See Seaman's 63 Cal. 3d at 780 (Bird, J. concurring and dissenting) These contracts sound a lot like complete contingent contracts, which are indeed the easiest case in which to see the propriety of tort remedies. Justice Bird argued that insurance contracts and employment contracts fall into her category, since the nature of the relationship is such that the parties could not have wanted the contract to ever be breached. See id. This assertion is hard to support. No insurance contract or employment contract will explicitly detail the required performance under every contingency, and there is no reason to believe that the parties would negotiate that every unforeseen contingency require performance by the insurer or employer.

The majority opinion in Seaman's retained the principle that it is the nature of the contract relationship, rather than the nature of the breach, which determines whether tort remedies are appropriate. Lower courts applying this principle developed specific lists of factors which make a contract subject to tort treatment for breach of the implied covenant.[83] These factors, which relate to the bargaining position and vulnerability of the victim of the breach, are not necessarily related to the nature of the breach itself. By emphasizing these factors rather than inquiring into whether the breaching party was acting opportunistically, the courts are likely to impose tort damages in inappropriate cases, and are likely to not use tort remedies when they would be optimal. In addition, the "special relationship" test really has no objectivity or predictive power.[84] The fundamental problem with the emphasis on the nature of the contract, though, is that no connection is made between

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[83] For example, Wallis v. Superior Court, 160 Cal. App. 3d 1109, 207 Cal. Rptr. 123 (1984) listed these factors: (1) unequal bargaining power; (2) non-profit motivation for entering the contract; (3) ordinary contract damages neither make the party whole nor make the breaching party accountable for its actions; (4) the breach victim is especially vulnerable because of the trust it put in the other party; and (5) the breaching party is aware of the vulnerability. Id. at 1118.

[84] See Putz & Klippen, "Commercial Bad Faith: Attorney Fees - Not Tort Liability - Is the Remedy for 'Stonewalling,'" 21 U.S.F.L. Rev. 419, 478 - 79 (1987) ("The fundamental flaw in the 'special relationship' test is that it is illusory. It provides a label to hang on a result but not a principled basis for decision.")

the "special relationship" and the need for tort damages.[85]

The Seaman's decision not to generalize the inquiry into the nature of the breach intensified the inquiry into the nature of the contract relationship. New arguments were made that certain relationships, such as the bank deposit and the employment relationships, were "special". Some courts tried to eliminate the inquiry into the nature of the breach entirely, by interpreting Seaman's as having established the new tort for denial of the existence of a contract as applying only in cases of special relationship. Though the issue is still unsettled, it seems as if these efforts will fail.[86]

An argument is being made, however, to overrule the Seaman's decision itself, and get rid of the new tort. The argument is that the cause of action is too vague and unprincipled to be applied.[87] For example, Judge Kozinski argued that it "is impossible to draw a principled distinction between a tortious denial of a contract's existence and a permissible denial of liability under the terms of the contract."[88] To support this claim, he criticized as too subjective the Seaman's

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[85] See Comment, "Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort, 73 Cal. L. Rev. 1291, 1301 (1985); Note, supra note 7, at 392-93.

[86] See Air-Sea Forwarders, Inc. v. Air Asia Company, Ltd. 880 F. 2d 176, 184-88 (1989), cert. denied 110 S.Ct. 868 (1990).

[87] See Oki v. America, Inc. v. Microtech Intern., Inc. 872 F. 2d 312, 315 (Kozinski, J. concurring)

[88] Oki, 872 F.2d at 315 (Kozinski, J., concurring). This argument has been made elsewhere. See Note, supra note 7, at 406.

court's test that conduct which "offends accepted notions of business ethics" is a tortious breach. While his point regarding that test has merit, that does not mean that no test exists. The distinction between opportunism and breach activity caused by the occurrence of unforeseen contingencies is a principle which can be used to impose tort damages, without undue uncertainty and without causing an increase in the number of lawsuits.[89] Judge Kozinski's main complaint is that the new tort reduces the voluntariness of contracts. This criticism, too, is a criticism of the particular standard adopted by the courts. A standard based on opportunism, on the other hand, is fundamentally a furtherance of the principle that contracts are areas of personal autonomy and individual freedom. The prevention of opportunism is based on a presumption that society is best off if contracts are executed in a way to which the parties actually agreed or would have agreed had they foreseen the relevant contingency.

