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I. INTRODUCTION

In Braesch v. Union Insurance Co., the Nebraska Supreme Court
first recognized the tort of bad faith denial of first party insurance claims. Nebraska was the thirty-sixth jurisdiction to recognize a cause of action for bad faith in first-party cases.  

This Note begins with an overview of the development of the law of bad faith in insurance. It discusses the earlier adoption of the bad faith tort action in situations where liability insurers breached their duty to settle claims in good faith. It further discusses why other courts transferred the third party insurer's obligation to deal in good faith to first party insurers.

Second, the Note outlines the facts and holding of the case. Third, it analyzes the court's rationale for imposing the duty of good faith and fair dealing upon insurers and for allowing mental distress damages for bad faith breach of first party insurance contracts. Fourth, it discusses the implications of that rationale for bad faith breach outside the insurance setting.

Finally, the Note examines the types of conduct that will expose an insurer to extracontractual tort damages in first party claims and cautions potential defendants that when a first party bad faith plaintiff successfully pleads a tort cause of action, certain defenses will not be available. The Note also incorporates the two subsequent Nebraska decisions which have applied the standard set forth in Braeschi.

insurer contracts to indemnify the insured against liability to third parties."  WILLIAM M. SHERNOFF, ET AL., INSURANCE BAD FAITH LITIGATION § 5.01, at 5-3 n.4 (1991).


3. Subsequent to the Braeschi decision the Nebraska Supreme Court held that a sufficient cause of action for bad faith had been stated when the plaintiff alleged that the insurer had denied fire insurance coverage based on suspected arson without conducting a proper investigation and subjecting the results to a reasonable evaluation and review. Ruwe v. Farmers Mut. United Ins. Co., 298 Neb. 67, 469
A. From Third Party Claims to First Party Claims

The cause of action for bad faith breach of an insurance contract originated in third party insurance claims. Under a typical liability insurance policy, the insurer has the duties of indemnifying and defending the insured, and is given exclusive control over the defense and settlement of claims brought by third parties.

In conducting the defense and settlement of third party claims, an insurer owes its insured a duty of good faith and a duty to use the care of a reasonably prudent liability insurer. Nonetheless, there is an inherent conflict of interest in settling claims which simultaneously affects the rights of both the insurer and the insured, creating the potential for an insurer to abuse the discretion entrusted by its insured. Thus, courts have imposed extracontractual consequential damages upon insurers that breach their duty of good faith.

The conflict of interest involved in settling claims is clearest in situations where a third party claimant makes a settlement offer at or near the policy limits. In this scenario, the insurer has very little upward risk. Under traditional contract principles, if an insurer breached its duty to pay claims, courts only awarded the amount due under the policy, plus legal interest. Thus, applying traditional con-

N.W.2d 129 (1991). See also Bailey v. Farmers Union Co-operative Ins. Co., No. A-91-1158, 1992 Neb. App. LEXIS 327 (Dec. 22, 1992). In Bailey the Plaintiff was awarded $150,000 in mental distress damages on a $52,000 property insurance policy. The insurer had represented to the insured that her claim was "questionable" six weeks after the insurer's adjuster had determined that the "loss was covered." Id. at *10-11. The insurer subsequently refused to pay the "replacement costs" of it's insured's house in spite of clear language in the policy and no reasonable basis for denying the claim. Id. at *13. See infra note 67.

4. "Because the first cases applying the tort of bad faith all involved the insurer's handling of third party claims against its insured, there was some doubt for awhile whether this new tort would be applicable to an insurer's unreasonable refusal to pay a claim by its own insured. . . . SHERNOFF, ET AL., supra note 1, § 1.07(2) at 1-25. See, e.g., Communale v. Traders & Gen. Ins. Co., 328 P.2d 198, 200 (Cal. 1958)(liability insurer must give equal consideration to insured's interests); Auto Mut. Indemnity Co. v. Shaw, 184 So. 852 (Fla. 1938)(implied duty allows consequential damages in amount of excess judgment); Hilker v. Western Auto. Ins. Co., 231 N.W. 257, 259 (Wis. 1930) aff'd on reh'g 235 N.W. 413 (1931)(control over settlement negotiations creates agency relationship).


7. See, e.g., Insurance Co. v. Piaggio, 83 U.S. 378 (1872)(insurance contract is agreement to pay money, plus interest when overdue); Rumford Falls Paper Co. v. Fidelity & Cas. Co., 49 A. 503 (Me. 1899)(insurer not liable for damage verdict exceeding policy limit by $1,000); Auerbach v. Maryland Casualty Co., 140 N.E.
tract rules resulted in great potential for abuse.

