



1985

Bad Faith in First Party Insurance Contracts—What's Next

Paula J. Casey

Follow this and additional works at: <https://lawrepository.ualr.edu/lawreview>



Part of the [Contracts Commons](#), and the [Insurance Law Commons](#)

Recommended Citation

Paula J. Casey, *Bad Faith in First Party Insurance Contracts—What's Next*, 8 U. ARK. LITTLE ROCK L. REV. 237 (1986).

Available at: <https://lawrepository.ualr.edu/lawreview/vol8/iss2/2>

This Article is brought to you for free and open access by Bowen Law Repository: Scholarship & Archives. It has been accepted for inclusion in University of Arkansas at Little Rock Law Review by an authorized editor of Bowen Law Repository: Scholarship & Archives. For more information, please contact mmserfass@ualr.edu.

UNIVERSITY OF ARKANSAS AT LITTLE ROCK
LAW JOURNAL

VOLUME 8

1985-86

NUMBER 2

BAD FAITH IN FIRST PARTY INSURANCE
CONTRACTS—WHAT'S NEXT?

*Paula J. Casey**

I. INTRODUCTION

Arkansas recently joined other jurisdictions in recognizing that an insurer which engages in practices in bad faith to avoid paying legitimate policy claims to its insured not only breaches a contract but also commits the tort of first party bad faith.¹ Damages for breach of contract are generally limited to those which were foreseeable or contemplated by the parties at the time the contract was made² while compensatory and punitive damages may be recovered in a tort action.³ Therefore, the recognition of the tort of first party bad faith broadens

* Associate Professor of Law, University of Arkansas at Little Rock School of Law.

1. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 665 S.W.2d 873 (1984); *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463 (1983). For a discussion of the cases see Note, *Tort Of Bad Faith In First Party Actions Recognized*, 7 UALR L.J. 671 (1984).

2. *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854); *Chicago, R.I. and P.R. Co. v. King*, 104 Ark. 215, 148 S.W. 1035 (1912).

3. Compensatory damages are awarded for the purpose of making the injured party whole. *Dunaway v. Troutt*, 232 Ark. 615, 339 S.W.2d 613 (1960). Negligence will not support an award of punitive damages; the tortfeasor's conduct must be willful or malicious. *Freeman v. Anderson*, 279 Ark. 282, 651 S.W.2d 450 (1983). Punitive damages are not generally recoverable in a contract action, *L.L. Cole & Son, Inc. v. Hickman*, 282 Ark. 6, 665 S.W.2d 278 (1984); *Snow v. Grace*, 25 Ark. 570 (1869), although some jurisdictions allow punitive damages in breach of contract cases. See J. MCCARTHY, *PUNITIVE DAMAGES IN BAD FAITH CASES* § 8 (3d ed. 1983) for a collection of cases awarding punitive damages in contract actions.

the range of damages which may be recovered by the insured in an action against the insurer for payment of policy benefits.⁴

This article will trace the expansion of the tort of third party bad faith in Arkansas to the recent recognition of first party bad faith. The proof necessary to establish the tort in Arkansas will be examined as well as the types of damages which may be imposed against an insurer. Finally, the article will discuss the possible application of the tort of bad faith to other contract actions in Arkansas.

II. THE BEGINNING OF BAD FAITH

Liability insurance policies typically provide that the insurer will control all aspects of litigation including settlement of lawsuits.⁵ An insured who fails or refuses to allow his insurer to control litigation breaches the insurance contract and relieves the insurer of liability under the terms of the policy.⁶ The insurer in control of litigation often is faced with a conflict of interest in making decisions about settlement. For example, when an insured has been sued for an amount greatly in excess of the policy limits and any offer to settle would require the insurer to pay the policy limits, the insurer actually gambles nothing if it chooses to pursue litigation to its conclusion rather than settle the case for the policy limit. The insured, on the other hand, is not only in the position of having a large judgment taken against him, but is also in the position of having someone else make the decisions about whether a settlement offer should be accepted. An insurer which negligently or in bad faith fails or refuses to settle a case, thus exposing its insured to a judgment in excess of the policy limits, commits the tort of third party bad faith.

Several decades prior to the recognition and development of third party bad faith as a tort,⁷ the Arkansas Supreme Court recognized that

4. For a discussion of the damages recovered by the plaintiffs in *Broadway Arms and Williams*, see *infra* notes 60-109 and accompanying text.

5. R. KEETON, *INSURANCE LAW* § 7.8 (3d ed. 1973).

6. *Gunter v. La Grone*, 253 Ark. 644, 488 S.W.2d 18 (1972).

7. The California court held in 1958 that a wrongful refusal to settle gave rise to a cause of action in either contract or in tort. *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958). An insured was allowed to recover damages for mental suffering which resulted from an insurer's failure to settle a case. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). The tort theories of recovery in third party cases were important to the later development of bad faith law in first party cases. Damages for intentional infliction of emotional distress were recovered by an insured when his insurer failed to pay benefits under a disability policy. *Fletcher v. Western Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970). In *Fletcher*, the court discussed an implied duty of fair dealing in insurance contracts. Breach of the implied duty of fair dealing blossomed into a first party bad faith tort in the landmark case of

an insurer should not be allowed to exploit its control of litigation to the detriment of the insured. In *Southern Surety Co. v. Puryear-Meyer Grocery Co.*,⁸ the insurer posed a defense in a lawsuit against its insured which protected the insurer against liability but left the insured exposed.⁹ The insured settled the case and sued the insurer for indemnification. In affirming the judgment against the insurer, the court found that the insurance company had a duty to defend against the claim of the third party and could not control the litigation with the sole purpose of absolving itself from liability to its insured.¹⁰

In 1954, the Arkansas Supreme Court again recognized that an insurer must deal fairly with its insured in *Home Indemnity Co. v. Snowden*.¹¹ The insurer claimed that Mr. Snowden, the insured, was not liable in a wrongful death action that had been filed against him and if he were liable there was no coverage under the policy.¹² Mr.

Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973). See Comment, *An Independent Duty of Good Faith and Fair Dealing in Insurance Contracts—Gruenberg v. Aetna Insurance Co.*, 11 SAN DIEGO L. REV. 492 (1975) for a discussion of the development of California law.

8. 151 Ark. 480, 236 S.W. 841 (1922).

9. The insured was sued by a third party as a result of an automobile accident. A default judgment was taken but was abandoned by the third party after the insured claimed a lack of notice in the lawsuit. A second suit was then instituted and process was served on the insured. The insured immediately notified the insurer of the second lawsuit. The insurance company took control of the litigation. After a second judgment was rendered against the insured in the court of common pleas, the insured appealed the case to circuit court. On appeal to circuit court, the insurer claimed that the second judgment from the court of common pleas was invalid because the first judgment made the case *res judicata*. The circuit court ruled that the second judgment was *res judicata* and the first judgment was established as valid. Because the insured had not notified the insurer of the institution of the first lawsuit, the insurer then claimed that it was not liable under the terms of the policy which provided that:

(a) Upon the occurrence of an accident covered by this policy, the assured shall give immediate written notice thereof with the fullest information obtainable at the time to the company, or its duly authorized agent. If a claim is made on account of such accident, the assured shall give like notice thereof, with full particulars. If suit is brought to enforce such claim, the assured shall immediately forward to the company every summons, or other process, as soon as same shall have been served upon him. The assured shall at all times render to the company all co-operation and assistance, except in a pecuniary way, within his power.

(b) The assured * * * shall not interfere in any negotiations for settlement, or in any legal proceeding conducted by the company on account of any claim. . . .

Id. at 483, 236 S.W. at 844.

10. *Id.* at 484, 236 S.W. at 845.

11. 223 Ark. 64, 264 S.W.2d 642 (1954).

12. Mr. Snowden owned and operated a number of frozen food locker plants. He hired a refrigeration contractor to make repairs to one of the plants. The contractor died of gas poisoning while trying to repair the refrigerators and his widow filed a wrongful death action against Mr. Snowden. Home Indemnity Company, the public liability insurance carrier for Mr. Snowden, advised him that they would protect "our mutual interest" but also advised him that he could em-

Snowden settled the case after the insurer refused to contribute the policy proceeds to the settlement, and he then filed suit against the insurer. Mr. Snowden received a verdict in the trial court for the full amount which he had expended in settlement of the case.¹³ On appeal, the Arkansas Supreme Court found that when an insurer assumes the responsibility of litigation on behalf of an insured, it owes the insured a duty of good faith. The court used language which indicated that the cause of action was in contract and that an insurer breaches the insurance contract by arbitrarily refusing to settle.¹⁴ The court applied a contract measure of damages in *Snowden* and reduced the judgment to the policy limit.¹⁵ If the court had determined that the cause of action was in tort, Mr. Snowden could have recovered damages in excess of the policy limit.