The inadequacy of determining when tort damages are appropriate based on the nature of the contract is apparent in the post-Seaman's cases which discussed whether tort damages were

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89 Judge Kozinski claimed that the "tortification of contract" "gives rise to a new form of entrepreneurship: investment in tort causes of action." The tort of bad faith denial of the existence of a contract, he argued, is a particularly good gamble because the stakes are high, and the standard is nebulous. See Oki 872 F.2d at 315-16 (Kozinski, J. concurring). However, by making the standard precise, and keeping the burden of proof of opportunism high, undesirable suits can be avoided. Furthermore, tort damages will deter opportunistic behavior, thereby eliminating the cause of many contract breaches and the resulting litigation. See Diamond, supra note 50, at 449.

appropriate for bad faith breach of the implied covenant in bank deposit and employment contracts. The first extension of tort damages beyond insurance contracts based on the existence of a special relationship occurred in the bank deposit context. In Commercial Cotton Co, Inc. v. United Cal. Bank,[90] the court seemed to have picked an appropriate case to impose tort damages, as there was a clear case of opportunism. Unfortunately, the court based its holding on the special relationship between the bank and depositor. Commercial Cotton involved a depositor's suit against his bank for negligence. The bank had honored a $4000 check drawn on the depositor's account even though the signatures on the check were unauthorized. The depositor did not realize that the error had been made until a year and a half had passed. When he made a claim to the bank, they informed him that the claim was barred by a one year statute of limitations. As it turns out, a case had just been decided against the bank in which the court held that the applicable statute of limitations was three years. The depositor sued, and the jury awarded him $4000 in compensatory damages, $20,000 for emotional distress, and $100,000 in punitive damages.

On appeal, the compensatory and punitive damages were upheld, but the emotional distress damages were denied for lack of evidence of harm. On the facts of the case,, the appellate court found it "inexplicable that UCB's general counsel could have been unaware of the Supreme Court holding affecting the bank

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[90] 163 Cal. App. 3d 511, 209 Cal Rptr 551 (1985).

for which he was general counsel" at the time he wrote the letter denying the depositor's claim. In pressing forward with its contention that the statute of limitations did not apply, the bank was found to have breached the implied covenant of good faith and fair dealing. As in Egan, the Commercial Cotton court relied on the quasi-fiduciary nature of the relationship between depositor and bank in making its holding. "The relationship of bank to depositor is at least quasi-fiduciary, and depositors reasonably expect a bank not to claim non-existent legal defenses to avoid reimbursement when the bank negligently disburses the entrusted funds." Since the jury found the bank's denial of liability to be spurious, and since the court agreed that it is inconceivable that the general counsel thought that his statutory limitations claim was legitimate, punitive damages are appropriate as a deterrence against such "stonewalling."

The Commercial Cotton court was facing an obvious case of opportunism. The opportunism arose out of the bank's ability to manipulate information regarding the existence of a contingency. The court can be seen as interpreting the contract to read as follows: "Should the depositor, within the statute of limitations period, file a claim that the bank negligently debited his account, and should this negligence be evident, the bank must reimburse the depositor's account for the amount of the negligent debit." In this case, there was no question as to the existence of any contingency, the negligence was clear, and the claim was made within the 3 year statute of limitations. However, the bank failed to live up to the performance requirement by attempting to manipulate information regarding the proper statute of limitations. The bank could be seen as gambling that the legally unsophisticated depositor would not know about the recent case which definitively determined the proper statute of limitations in a negligence case. Since such behavior is opportunistic, punitive damages are justified. Unfortunately, the court did not justify its decision on these general grounds, but rather continued to limit the reach of punitives by holding that the quasi-fiduciary nature of the relationship was the determining factor. The Commercial Cotton decision was left vulnerable to attack by a court willing to find that the banking relationship is not quasi-fiduciary. Indeed, in Price v. Wells Fargo Bank, another appellate court did just that. In reviewing the doctrinal development of the tortious breach of the implied covenant, the Price court criticized the "loose extension" of the tort from the insurance context into areas such as banking based on the existence of a "quasi-fiduciary" relationship.

The Supreme Court of California tackled the question of special relationship in the employment context in Foley v. Interactive Data Corp..[91] In Foley, the court held that tort damages were inappropriate for bad faith breach of the implied covenant in employment contracts. The Foley court found that the plaintiff-employee had indeed made out a sufficient showing that he had an implied-in-fact contract with his employer which

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[91] 47 Cal. 3d 654, 765 P.2d 371, 254 Cal. Rptr. 211 (1988).

limited the employer's right to fire him arbitrarily. The court then had to decide whether a bad faith breach of this implicit provision merited tort damages. The court began its discussion by criticizing lower courts which had found tort damages appropriate. The court pointed out that these lower courts erred in relying on the insurance line of cases without "engaging in a comparative analysis of insurance and employment relationships."[92] In addition, the Foley court started with the traditional presumption that contract and tort remedies are fundamentally different,[93] and therefore characterized the imposition of tort damages in insurance cases as a "departure from established principles of contract law."[94] The court then engaged in an inquiry into whether the nature of the employment contract justified such a radical departure from traditional contract law.[95]

The court began by questioning the appropriateness of the "special relationship" test, pointing out its lack of determinacy

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[92] Foley 254 Cal. Rptr. at 229.