Under traditional contract rules, insurers faced with settlement offers at or near the policy limits have everything to gain and very little to lose. There is considerable potential for an insurer to save money on the policy by forcing litigation. By litigating, an insurer may pressure a claimant to settle for less or may even avoid liability altogether. At the same time, the insurer who fails to conduct the settlement in good faith exposes her insured to great risks of liability in excess of policy coverage.

Early third party decisions recognized that insurers concurrently defended their own interests and the interests of their insured, a conflict that makes traditional contract remedies inadequate for compensating the victims of bad faith conduct and for deterring such conduct. By applying the traditional contractual duty of good faith to third party insurance claims and recharacterizing the claim as a tort action, courts were able to counter this conflict of interest. Early third party bad faith actions awarded damages in excess of the policy limits when insurers breached their duty to defend and settle claims in good faith. The consequential damages which accompanied this cause of action provided insurers with a powerful incentive to settle claims in good faith.

California's courts first recognized that the third party insurers' good faith obligation was not one peculiar to liability insurers in Gruenburg v. Aetna Insurance Co. Gruenberg differed from earlier third party decisions in that the insured was seeking to recover for his own losses rather than seeking indemnity for liability to a third party. This type of claim is called a first party claim.

In Gruenberg, the insured was denied payment under a fire insurance policy after his business burned. Following the fire, the insur-

577, 579 (N.Y. 1923)(liability insurer had not breached any duty by refusing to settle). These cases apply to insurance contracts the rule of the landmark case Hadley v. Baxendale, 156 Eng. Rep. 145 (1954)(no damages beyond the price of the bargained for object of contract).

8. "The insurer . . . stands to save the value of the policy by successfully litigating the claim, while liability is contractually limited in the event that the third party prevails. Thus, the insurer stands to gain by refusing a settlement offer at or near the policy limits and instead taking the risk of litigation." SHERNOFF, ET AL., supra note 1, § 3.01 at 3-4.


10. "The policy limits restrict only the amount the insurer may have to pay in the performance of the contract as compensation to a third person for personal injuries caused by the insured; they do not restrict the damages recoverable by the insured for a breach of contract by the insurer." Communale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1959).


12. Id. at 1034.
ance adjuster implied to the arson investigator that the insured had criminal motives. Thereafter, the insurer denied coverage because the insured would not submit to an examination during the pendency of the criminal charges. The *Gruenburg* court held the insurer liable in tort for breach of the implied covenant of good faith and fair dealing:

[In the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payment due under a policy. . . . That responsibility is not the requirement mandated by the terms of the policy itself—to defend, settle, or pay. It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities.]

Thirty-four jurisdictions eventually followed California's lead.

In January 1991, the Nebraska Supreme Court joined these jurisdictions and recognized the bad faith cause of action in a first party claim in *Braesch*.

**B. Facts and Issues**

The *Braesch* decision involved an uninsured motorist policy which was issued to Duane E. Braesch and Helen E. Braesch, husband and wife, by Union Insurance Company. The policy provided $100,000 coverage for bodily injury "which the insured or covered person was legally entitled to recover from the owner or operator of an uninsured motor vehicle." The Braesches alleged that their daughter, Lori J. Braesch, was killed in an accident by a negligent uninsured motorist while she was driving a vehicle covered under the policy. The Braesches further alleged that Union denied payment of the claim without adequately investigating it or developing any defense. After three years and repeated efforts by the Braesches to settle, the decedent's administrator sued the insurer and won a judgement for $185,000. The surviving parents then sued the insurer.

In this action, the Braesches sought general damages based upon 1) the tort of bad faith and 2) the tort of intentional infliction of emotional distress. Under the first theory of relief, the Braesches alleged:

[Despite repeated efforts by the Braesches and their counsel to settle the suit on the uninsured motorist coverage, Union, in bad faith, refused to settle such litigation and never entered into serious negotiations, and engaged in only a perfunctory investigation and developed no defense.]

The Braesches' amended petition also alleged that "Union's refusal to settle was part of an effort to put psychological pressure on each of

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13. *Id.* at 1037.
16. *Id.* at 47, 464 N.W.2d at 771.
17. *Id.* at 47, 464 N.W.2d at 772.
the Braesches to settle the wrongful death claim for sums considera-
likely less than its value."^{18}

The Braesches' second theory of relief was intentional infliction of
emotional distress. The Braesches alleged that Union should have
known that forcing the litigation would cause them mental pain and
suffering and that they were entitled to damages for having to relive
their daughter's death.^{19}

The trial court sustained demurrers to both the bad faith and the
intentional infliction of emotional distress claims and dismissed the
plaintiffs' lawsuits.