It was not until several years later, in *Southern Farm Bureau Casualty Insurance Co. v. Parker*,¹⁶ that the court moved from a contract to a tort analysis of third party bad faith. In *Parker*, the court extended an insurer's liability for failure to settle third party claims from the bad faith standard which was set out in *Snowden* to a standard of mere negligence. The court reasoned in *Parker* that a failure to settle could be a negligent act even though the insurer was acting in good faith.¹⁷ The court's holding that the insurer's liability could be based on negligence was a clear indication that the cause of action was based in tort although the court never addressed the question. Any doubt that might have remained about whether the cause of action was in contract or in tort was dispelled the next year in *Southern Farm Bureau Casualty Co. v. Hardin*.¹⁸ In *Hardin*, the court reversed a decision awarding pre-judgment interest against an insurer, holding that the action was one in tort.¹⁹

The determination of whether the action is in tort or in contract is significant because of the difference in the types of damages which are recoverable. Under traditional contract theory, a party's expectation in-

ploy an attorney at his own expense if he so desired. The insurance company took the position during the conference that if the refrigeration contractor could be shown to be an employee of Mr. Snowden rather than an independent contractor, the insurance company would not be liable under its policy. *Id.*

13. Mr. Snowden settled the case for \$8,467.77 but the face value of the insurance policy was only \$5,000. *Id.* at 69-71, 264 S.W.2d at 645.

14. *Id.* at 70, 264 S.W.2d at 645.

15. *Id.* at 71, 264 S.W.2d at 646.

16. 232 Ark. 841, 341 S.W.2d 36 (1960).

17. *Id.* at 848, 341 S.W.2d at 41.

18. 233 Ark. 1011, 351 S.W.2d 153 (1961).

19. *Id.* at 1014, 351 S.W.2d at 155.

terest is protected by awarding him the benefit of the bargain in the event the other party breaches.²⁰ In the context of liability insurance, if an insurer fulfills its contract, the policy limit is the maximum extent of its liability.²¹ Following this theory, an insured who faces a judgment in excess of his policy limits after his insurer fails to settle a case can only expect the insurer to pay the face amount of the policy.²² However, by using a tort theory of damages, the court can award damages beyond those which would be allowable in contract actions. The injured party in a tort action is generally entitled to compensation for all injuries caused by the defendant.²³ In addition, if the defendant's conduct is sufficiently malicious, punitive damages may be awarded.²⁴

It is well settled in Arkansas that an insurer may be liable for extracontractual damages if the insurer fraudulently, negligently, or in bad faith fails or refuses to settle a case within the policy limits.²⁵ This rule of law provided the basis for the recognition of first party torts of bad faith in Arkansas.

III. EXTENSION OF BAD FAITH TO FIRST PARTY CONTRACTS

The idea that an insurer has a duty to act fairly and in good faith when dealing with its insured in a third party situation or risk liability beyond the face amount of the policy was gradually extended to include dealings which were between just the insured and insurer. While early cases were either based on contract,²⁶ or found their roots in already established torts²⁷ (such as intentional infliction of severe mental distress), the cause of action for bad faith in insurance contracts evolved into a full-fledged tort in its own right. By the time the Arkansas courts were faced with the question of first party bad faith the issue

20. *Rebsamen Companies, Inc. v. Ark. State Hospital Employees Federal Credit Union*, 258 Ark. 160, 522 S.W.2d 845 (1975).

21. *But see* *Lawton v. Great Southwest Fire Ins. Co.*, 118 N.H. 607, 392 A.2d 576 (1978), where the court held that the insured's extracontractual damages were a foreseeable result of the insurer's breach.

22. *See* *Home Indem. Co. v. Snowden*, 233 Ark. 64, 264 S.W.2d 642 (1954), where the court applied a contract measure of damages for the insurer's breach.

23. *See, e.g., St. Louis Southwestern Ry. Co. v. Brummett*, 201 Ark. 53, 143 S.W.2d 555 (1940).

24. *See, e.g., Barlow v. Lowder*, 35 Ark. 492 (1880).

25. *See, e.g., Tri-State Ins. Co. v. Busby*, 251 Ark. 568, 473 S.W.2d 893 (1971).

26. *See supra* note 21.

27. *See, e.g., Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

had been settled in a number of jurisdictions.²⁸

The question was raised initially in Arkansas in *Findley v. Time Insurance Co.*²⁹ In that case, the insured had purchased a major medical policy from the insurer and later filed claims against the policy. The insurer refused to pay the claims alleging that the insured had failed to disclose prior existing conditions which, if disclosed, would have resulted in the insurer not issuing the policy. The insured sued, alleging causes of action in both contract and tort. The supreme court affirmed the trial court's dismissal, holding that the complaint did not state a cause of action in tort for bad faith. The first party tort of bad faith was described in *Findley* as a logical extension of third party bad faith.³⁰ The court then approved the traditional method of distinguishing the type of conduct which will amount to a tort based on breach of contract. In order for an insurer to be liable for bad faith based on breach of a first party insurance contract in Arkansas, the insurer would have to engage in affirmative conduct. In other words, the insurer would have to do more than simply refuse to pay, which could be described as nonfeasance. The insurer would have to be "actively engaged in dishonest, malicious, or oppressive conduct in order to avoid its liability."³¹ However, in the best judicial tradition, the court stopped short of actually recognizing bad faith as a tort in Arkansas because of its finding that the facts alleged in *Findley* failed to state a cause of action.

Almost five years after *Findley*³² the court was forced to answer

28. See, e.g., *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 647 P.2d 1127 (1982), cert. denied, 459 U.S. 1070 (1982); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

29. 264 Ark. 647, 573 S.W.2d 908 (1978).

30. *Id.* at 649, 573 S.W.2d at 909. The court, after stating that the tort of first party bad faith was a logical extension of the third party bad faith tort, set out a hypothetical to illustrate the problems in third party cases. *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970), was cited as "the landmark decision extending the doctrine of the failure to settle cases. . . ." The court never addressed the similarities or differences of first and third party cases nor did the court explain the logic of the extension.

31. 264 Ark. at 654-55, 573 S.W.2d at 911-12.

32. In the interim between *Findley* and *Broadway Arms* the court recognized that the contractual relationship between the insurer and the insured did not protect the insurer from liability for tortious conduct. In 1978, the Arkansas Court of Appeals determined that a cause of action in deceit would lie against an insurance company. In *Sturgeon v. American Family Life Assurance Co.*, 266 Ark. 1040, 589 S.W.2d 207 (1979), the insurer sold a cancer insurance policy to Mr. Sturgeon and represented that the policy would pay benefits in addition to any other benefits Mr. Sturgeon might have. The company later refused to pay the claims which resulted from Mr. Sturgeon having cancer of the larynx. The trial court made a pre-trial ruling that the complaint stated a cause of action in contract and refused to allow discovery of information regarding punitive damages. In reversing the trial court's decision that the complaint was in contract and not in tort,

the question of whether Arkansas would recognize the tort of bad faith in first party insurance contracts in the case of *Aetna Casualty and Surety Co. v. Broadway Arms Corp.*³³ Broadway Arms Corporation was insured against fire loss by Aetna Casualty and Surety Company. A fire at Broadway Arms Corporation destroyed or damaged all inventory and resulted in the business being closed. Several days after the fire Aetna paid Broadway Arms \$30,000 as a partial payment on the loss. Attempts to negotiate a settlement on the remainder of the claim failed and eventually Broadway Arms Corporation filed suit against Aetna claiming damages based on the tort of bad faith. The jury found that Aetna had acted in bad faith and awarded \$175,000 compensatory damages and \$5,000,000 in punitive damages to Broadway Arms Corporation.

Broadway Arms Corporation made three allegations of bad faith against Aetna. The first was that Aetna had refused to pay policy limits under the fire coverage. It was also alleged that Aetna had failed to release the salvage of the fire to Broadway Arms Corporation. The final allegation was that an agent of Aetna had threatened to report Broadway Arms Corporation to the Internal Revenue Service.³⁴ The jury found that Broadway Arms was entitled to more money under the policy provisions than was offered by Aetna during negotiations. In addi-

the court of appeals held that the complaint contained all of the elements of the tort of deceit.