[93] See Foley, 254 Cal. Rptr. at 227 ("The distinction between tort and contract is well grounded in common law, and divergent objectives underlie the remedies created in the two areas. Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate 'social policy'" (citing Prosser, Law of Torts (4th ed. 1971) p. 613)).

[94] Foley 254 Cal. Rptr. at 229.

[95] See Foley 254 Cal. Rptr. at 232 ("We must, therefore, consider with great care claims that extension of the exceptional approach taken in [insurance] cases is automatically appropriate if certain hallmarks and similarities can be adduced in another contract setting.")

and relevance to the question of determining when tort damages are appropriate for breach of the implied covenant.[96] The court then found that even if the test were the appropriate one, that the employment relationship just does not meet enough of the elements that have been proposed as characteristic of a "special relationship."[97] Finally, the court claimed that the employment relationship is fundamentally different from insurance contracts in that in the insurance relationship the parties are financially at odds, whereas in the employment context, in general, "it is to the employer's economic benefit to retain good employees."[98] While the court recognized that there may be some remaining bad motives for discharge not covered by law, that "in terms of abstract employment relationships as contrasted with abstract insurance relationships, there is less inherent relevant tension between the interests of employers and employees than exists between that of insureds and insurers."[99] Thus, the court held, there is less of a need for tort damages in the employment

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[96] See Foley 254 Cal. Rptr. at 232-33. For another argument that the "special relationship" test is too vague and subjective, see Note, "Formulating Standards for Awards of Punitive Damages in the Borderland of Contract and Tort," 74 Cal. L. Rev. 2033 (1987). Unfortunately, the note proposes what is also a fuzzy standard, calling for tort damages when there has been a deviation from commercially accepted norms.

[97] Foley 254 Cal. Rptr. at 234.

[98] Foley 254 Cal. Rptr. at 234. The court argues that the law already punishes many bad cause motivations for firings, such as various types of discrimination and for "whistle-blowing." Id. at 234 n.30.

[99] Foley 254 Cal. Rptr. at 234.

context.

However, opportunism can serve as a principle upon which to justify tort damages in the employment context, regardless of whether such opportunism is more or less likely to occur than in the insurance context. The potential existence of opportunism in the employment context generally, though perhaps not in breach at issue in Foley, is obvious. For instance, the Foley case discusses a Nevada case where tort damages were found appropriate in a case involving a discharge by an employer with the motive of "defeating contractual retirement benefits."[100] That is, the employer, knowing that the benefits were due, hoped to manipulate information or take advantage of some information imperfection, perhaps regarding the extent of the benefits, by firing the employee before he could receive the benefits. An employer may indeed have occasion to engage in opportunistic behavior, which must be countered with tort damages.[101] By continuing to base the imposition of tort damages on analyses of the nature of

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[100] See Foley 254 Cal. Rptr. at 229 n.26 (quoting from K Mart Corp. v. Ponsock, 732 P. 2d 1364, 1370 (Nev. 1987)).

[101] See Note, "Employer Opportunism and the Need for a Just Cause Standard," 103 Harv. L. Rev. 510, 517-523 (1989) (arguing that in order to prevent shirking, employers often institute deferred compensation schemes, the existence of which give profit-maximizing employers incentives to fire productive workers); Jordan v. Duff and Phelps, Inc. 815 F.2d 429, 438-39 (7th Cir. 1987). The existence of a reason for firing is not enough to make out a case for punitive damages, however, since compensatory damages will deter such behavior by eliminating the gain - the employee can sue to get his contractual deferred benefits. However, employers are likely to have information advantages regarding the value of such benefits due, advantages which the employer can exploit to avoid liability. This opportunism can only be countered by punitive damages.

different contract relationships in the abstract, rather than dealing with the particulars of the nature of any one breach, the court cannot produce a coherent and limited principle upon which to base the imposition of tort damages.

III: Conclusion

In this paper I have argued that tort damages are appropriate and necessary to counter opportunistic breaches of contract. I have also tried to show that current doctrine is misguided in emphasizing the nature of the contract, rather than the nature of the breach, in justifying tort damages.