The Arkansas Supreme Court approved the court of appeals ruling in *Sturgeon* in deciding the case of *M.F.A. Mutual Ins. Co. v. Keller*, 274 Ark. 281, 623 S.W.2d 841 (1981). However, the *Keller* decision demonstrates the difficulty of applying the cause of action in deceit to some insurance cases. In *Keller*, the insured's proof of loss claim for \$44,000 for fire loss on a house was refused by the insurer. The insurer offered \$22,750 to the insured to settle the claim. The insured filed suit, which resulted in a judgment for the claim on the policy, a penalty and attorney's fees, compensatory and punitive damages. The Arkansas Supreme Court reversed the award for compensatory and punitive damages, which were based on the tort of deceit. The court noted that the cause of action for deceit requires that a defendant knowingly make a false representation with the intention to induce the plaintiff to act or refrain from acting in reliance on the misrepresentation. In addition, the plaintiff must justifiably rely upon the defendant's representation with resulting damages. The court then found that there was substantial evidence to support a finding that the insurance company had made false representations of fact to its insured in denying that the insurer's appraiser had estimated the cost of repair to the house at \$40,000 to \$50,000 and in alleging that local contractors refused to bid on the house. The court also found that there was substantial evidence to find that the representations were made knowingly by the insurance company with the intention of inducing the insured to accept the \$22,750 offer of settlement which had been made. However, the insured had not accepted the insurer's offer of settlement, apparently because the insured knew that the offer was too low. Therefore, the insured had not acted in reliance on the insurer's representations and had suffered no damage as a result. The court reversed the judgment for compensatory and punitive damages.

33. 281 Ark. 128, 664 S.W.2d 463 (1983).

34. *Id.* at 134, 664 S.W.2d at 466.

tion, the jury found that Aetna had committed acts of bad faith. On appeal, the court found that the salvage from the fire had remained in the control of Broadway Arms Corporation at all times. The court held that, as a matter of law, there was nothing about the handling of the salvage claim which was dishonest, malicious, or oppressive. Because the case was remanded,³⁵ the court did not make a finding about the alleged threat involving the Internal Revenue Service. Although the Broadway Arms case was reversed and remanded for a new trial, any doubts which may have remained after *Findley* were eliminated; Arkansas clearly recognizes that bad faith is an actionable tort in the context of first party insurance contracts.³⁶

Within a matter of weeks, the court had the opportunity to further elaborate on the tort of bad faith in *Employers Equitable Life Insurance Co. v. Williams*.³⁷ Mr. Williams had purchased a health and accident policy from Employers Equitable on July 1, 1980. The policy was for a one month term, was renewable monthly, and had a thirty-one day grace period. The policy also provided that acceptance of a late premium payment without a request for reapplication would automatically result in the policy being reinstated. However, Employers Equitable could issue a conditional receipt and require the insured to reapply. If the reapplication was not rejected within forty-five days, the policy would be automatically reinstated.

Mr. Williams had a heart attack on November 1, 1981. In December, he filed a claim for benefits. Mr. Williams made repeated inquiries about the status of his claim and was told that it was being processed. On March 22, 1982, Mr. Williams received his benefit check and a notice that because of late payments of premiums he would have to submit a reapplication for insurance. His reapplication was denied by Employers Equitable on May 7, 1982.

In the meantime, the Arkansas Insurance Department began an investigation of Employers Equitable. As a result of the investigation,

35. The case was reversed and remanded because the court found that a jury instruction based on a section of the Trade Practices Act, ARK. STAT. ANN. § 66-3005(9) (1980) was improper. The statute defines conduct which constitutes "Unfair Claims Settlement Practices" under the Act. However, the portion of the statute which reads, "committing or performing with such frequency as to indicate a general business practice, any of the following," was omitted from the instruction. The court also found that violation of the Trade Practices Act is not necessarily evidence of bad faith. See Glasgow, *First Party Bad Faith Comes to Arkansas*, 18 ARKANSAS LAWYER 48 (1984), for the attorney's view of the case and the trial.

36. The *Broadway Arms* case was settled during the second trial for an undisclosed amount of money. Arkansas Gazette, July 21, 1984, at 13A, col. 5.

37. 282 Ark. 29, 665 S.W.2d 873 (1984).

Employers Equitable was issued the largest fine ever levied under the insurance penalty statute in the history of the state. In addition, its license to operate was suspended twice.

Employers Equitable claimed that Mr. Williams' policy was cancelled because his February payment was not made until March 15th. The court found that although the insurance company's worksheets, which were entered by hand, reflected that Mr. Williams had made no premium payments in February and March, the company's computer cards showed that the February payment and the March payment were both timely made. In addition, there was evidence that the computer cards had been altered. The jury found that the insurance company had acted in bad faith by declaring that the policy had lapsed. On appeal, the Arkansas Supreme Court affirmed the decision and held that there was substantial evidence that the insurance company had acted in bad faith. The court further held that there was sufficient evidence to support the award of \$25,000 in compensatory damages and \$75,000 in punitive damages as well as a statutory penalty and attorney's fees.

The *Broadway Arms* and *Williams* decisions place Arkansas in the ever growing number of jurisdictions which have recognized the tort of bad faith in first party insurance contracts. *Findley* and *Broadway Arms* both refer to the new tort as a logical extension of the third party bad faith tort. However, comparison of the standard of conduct applied to insurers, the recoverable damages, and the insurer/insured relationship in the two situations provides some evidence that the third party tort is not a logical foundation for the first party tort. Recognition of the first party tort may provide a basis for extending tort remedies to other kinds of contract actions.

IV. ESTABLISHING BAD FAITH

A. *The Insurer's Standard of Conduct*

In order to recover damages in excess of the policy limits from an insurer in a third party action in Arkansas, the insured need only prove that the insurer acted negligently with regard to the litigation or settlement.³⁸ Where the insurer is under a duty to act, its failure to act might give rise to liability based on negligence.³⁹ Negligence on the part of the insurer is not sufficient to establish the tort of first party bad faith in Arkansas.⁴⁰ In a first party action, the insured must prove

38. *Southern Farm Bureau Casualty Co. v. Parker*, 232 Ark. 841, 341 S.W.2d 36 (1960).

39. See W. KEETON, PROSSER AND KEETON ON TORTS § 56 (5th ed. 1984).

40. *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463

that the insurer affirmatively engaged in dishonest, malicious, or oppressive conduct. "Such a claim cannot be based upon good faith denial, offers to compromise a claim or for other honest errors of judgment by the insurer. Neither can this type of claim be based upon negligence or bad judgment so long as the insurer is acting in good faith."⁴¹

Exactly what constitutes affirmative misconduct is a question of fact to be determined by the trier of fact.⁴² A threat by the insurer to report the payment of policy proceeds to the Internal Revenue Service was one of the acts the insured alleged constituted bad faith in *Broadway Arms*.⁴³ The court held that the allegation presented a fact issue to be determined on remand. In *Williams*,⁴⁴ the jury found that the insurer acted in bad faith by declaring that the policy had lapsed and could not be reinstated.⁴⁵ The insured presented proof during the trial that the insurer had altered records to falsely show that the policy had lapsed when in fact the insurer was holding checks that the insured had tendered as policy premiums. In addition, the insurer had mailed the insured a form to sign which asked the insured to acknowledge that he had failed to pay his monthly premiums. The court found that this constituted substantial evidence on which to base bad faith liability.⁴⁶

The Arkansas Supreme Court has consistently emphasized that *affirmative* misconduct is required to establish first party bad faith; mere failure to act will not give rise to the tort.⁴⁷ In *Findley*, where the insured's cause of action in tort was based on allegations that the insurer had failed to explain its reasons for refusing to pay claims, had failed to investigate the diagnosis of the insured's condition and had failed to contact the insured's physicians, the court upheld the trial court's dismissal of that portion of the complaint for failure to state a cause of action. The court reasoned that inaction on the part of the insurer was insufficient to establish the tort noting that "an action in tort cannot ordinarily be based upon a breach of contract which amounts to mere nonfeasance, which means not doing the thing at all, as distinguished

(1983).

41. *Id.* at 133, 664 S.W.2d at 465.

42. *Id.* at 134, 664 S.W.2d at 466.

43. *Id.*

44. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 665 S.W.2d 873 (1984).

45. *Id.* at 29, 665 S.W.2d at 873.

46. *Id.* at 33, 665 S.W.2d at 875.

47. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 665 S.W.2d 873 (1984); *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463 (1984); *Findley v. Time Ins. Co.*, 264 Ark. 647, 573 S.W.2d 908 (1978).

from misfeasance, which means doing it improperly.”⁴⁸

B. *Evidence of Insurer's Practices*

The Arkansas Trade Practices Act⁴⁹ provides in pertinent part that:

The following are hereby defined as unfair methods of competition and unfair or deceptive acts or practices in the business of insurance:

(9) UNFAIR CLAIMS SETTLEMENT PRACTICES. Committing or performing with such frequency as to indicate a general business practice, any of the following:

(a) Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;

(b) Failing to acknowledge and act reasonably and promptly upon communications with respect to claims arising under insurance policies;

(c) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;

(d) Refusing to pay claims without conducting a reasonable investigation based upon all available information;

(e) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;

(f) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;

(g) Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured;

(h) Making claim payments to policyholders or beneficiaries not accompanied by a statement setting forth the coverage under which payments are being made;

(i) Delaying the investigation or payment of claims by requiring an insured, claimant or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information;

(j) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts of applicable law for denial of a claim or for the offer of a compromise

48. Findley v. Time Ins. Co., 264 Ark. 647, 653, 573 S.W.2d 908, 911 (1978).

49. ARK. STAT. ANN. §§ 66-3001 to -3014 (Cum. Supp. 1985).

settlement.

(k) Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds;

(l) Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application;

(m) Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose [purpose] of compelling them to accept settlements or compromises less than the amount awarded in arbitration;

(n) Failing to promptly settle claims, where liability has become reasonably clear, under one [1] portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

In *Broadway Arms* the jury was instructed that violation of the Trade Practices Act was some evidence of bad faith which should be considered in the case.⁵⁰ The Arkansas Supreme Court ruled that the instruction was improper because although the statute provides that the prohibited practices must be committed with "such frequency as to indicate a general business practice,"⁵¹ the evidence at trial only described the specific acts which were committed by the insurer against Broadway Arms. The court found that the instruction improperly stated that a violation of the Trade Practices Act was evidence of bad faith and noted that only one section of that act related to bad faith.⁵² The extent to which evidence of violations of the Trade Practices Act can be used at trial is not clear from the opinion in *Broadway Arms*.

In *Williams*, the court clearly approved of the introduction of evidence regarding specific acts that the insurer had committed which were violations of the Trade Practices Act and which were unrelated to the plaintiff insured's case.⁵³ The Arkansas Insurance Department had

50. *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 134, 664 S.W.2d 463, 466 (1983).

51. ARK. STAT. ANN. § 66-3005(9) (Cum. Supp. 1985). The court's statement that only subsection 9(f) relates by implication to bad faith is apparently a reference to the fact that only subsection (f) contains the good faith standards. Most of the other prohibited practices which are set out in the Act describe nonfeasance rather than misfeasance. However, subsection (a) deals with misrepresentation and subsections (k) and (m) also deal with affirmative acts on the part of the insurer.

52. 281 Ark. at 134, 664 S.W.2d at 466.

53. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 665 S.W.2d 873 (1984).

conducted an investigation of the insurer in *Williams*. An investigator for the Arkansas Insurance Department testified that as he seized some claims files from the office of Employers Equitable a secretary tried to destroy a note from the president of the company which read: "work this one to death. Best regards, p.s. throw this note away now."⁵⁴ A claims underwriter for the company testified that she had been instructed to refuse to pay claims and that she had been offered bonuses to deny claims. There was also evidence that the company regularly engaged in practices designed to delay payment of claims. While none of these acts establish affirmative misconduct on the part of Employers Equitable towards the plaintiff, the acts are evidence of malice which may be inferred from conduct in surrounding circumstances.⁵⁵ As a result of the investigation, the largest fine ever levied against an insurer in Arkansas was levied against Employers Equitable.⁵⁶

C. *Expert Testimony*

While the use of expert testimony is not absolutely necessary in a bad faith case, it may sometimes be desirable.⁵⁷ In *Broadway Arms*, the plaintiff presented testimony of two attorneys regarding the practices of the insurer.⁵⁸ The Arkansas Supreme Court held that the trial court had not abused its discretion in refusing to admit the opinions offered by the two attorneys on the issues of bad faith. The offer of proof by one attorney was that the insurer had violated the Trade Practices Act and that the acts were willful, malicious or oppressive. In discussing the appropriate role for the insured's former attorney at the trial on remand, the court indicated that expert testimony would be proper in a bad faith case. However, the court went on to say that an expert witness may not testify that the insurer acted in bad faith because to do so would not only "touch upon the ultimate issue but would in effect tell the jury how to decide the case."⁵⁹

54. *Id.* at 31, 665 S.W.2d at 874.

55. *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 134, 664 S.W.2d 463, 465 (1983).

56. Employers Equitable ultimately was fined \$50,500 and the company's license to operate was suspended twice by the Arkansas Insurance Department. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 31, 665 S.W.2d 873, 874 (1984).

57. See J. MCCARTHY, *PUNITIVE DAMAGES IN BAD FAITH CASES* § 4.11 (3d ed. 1983).

58. *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 134, 664 S.W.2d 463, 466 (1983).

59. *Id.* at 137, 664 S.W.2d at 467.

V. DAMAGES IN BAD FAITH ACTIONS

Perhaps the most important aspect of bad faith is the broader range of damages which results from the recognition of a tort. In third party actions, the insurer has been held liable for the total amount of any judgment against the insured, even when it was beyond the policy limit, if the insurer was negligent or acted in bad faith in failing to make settlement.⁶⁰ Those damages compensate the insured for the injury he has suffered as a result of the insurer's conduct.⁶¹ There has been no reported case of an award of punitive damages for third party bad faith in Arkansas, although punitive damages could conceivably be based on a theory of bad faith on the part of the insurer.⁶² Punitive damages would not be allowed as a result of an insurer's negligent conduct.⁶³

The application of a tort theory of recovery to first party actions raises the possibility of large judgments being taken against insurers because both compensatory and punitive damages may be awarded. An insured must prove that the insurer's conduct was dishonest, malicious, or oppressive in order to recover compensatory damages for first party bad faith.⁶⁴ Punitive damages require proof of malice which can be inferred from dishonest, fraudulent, or malicious conduct.⁶⁵ Therefore, punitive damages would seem to be appropriate any time that liability for compensatory damages for first party bad faith has been established. The jury awarded \$5,000,000 for punitive damages in *Broadway Arms* and \$175,000 for compensatory damages.⁶⁶ In *Williams*, the supreme court affirmed a jury award of \$75,000 for punitive damages where the compensatory damages were \$25,000.⁶⁷ The purpose of punitive damages is to punish the wrongdoer and to serve as a deterrent to other potential wrongdoers.⁶⁸ Thus, punitive damages may be considered a penalty. Arkansas also imposes other penalties against insurers

60. See, e.g., *Members Mutual Ins. Co. v. Blissett*, 254 Ark. 211, 492 S.W.2d 429 (1973).

61. See H. BRILL, ARKANSAS LAW OF DAMAGES § 24-3 (1984).

62. In order to recover punitive damages, the insured would have to prove that the insurer acted with malice. See *Ray Dodge, Inc. v. Moore*, 251 Ark. 1036, 479 S.W.2d 518 (1972).

63. Negligence cannot support an award of punitive damages in Arkansas. *Freeman v. Anderson*, 279 Ark. 282, 651 S.W.2d 450 (1983).

64. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 665 S.W.2d 873 (1984); *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463 (1983).

65. See *Ray Dodge, Inc. v. Moore*, 251 Ark. 1036, 479 S.W.2d 518 (1972).

66. 281 Ark. 128, 131, 664 S.W.2d 463, 464 (1983).

67. 282 Ark. 29, 665 S.W.2d 873 (1984).

68. See H. BRILL, ARKANSAS LAW OF DAMAGES § 4-1 (1984); D. DOBBS, REMEDIES § 3.9 (1973).

by statute.

The insurance industry in Arkansas is regulated by a comprehensive statutory scheme which is designed to protect individual insureds and the public as a whole. In 1959, Arkansas adopted the Trade Practices Act,⁶⁹ which prohibits unfair methods of competition in the insurance industry and unfair and deceptive acts and practices. Included in the list of prohibited acts are those acts specifically related to the settlement of insurance claims.⁷⁰ The insurance commissioner is authorized to investigate insurers to determine whether the insurers are engaging in prohibited practices.⁷¹ After notice to the insurer and a hearing,⁷² an insurer may be penalized if the commissioner determines that the statute has been violated.⁷³ The penalties for violation of the Trade Practices Act include suspension or revocation of the insurer's license, fines, and orders to cease and desist prohibited practices.⁷⁴ All insurers are covered by this Act.⁷⁵

Arkansas also has a penalty statute which may be used by individual insureds in lawsuits against insurers which fail to pay claims.⁷⁶ In order to recover attorneys' fees and a 12% penalty under the Arkansas statute,⁷⁷ an insured must prove that the insurer refused to pay a claim

69. ARK. STAT. ANN. § 66-3001 *et seq.* (Supp. 1985).

70. ARK. STAT. ANN. § 66-3005 (Supp. 1985) defines the prohibited practices. The pertinent portions of the statute are set out in the text accompanying note 49, *supra*.

71. ARK. STAT. ANN. § 66-3006 (1980).

72. ARK. STAT. ANN. § 66-3007 (1980).

73. *Id.*

74. ARK. STAT. ANN. § 66-3008 (Supp. 1985).

75. *See* ARK. STAT. ANN. §§ 66-3003 and 66-3004 (1980).

76. ARK. STAT. ANN. § 66-3238 (1980).

77. The statute provides that:

In all cases where loss occurs and the cargo, fire, marine, casualty, fidelity, surety, cyclone, tornado, life, health, accident, medical, hospital, or surgical benefit insurance company and fraternal benefits society or farmer's mutual aid association liable therefore shall fail to pay the same within the time specified in the policy, after demand made therefore, such person, firm, corporation and/or association shall be liable to pay the holder of such policy or his assigns, in addition to the amount of such loss, twelve percent (12%) damages upon the amount of such loss, together with all reasonable attorney's fees for the prosecution and collection of said loss; said attorney's fees to be taxed by the court when the same is heard on original action, by appeal or otherwise, and to be taxed up as a part of the costs therein and collected as other costs are, or may be by law collected; and writs of attachment or garnishment filed or issued after proof of loss or death has been received by the company shall not defeat the provisions of this section, provided the company or association, desiring to pay the amount of the claim as shown in the proof of loss or death may pay said amount in to the registry of the court, after issuance of writs of attachment and garnishment in which event there shall be no further liability on the part of said company.

ARK. STAT. ANN. § 66-3238 (1980).

after demand was made.⁷⁸ The insured must then prevail at trial and recover the exact amount prayed for in his complaint.⁷⁹ Although the courts require a strict construction of this statute because it is penal in nature,⁸⁰ an insurer is held strictly liable for its failure to pay when the insured meets the conditions precedent to recovery under the statute.⁸¹

Arkansas law regulating the insurance industry is similar to laws of other jurisdictions.⁸² However, this similarity of statutory remedies has been no bar to a wide variety of interpretations on the effect of statutory remedies on the recognition of bad faith torts. At one extreme, some courts have held that statutory remedies were sufficient to provide compensation to an insured. For example, in Kansas, which has both a statutory penalty⁸³ and the Model Trade Practices Act,⁸⁴ the Kansas Supreme Court held that it was undesirable for the court to further expand an insured's remedies by judicial fiat.⁸⁵

At the opposite extreme, some jurisdictions have held that statutory regulation of the insurance industry demonstrated the legislature's intention to provide adequate remedies to insureds and thus justified recognition of the tort of bad faith. The Oklahoma Supreme Court, in recognizing the tort of bad faith in a first party insurance contract,⁸⁶ justified its decision in part on the extensive statutory regulation of the insurance industry in that state.⁸⁷

78. *Federal Life & Casualty Co. v. Weyer*, 239 Ark. 663, 391 S.W.2d 22 (1965).

79. *Countryside Casualty Co. v. Grant*, 269 Ark. 526, 601 S.W.2d 875 (1980).

80. *Time Ins. Co. v. Boren*, 271 Ark. 183, 607 S.W.2d 412 (1980).

81. *Life & Casualty Ins. Co. v. Wiggins*, 224 Ark. 377, 273 S.W.2d 405 (1954).

82. The Uniform Trade Practices Act is model legislation which was developed by the National Association of Insurance Commissioners. The Act was adopted as Act 148 of 1959 in Arkansas.

83. KAN. STAT. ANN. § 40-256 (1981). The Kansas penalty statute provides only for attorneys' fees.

84. KAN. STAT. ANN. § 40-2404 (Supp. 1984).

85. *Spencer v. Aetna Life & Casualty Ins. Co.*, 227 Kan. 914, 611 P.2d 149 (1980). For a discussion of the *Spencer* decision see Note, *Is There an Adequate Remedy After Spencer v. Aetna Life & Casualty Co.?* 29 U. KAN. L.R. 277 (1981).

86. *Christian v. American Home Assurance Co.*, 577 P.2d 899 (Okla. 1978). The Oklahoma Supreme Court specifically found a tort based on breach of the implied duty of good faith and fair dealing. Punitive damages could only be awarded by characterizing the action as one in tort because Oklahoma prohibits the award of punitive damages in contract actions by statute. OKLA. STAT. tit. 23, § 22 (1971). See Note, *The New Tort of Bad Faith Breach of Contract: Christian v. American Home Assurance Corp.*, 13 TULSA L.J. 605 (1978).

87. Oklahoma has adopted the Uniform Trade Practices Act, OKLA. STAT. ANN. tit. 36, § 1201 (West 1976), and statutory penalties which provide for attorneys' fees. OKLA. STAT. ANN. tit. 36, § 1105 (West 1976) allows for an attorney's fee of not less than \$100 and not more than one-third of the judgment as a remedy against an unauthorized insurer. In accident and health insurance claims which result in lawsuits, the prevailing party is entitled to recover attorneys' fees and no minimum or maximum amount is set. OKLA. STAT. ANN. tit. 36, § 1219 (West 1976).

The Eighth Circuit Court of Appeals predicted in 1980 that Arkansas would not recognize the tort of bad faith because of the penalty statute. In *Robinson v. MFA Mutual Ins. Co.*,⁸⁸ the court said:

Unlike nearly all states now recognizing the bad faith tort cause of action, Arkansas by statute imposes penalties on insurance companies wrongfully refusing to pay valid claims. . . . Our research indicates that no state which has a statutorily prescribed penalty (approximately 14 states total) as Arkansas, has also permitted the bad faith tort by judicial fiat. . . . Apparently, the view is slowly spreading that states will have either the bad faith tort or the statutory penalty, but not both.⁸⁹

However, when the insurance company in *Broadway Arms* argued that the statutory penalties available in Arkansas preempted the tort of bad faith, the Arkansas Supreme Court responded that the tort of bad faith was a wrong for which there was no adequate statutory remedy. The court said:

[T]he Trade Practices Act is only an effort to clean up undesirable conduct of insurers and the penalty and fee statute applies only to first party claims. The penalty and fees statute is the primary remedy an insured has against an insurer who fails or refuses to pay a claim when there is no bad faith. The Trade Practices Act provides for procedures and penalties to be utilized by the provisions of the act. Neither of these remedies deals with the area of bad faith much less preempts it.⁹⁰

Of the states which impose statutory penalties against an insurer for failure to pay claims in a timely manner, almost half impose the penalty on a strict liability basis while the remainder require proof that the insurer is acting in bad faith.⁹¹ Arkansas, a strict liability state,⁹² has ruled that the penalty statute does not preempt the bad faith tort.⁹³ The ruling is logical since the issue of bad faith never arises in the imposition of the penalty.⁹⁴ Malicious conduct and innocent error may

88. 629 F.2d 497 (8th Cir. 1980).

89. *Id.* at 501 n.5.

90. 281 Ark. 128, 133, 664 S.W.2d 463, 465 (1983).

91. See Holmes, *A Model First-Party Insurance Excess-Liability Act*, 14 GA. L. REV. 497 (1980).

92. The good faith of the insurer in contesting liability under the policy is no defense to imposition of the penalty. *Life & Casualty Ins. Co. v. Wiggins*, 224 Ark. 377, 273 S.W.2d 405 (1954).

93. *Aetna Casualty & Surety Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463 (1983).

94. ARK. STAT. ANN. § 66-3238 (1980) is set out *supra* at note 77.

both be the basis for the penalty. The insured need only show that he was entitled to recover on the claim, that the claim remains unpaid despite demand, and that he has recovered the amount for which he sued.⁹⁵ The irony lies in carrying this logic to its ultimate conclusion. If Arkansas required proof of an insurer's bad faith in order to assess the penalty, would the penalty then be considered preemptive of the tort and the exclusive remedy for the wrong?

Although the insured in *Broadway Arms* did not recover statutory penalties, the insured in *Williams* recovered statutory penalties and attorneys' fees in addition to compensatory and punitive damages. This recovery led Justice Hickman, in his dissenting opinion in *Williams*, to observe that "we now have in Arkansas double recovery for breach of contract; one pursuant to statute, with appropriate penalties for failure to pay claims, for whatever reason; and another in the majority's new remedy for bad faith."⁹⁶

The broad array of damages which are available to an insured in a first party action raises interesting questions about the election of remedies.

The doctrine of election of remedies provides that if a party has two or more inconsistent remedies on a single cause of action, only one remedy may be ultimately pursued and only one remedy satisfied. . . . If a party has two or more remedies that are concurrent and consistent, the party may pursue all of them and recover on all of them.⁹⁷

The issue of election of remedies is not addressed in *Broadway Arms* or *Williams*. In *Sturgeon v. American Family Life Assurance Co.*,⁹⁸ the Arkansas Court of Appeals noted that the plaintiff might be required to make an election of remedies.⁹⁹ The two remedies addressed in that action were contract and deceit,¹⁰⁰ which are inconsistent.¹⁰¹ However, in the situation where the insured is claiming that the insurer has breached the contract of insurance by failing to pay a claim and that the insurer's breach is in bad faith, the remedies are consistent. Thus, in the *Williams* case the insured recovered for breach of the insurance

95. See, e.g., *Highlands Ins. Co. v. William Burris Masonry Contractors, Inc.*, 258 Ark. 694, 528 S.W.2d 405 (1975).

96. 282 Ark. 29, 34, 665 S.W.2d 873, 876 (1984) (Hickman, J., dissenting).

97. H. BRILL, *ARKANSAS LAW OF DAMAGES* § 1-10 (1984).

98. 266 Ark. 1040, 589 S.W.2d 207 (1979).

99. *Id.* at 1043, 589 S.W.2d at 209.

100. For an explanation of the case, see *supra* note 32.

101. See Brill, *The Election of Remedies Doctrine in Arkansas*, 37 ARK. L. REV. 385 (1983).

contract, statutory penalties and attorneys' fees, and in addition, recovered compensatory and punitive damages for the tort.¹⁰²

One of the most obvious reasons for forcing a plaintiff to choose between remedies is to prevent a plaintiff from recovering multiple damages for the same injury.¹⁰³ The damages for breach of contract and compensatory damages for the tort of bad faith are easy to distinguish. The compensatory damages generally would be any damage that the insured had suffered which was not compensated by the contract. For example, in *Williams* the insured recovered for insurance benefits as a result of the insurer's breach of the contract. In addition, the insured recovered \$25,000 for compensatory damages.¹⁰⁴ The court found that the insured's proof that he had suffered a second heart attack after the insurer's breach and had suffered the anxiety of not knowing whether he had insurance coverage was sufficient to support the award of compensatory damages.¹⁰⁵

Judgments for both punitive damages and statutory penalties are more difficult to reconcile. The purpose of punitive damages is to punish a defendant and to serve as a deterrent to other potential wrongdoers.¹⁰⁶ In addition, punitive damages are sometimes thought to encourage plaintiffs to bring lawsuits as "private attorneys general" for the good of society.¹⁰⁷ The purpose of the penalty statute is to prevent defenses by insurers for the purposes of delay and to reimburse the insured for expenses incurred in enforcing the insurance contract.¹⁰⁸ In addition, the courts on numerous occasions have held that the statute is penal in nature.¹⁰⁹ Although strong argument can be made that a judgment for both the penalty and punitive damages, which are windfalls to begin with, amounts to double recovery, such a recovery was permitted in *Williams*.

VI. EXPANSION OF THE TORT OF BAD FAITH TO OTHER TYPES OF CONTRACTS

The tort of bad faith has been extended by the courts from third

102. 282 Ark. 29, 665 S.W.2d 873 (1984).

103. See, e.g., *Harrison v. Fulk*, 128 Ark. 229, 193 S.W. 532 (1917).

104. 282 Ark. 29, 665 S.W.2d 873 (1984).

105. *Id.* at 33, 665 S.W.2d at 875.

106. See *Southern Farm Bureau Casualty Ins. Co. v. Daniel*, 246 Ark. 849, 440 S.W.2d 582 (1969).

107. D. DOBBS, REMEDIES § 3.9 (1973).

108. *Sun Life Assurance Co. v. Coker*, 187 Ark. 602, 61 S.W.2d 447 (1933).

109. See, e.g., *Callum v. Farmers Union Mut. Ins. Co.*, 256 Ark. 376, 508 S.W.2d 316 (1974).

party to first party situations despite significant differences in the nature of the relationship between the insurer and the insured in first and third party situations. In the third party situation, the insured must agree to allow the insurer to control the claim, the litigation, and otherwise act in the insured's behalf.¹¹⁰ This relationship has been characterized by a number of courts as fiduciary. In a fiduciary relationship, the law imposes a duty upon the fiduciary to act in fairness and good faith.¹¹¹ It is the breach of this duty which is the basis of the tort in third party actions.

When a liability insurance company by the terms of its policy obtains from the insured a power, irrevocable during the continuance of its liability under the policy, to determine whether an offer of compromise of a claim shall be accepted or rejected, it creates a fiduciary relationship between it and the insured with the resulting duties that grow out of such a relationship. Under policies like those here involved, the insurer and the insured owe to each other the duty to exercise the utmost good faith. While the insurance company, in determining whether to accept or reject an offer of compromise, may properly give consideration to its own interest, it must, in good faith, give at least equal consideration to the interest of the insured and if it fails so to do it acts in bad faith.¹¹²

If the insurer breached only those duties which it had voluntarily assumed by the terms of the contract, the breach would only give rise to a contract action.¹¹³ It is because the breach is of a duty imposed by law on a fiduciary that the cause of action is in tort.

The relationship between the insurer and the insured in first party situations may or may not be analogous to a fiduciary relationship. Even assuming that the relationship can be characterized as fiduciary initially, the relationship is greatly altered between the insurer and the insured when a proof of loss is filed. At that point, the insurer and the insured become adversaries as they each attempt to resolve the claim with the best possible results for themselves. The *Broadway Arms* case provides an example of the nature of the relationship between the insurer and the insured. In that case, negotiations between the insured's lawyer and the insurer's employee were the basis for one of the allega-

110. See R. KEETON, *INSURANCE LAW* § 7.8 (3d ed. 1973).

111. *Collins v. Heitman*, 225 Ark. 666, 284 S.W.2d 628 (1956).

112. *Southern Farm Bureau Casualty Ins. Co. v. Parker*, 232 Ark. 841, 848-49, 341 S.W.2d 36, 41 (1960) (quoting *American Fidelity & Casualty Co. v. Nichols*, 173 F.2d 830, 832 (10th Cir. 1949)).

113. W. KEETON, *PROSSER & KEETON ON TORTS*, § 92 (5th ed. 1984).

tions of bad faith.¹¹⁴ As Justice Hickman noted in his concurring and dissenting opinion, "this was a conversation between a lawyer hired by the appellee to get the maximum benefits under the policy and an adjuster hired to see that no more was paid than was owed under the policy."¹¹⁵ It is unrealistic to expect an insurer to act as a fiduciary to an adversary.

Assuming that no fiduciary duty exists between an insurer and an insured in a first party situation, what duty does an insurer owe to an insured in a first party situation? The Arkansas Supreme Court found that insurers have an obligation to pay claims to insureds in good faith. "An insurance company may incur liability for the first party tort of bad faith when it affirmatively engages in dishonest, malicious, or oppressive conduct in order to avoid a just obligation to its insured."¹¹⁶

If the courts recognize that the first party tort of bad faith is based on breach of an implied in law duty of good faith,¹¹⁷ there may be further expansion of tort liability as a result of contracts.¹¹⁸ The first party tort of bad faith provides an analytically sound basis for extending the tort of bad faith to some types of contracts in Arkansas. Such an expansion is already taking place in other jurisdictions.¹¹⁹

In 1967, Montana announced that an insurer could be assessed punitive damages where there was a violation of the state insurance law even though punitive damages were not generally recoverable for breach of contract.¹²⁰ The breach of a duty imposed by law gave rise to

114. 281 Ark. 128, 134, 664 S.W.2d 463, 466 (1983).

115. *Id.* at 140, 664 S.W.2d at 469.

116. *Employers Equitable Life Ins. Co. v. Williams*, 282 Ark. 29, 30, 665 S.W.2d 873, 873-74 (1984) (citation omitted).

117. The duty of good faith is implied in contracts. *See* ARK. STAT. ANN. § 85-1-203 (1961); RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

118. *See* Diamond, *The Tort of Bad Faith Breach: When, If At All, Should It Be Extended Beyond Insurance Transactions?*, 64 MARQ. L. REV. 425 (1981).

119. At least one jurisdiction has specifically declined to recognize a tort based on breach of a commercial contract. In *Standard Pipeline Coating Co. v. Soloman & Teslovich, Inc.*, 344 Pa. Super. 367, 496 A.2d 840 (1985), the Superior Court of Pennsylvania refused to recognize such a tort.

120. *State ex rel. Larson v. District Court of Eighth Judicial Dist.*, 149 Mont. 131, 423 P.2d 598 (1967). The insured in *Larson* filed a lawsuit after the insurer stopped making credit disability payments and the insured's car was repossessed. According to the insured, the insurer made no attempt to determine whether the insured continued to be disabled despite the insured's request that the insurer investigate and have the insured examined by a doctor of the insurer's choice. The insured requested actual and punitive damages in the lawsuit alleging both breach of the insurance contract and that the insurer's acts were in violation of Montana law which required immediate payment upon proof of loss. REV. CODES OF MONT. § 40-4011 (1947). The trial court granted the insurer's motion to strike the portions of the complaint dealing with punitive damages and the insured instituted an original proceeding seeking a writ of supervisory control to determine his

the punitive damages.¹²¹ In 1983, the Montana Supreme Court, finding that a covenant of good faith and fair dealing is implied in employment contracts, reversed a summary judgment which had been entered in favor of the employer in *Gates v. Life of Montana Insurance Co.*¹²² After a trial of the case resulted in a jury verdict for the employee for \$1,891 in compensatory damages and \$50,000 in punitive damages, the trial court affirmed the award of compensatory damages but entered judgment notwithstanding the verdict in favor of the defendant on punitive damages.¹²³ The Montana Supreme Court upheld the award of compensatory damages and ordered the trial court to reinstate the award of punitive damages, finding that:

An action for breach of an implied covenant of fair dealing, at first blush, may sound both in contract and tort. The duty arises out of the employment relationship yet the duty exists apart from, and in addition to, any terms agreed to by the parties. In this respect, the duty is much like the duty to act in good faith in discharging insurance contractual obligations. The duty is imposed by operation of law and therefore its breach should find a remedy in tort. . . . Breach of the duty owed to deal fairly and in good faith in the employment relationship is a tort for which punitive damages can be recovered if defendant's conduct is sufficiently culpable.¹²⁴

In *Crenshaw v. Bozeman Deaconess Hospital*,¹²⁵ the Montana Supreme Court held that the implied covenant of good faith and fair dealing in employment contracts also extends to probationary employees.

In 1984, the Montana Supreme Court announced that punitive damages could be recovered where there was a breach of a statutory obligation of good faith and the conduct was sufficiently culpable in *First National Bank v. Twombly*.¹²⁶ Twombly and his wife had borrowed \$3,500 on a promissory note which was accompanied by a security agreement granting the bank a security interest in an ice machine, inventory, and accounts receivable. Shortly before the lump sum pay-

right to exemplary damages in the lawsuit. The Montana Supreme Court reconciled *Westfall v. Motors Ins. Corp.*, 140 Mont. 564, 374 P.2d 96 (1962) in holding that punitive damages were recoverable in the action. The court said that a unique situation was presented by the insurance contract case because "some acts may be both breaches of contract and violations of the laws of Montana." 149 Mont. 131, 133, 423 P.2d 598, 600 (1983).

121. 149 Mont. at 135, 423 P.2d at 600.

122. 196 Mont. 178, 638 P.2d 1063 (1982).

123. *Gates v. Life of Montana Ins. Co.*, 40 Mont. 1287, 668 P.2d 213 (1983).

124. *Id.* at 1288, 668 P.2d at 214 (citations omitted).

125. 693 P.2d 487 (Mont. 1984).

126. 689 P.2d 1226 (Mont. 1984).

ment of principal and interest were due on the note, the Twomblys' attempt to purchase the restaurant they were running on a lease/purchase agreement failed. They contacted an employee of the bank and worked out an agreement to reduce the principal amount of the note and bring the interest current by the due date. The remainder of the loan would be converted to an installment loan. Two weeks before the due date, Twombly contacted another employee of the bank to discuss converting the loan. Upon being told that the loan would not be converted, Twombly became upset and said that he would not be able to pay the entire loan in two weeks. After the phone conversation and based on Twombly's statement, the bank determined that the note was in jeopardy and offset Twombly's checking account in the amount of \$2,865.¹²⁷ The bank sued for the remainder of the promissory note and Twombly counterclaimed, alleging breach of the duty of good faith. The jury awarded Twombly \$4,000 in compensatory damages but the trial court refused to instruct the jury on punitive damages.¹²⁸

The court noted that the Uniform Commercial Code, which applies to the type of transaction at issue in *Twombly*, imposes an obligation of good faith on every contract and duty within the Code.¹²⁹ In addition, the Uniform Commercial Code provides that where a contract allows a party to accelerate payment or performance "at will" or "when he deems himself insecure," the provision "shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired."¹³⁰ After noting that the obligation to act in good faith is imposed by law, the court said: "When the duty to exercise good faith is imposed by law rather than the contract itself, as in *Gates v. Life of Montana Insurance Company* . . . the breach of that duty is tortious. Therefore, punitive damages are recoverable if the Bank's conduct is sufficiently culpable."¹³¹ The case was remanded for a new trial on the issue of punitive damages.¹³²

127. 689 P.2d at 1228-29.

128. The trial court's judgment offset the balance due on the note, the interest accrued and attorney's fees in favor of the bank. Therefore, judgment was entered for the Twomblys in the amount of \$1,392.49. 689 P.2d at 1227-28.

129. See MONT. CODE ANN. § 30-1-203 (1985), which provides: "Obligation of Good Faith. Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."

130. MONT. CODE ANN. § 30-1-208 (1985).

131. First Nat'l Bank v. Twombly, 689 P.2d 1226, 1230 (Mont. 1984) (citations omitted).

132. 689 P.2d at 1231.

In *Morse v. Espeland*,¹³³ an attorney sued a former client for attorneys' fees. The attorney won a motion for summary judgment on the client's counterclaim, which alleged a breach of fiduciary duty, constructive fraud, actual fraud, deceit and legal malpractice. On appeal from the award of summary judgment, the Montana Supreme Court found that the complaint stated facts sufficient to support a claim for bad faith on the part of the attorney. The court said:

[A]s an attorney, respondent owed his client the obligation to deal fairly and in good faith when negotiating a fee and when ultimately charging and collecting the fee. The inequality that exists between attorney and client in bargaining over a fee is apparent. The attorney knows his or her legal rights. The client probably does not. In negotiating and collecting the fee, the attorney is represented. The client is not. In negotiating and collecting the fee, the attorney is in a vastly superior position to the client and the rationale of *Gates and Dare*, supra, mandates the application of the covenant to this relationship. If the facts alleged by the appellant are true, the fact-finder could determine there was a breach of the obligation owed to deal fairly and in good faith.¹³⁴

The appellate courts of California have been faced with the prospect of extending the tort of bad faith breach of contract to commercial contracts other than insurance on a number of occasions.¹³⁵ Although the courts on several occasions declined to extend liability,¹³⁶ or simply avoided the issue,¹³⁷ the court in *Cleary v. American Airlines*¹³⁸ held that the plaintiff had stated a cause of action for the tort of bad faith breach of contract. The plaintiff, who was an employee of American Airlines, claimed that he had been fired for participating in union activities. The trial court found that the plaintiff had not stated a cause

133. 696 P.2d 428 (Mont. 1985). The client alleged that the attorney had given her the impression at their initial meeting that he would charge \$5,000 for a dissolution unless the dissolution became particularly complicated, in which case the fee might be higher. During the course of the proceedings the client received and rejected a settlement offer between \$100,000 and \$125,000. The client's final judgment consisted of property valued at \$667,555.75. The attorney then informed the client that the dissolution was going to cost her a lot of money and asked her to agree to a 10% fee. The client refused to pay the attorney and a lawsuit resulted.

134. 696 P.2d at 430-31.

135. See Louderback & Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F.L. REV. 187 (1981) for a discussion of the development of law in California.

136. *Wagner v. Benson*, 101 Cal. App. 3d 27, 161 Cal. Rptr. 516 (1980); *Sawyer v. Bank of America*, 83 Cal. App. 3d 135, 145 Cal. Rptr. 623 (1978).

137. *Tameny v. Atlantic Richfield*, 27 Cal. 3d 167, 610 P.2d 1330, 164 Cal. Rptr. 839 (1980).

138. 111 Cal. App. 3d 443, 168 Cal. Rptr. 722 (1980).

of action for wrongful discharge, but the court of appeals reversed, stating that "[t]ermination of employment without legal cause after such a period of time¹³⁹ offends the implied-in-law covenant of good faith and fair dealings contained in all contracts, including employment contracts."¹⁴⁰

The extension of the tort of bad faith breach to employment relationships was again recognized by the California Court of Appeals in *Rulon-Miller v. International Business Machines Corp.*¹⁴¹ The plaintiff's employment with IBM was terminated because of her personal relationship with an employee of an IBM competitor. The employer claimed that the plaintiff's relationship created a conflict of interest. The court determined that not only was there no conflict of interest but that IBM had established a policy of no company interest in the outside activities of an employee so long as the activities did not interfere with the work of the employee. The court of appeals affirmed the finding of breach of the duty to act towards the employee in good faith.¹⁴²

In 1984, the California Supreme Court heard *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*¹⁴³ Seaman's negotiated with Standard to obtain an oil supply contract in order to lease space in a marina to operate a marine fuel distributorship. Standard sent a letter to Seaman's confirming the agreement and Seaman's used the letter as evidence of an oil supply contract in order to obtain the lease from the city. A year later Standard informed Seaman's that it could not meet the terms of the letter, apparently due to the effect of the Arab oil embargo. Seaman's instigated an appeal with the Federal Energy Office and was told that a supply order would be issued if Seaman's could establish that a valid supply contract existed between Seaman's and Standard. Standard was aware that Seaman's could not afford to finance a trial to prove the existence of the contract but refused to acknowledge the existence of the contract. Seaman's went out of business and sued Standard for intentional interference with contractual relationships, breach of contract, and breach of the implied covenant of

139. The plaintiff had been employed by American Airlines for 18 years. *Id.* at 450, 168 Cal. Rptr. at 729.

140. *Id.*

141. 162 Cal. App. 3d 241, 208 Cal. Rptr. 524 (1984).

142. In affirming the decision, the court of appeals stated "[i]t is not so much the duty owed under the contract as the duty arising from the relationship of one party to another That duty, at least, is implied from the formulation of the tort, namely, to act without bad faith and with probable cause." *Id.* at 249, 208 Cal. Rptr. at 533.

143. 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984).

good faith and fair dealing.¹⁴⁴ The California Supreme Court was thus faced squarely with the issue of whether to extend tort liability for breach of the implied covenant of good faith to a commercial contract. The court, however, found that it was not necessary to determine whether Standard incurred liability as a result of breach of the implied covenant of good faith. The court held that "[i]t is sufficient to recognize that a party to a contract may incur tort liability 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."¹⁴⁵ Although the tort which was recognized by the court in *Seaman's* is more limited than a simple recognition of the existence of a tort of bad faith breach in commercial contracts, it definitely broadens the application of tort remedies to commercial contract settings outside the area of insurance.¹⁴⁶

The California Supreme Court in *Seaman's* discussed its reluctance to extend the tort of bad faith breach.

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. No doubt there are other relationships with similar characteristics and deserving of similar legal treatment.

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.¹⁴⁷

In *Wilson v. Donze*,¹⁴⁸ the Texas Court of Appeals affirmed an award of compensatory and punitive damages against a real estate broker.¹⁴⁹ The broker purchased the plaintiffs' property as trustee and resold it the same day for a profit of almost \$30,000. The court held that the broker's "willful and malicious breach of his fiduciary duty . . . was of such a tortious nature as to permit the recovery of exemplary damages."¹⁵⁰

144. *Id.* at 762, 686 P.2d at 1162, 206 Cal. Rptr. at 358.

145. *Id.* at 769, 686 P.2d at 1167, 206 Cal. Rptr. at 363.

146. See Comment, *Sailing the Uncharted Seas of Bad Faith: Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 69 MINN. L. REV. 1161 (1985).

147. 36 Cal. 3d 752, 686 P.2d 1158, 1166-67, 206 Cal. Rptr. 354, 362-63 (1984) (citation omitted).

148. 692 S.W.2d 734 (Tex. App. 1985).

149. The jury awarded \$24,900 in actual damages and \$35,000 in exemplary damages. *Id.* at 736.

150. *Id.* at 740.

The Arkansas Supreme Court seemed willing to extend the tort of bad faith to surety relationships in *Johnson v. Safeco Insurance Co.*¹⁵¹ The plaintiffs made an offer to purchase a house and paid \$400 as earnest money. Although the offer was not accepted, the real estate broker and salesman refunded only \$100 of the earnest money. Safeco Insurance Company was the surety on the broker's statutory bond.¹⁵² The Johnsons filed suit against Safeco alleging that Safeco failed, in bad faith, to investigate their claim and failed to pay the \$300. The court found that the plaintiffs' complaint was demurrable because there was no allegation of affirmative wrongdoing on the part of the surety.¹⁵³ However, the court did not go so far as to say that no such cause of action was recognized under Arkansas law.

The Arkansas Supreme Court, however, has clearly indicated that Arkansas does not recognize "tortious breach of contract," at least outside the insurance area. In *L.L. Cole and Son, Inc. v. Hickman*,¹⁵⁴ an opinion which was delivered the same day as *Williams*, the court reversed a judgment for punitive damages because it appeared to be based on a breach of contract. Mr. Hickman had leased farmland from L.L. Cole and Son, Inc., for the purpose of raising crops. Mr. Hickman sought punitive damages as a result of "tortious breach of contract" alleging that an agent of L.L. Cole and Son, Inc., had intentionally breached the contract by interfering with his attempts to raise crops. He also alleged that the agent had called him between midnight and two a.m. to curse and abuse him, and the agent had pursued a course of conduct designed to "harass, ridicule, and embarrass the plain-

151. 265 Ark. 9, 576 S.W.2d 220 (1979).

152. See ARK. STAT. ANN. § 71-1305 (Supp. 1977), which requires real estate brokers to post a \$2,000 bond.

153. The court compared Safeco's position to that of an insurer in a first party situation and found that:

Safeco's position is even stronger than that of the insurance company in *Findley*, for Safeco was merely a surety upon the broker's bond, not an insurance company issuing a policy directly to the plaintiffs and receiving its premiums from them. If a surety should pay a claim when there is no liability on the part of its principal, it is treated as a volunteer and cannot recover the payment from the principal. *Fireman's Fund Ins. Co. v. Clark*, 253 Ark. 1025, 490 S.W.2d 447 (1973). Another possible defense, in addition to any that might be raised by the principal, could be that the \$2,000 maximum liability under the bond had been discharged in the payment of other claims or had to be prorated among various claimants. Thus the mere allegation that the broker and the salesman failed to return the plaintiffs' earnest money does not necessarily state a cause of action against the surety.

265 Ark. 10, 11, 576 S.W.2d 220, 221-22.

154. 282 Ark. 6, 665 S.W.2d 278 (1984).

tiff.”¹⁵⁵ There was proof at trial that the agent had intentionally interfered with Mr. Hickman’s farm work, had removed the key to a relift pump causing damage to the crops for lack of water, and had ordered Mr. Hickman from one of the fields that had been leased. The jury returned a verdict for \$42,270 in compensatory damages and \$275,000 in punitive damages.

After acknowledging that the law in regard to the relation between causes of action in contract and tort is confused and still in the process of developing, the court determined that the cause of action in this case was actually one in contract. The court went on to find that although there were cases in Arkansas which seem to allow punitive damages in contract actions, all of these cases were actually situations in which the punitive damages were based on independent tortious acts. The court then held that, prospectively, punitive damages would not be available in contract actions.¹⁵⁶ In addition, the cause of action in tort must be specifically plead and proved.

The opinion indicates that where an action in either contract or tort is possible, the plaintiff will have to elect between the two remedies.

Ordinarily, where on the facts either an action in contract or one in tort is possible, the plaintiff must make a choice. A plaintiff should either plead and prove his cause of action in contract or in tort. Since the purpose of the law of contracts is to see that promises are performed while the law of torts provides redress for various injuries, and since punitive damages are ordinarily not awarded in contract but may be awarded in tort, the distinction is an important one. Where on the facts the action may sound either in contract or tort or both, the court itself will often seek to determine the real character of the action.¹⁵⁷

This decision is extremely difficult to reconcile with the *Williams* opinion, which was handed down the same day. In *Williams*, the court affirmed judgments for damages for breach of contract and for tortious conduct arising out of the same incident.¹⁵⁸ The distinguishing feature in the two causes of action is that one is for breach of an insurance contract while the other is for breach of a lease of real property. In neither case does a fiduciary relationship exist between the plaintiff and the defendant. In both cases, a valid argument can be made that the

155. *Id.* at 7, 665 S.W.2d at 280.

156. *Id.* at 10, 665 S.W.2d at 281.

157. *Id.* at 9, 665 S.W.2d at 281 (citation omitted).

158. 282 Ark. 29, 665 S.W.2d 873 (1984).

law imposes an obligation on the parties to deal with each other in good faith. At some point, the Arkansas Supreme Court will have to recognize the similarities between bad faith breach of insurance contracts and bad faith breach of other types of contracts and either reconcile or distinguish the two.

VII. CONCLUSION

Insurers have long been subjected to extensive statutory regulation and high standards of care because of the nature of their business. Persons who purchase insurance are purchasing the security of knowing that in the event of a tragedy or disaster they will at least be cared for financially. The recognition of first party bad faith in Arkansas can be viewed quite simply as completing the remedies which should be available to an insured. With the third party bad faith tort, Arkansas provided a remedy for compensating insureds who suffered excessive judgments because of their insurers' mishandling of litigation. Statutory penalties have provided compensation to insureds who suffered delay in payment of insurance proceeds regardless of the reason for delay. First party bad faith now provides compensation for insureds who suffer damages as a result of their insurers' willful and malicious misconduct.

The recognition of the tort of bad faith in first party insurance relationships may mark the first step towards recognition of bad faith torts in other types of contractual relationships. Although the Arkansas Supreme Court did not willingly embrace a tort remedy as well as a contract remedy in *L.L. Cole and Sons*, the court did not rule out such a cause of action. The court merely held that a plaintiff would have to choose between the tort and contract remedies, not that the tort remedy was unavailable. There is a distinct possibility that the tort of bad faith breach could be applied in contracts other than insurance in future Arkansas cases.