C. Holding

The Nebraska Supreme Court reversed the trial court and recog-
nized the cause of action for bad faith failure of an insurer to settle a
first party claim. However, the court upheld the trial court finding
that the Braesches failed to state an actionable claim for intentional
infliction of emotional distress.^{20}

The Braesch court held that because of the "public interest in in-
surance contracts, the nature of insurance contracts, and the inequity
of the bargaining power between the insurer and the policyholder,"
extracontractual tort liability had to be extended to first party breach
of contract cases.^{21} The court attempted to draw a bright line limiting
the reach of the bad faith breach of contract tort to insurance con-
tracts by distinguishing insurance contracts from other commercial
contracts.^{22} The court thus expanded the rights of insurance consum-
ers while addressing the commercial interests' concerns regarding the
exposure of businesses to tort actions in non-insurance contractual
settings.

The Braesch court adopted the standard of care applied by the Wis-
sconsin Supreme Court in Anderson v. Continental Ins. Co.,^{23} which
requires the plaintiff to show some form of intentional wrongdoing.

^{18} Id. at 47, 464 N.W.2d at 772.
^{19} Id. at 47-48, 464 N.W.2d at 772.
^{20} The Nebraska Supreme Court held that "[t]o state a cause of action for inten-
tional infliction of emotional distress, a plaintiff must allege that (1) there has
been intentional or reckless conduct, (2) the conduct was so outrageous in charac-
ter and so extreme in degree as to go beyond all possible bounds of decency and it
is to be regarded as atrocious and utterly intolerable in a civilized community,
and (3) the conduct caused emotional distress so severe that no reasonable person
should be expected to endure it." Id. at 60, 464 N.W.2d at 778-79. The Braesch
court concluded that the insurer's conduct was not sufficiently outrageous and
that the Braesches' emotional distress was not severe enough to support this the-
ory of relief. Id. at 60, 464 N.W.2d at 779.
^{21} Id. at 51, 464 N.W.2d at 774.
^{22} Id.
^{23} 271 N.W.2d 368, 376 (Wis. 1978).
The plaintiff alleges sufficient facts of intentional wrongdoing if she shows a "reckless disregard of the lack of reasonable basis for denying the claim." The Braesch court found that the plaintiff could satisfy this element of the Anderson test by showing Union's delaying tactics and Union's failure to develop any reasonable defense to the Braesches' claim.

The court noted that damages for mental distress are normally not allowed in breach of contract actions unless the breach amounted "in substance to a willful or independent tort." Additionally, the court stated that the Braesches had pled sufficient facts to state a cause of action for bad faith settlement. Union's settlement tactics were so severe that the court considered their conduct tortious. Since the Braesches recovered for all the injuries sustained as a proximate result of Union's conduct, it was proper for them to claim as damages their mental suffering caused by the bad faith tortious conduct.

II. RATIONALE OF THE TORT OF BAD FAITH IN THE FIRST PARTY CONTEXT

In Braesch, the court implied the covenant of good faith and fair dealing in a first party insurance claims. In the process, the court rejected Union's contention that the adversarial nature of uninsured motorist claims precluded the imposition the bad faith tort. Union's argument was based on the premise that the fiduciary relationship involved in settling third party claims is necessary to impose bad faith liability.

Union maintained that in third party claims the insurer's authority to act on the insured's behalf was similar to an attorney-client relationship. Union attempted to distinguish uninsured motorist claims from early third party decisions by noting that in the uninsured motorist context, the insured is trying to recover from the uninsured motorist and the insurer is assuming the position of the uninsured motorist. Union contended that the "insured and insurer become adversaries, not principal and agent who deal in trust." Therefore, Union concluded that there was no bad faith tort in first party cases because of the absence of a fiduciary relationship.

25. Id.
26. Id. at 59, 464 N.W.2d at 778.
27. Id.
28. Id. at 51, 464 N.W.2d at 774.
29. Id. at 50, 464 N.W.2d at 773.
30. Id.
31. Id.
32. See also Spencer v. Aetna Life & Casualty Ins. Co., 611 P.2d 149, 155 (Kan. 1980) (no fiduciary relationship between parties to uninsured motorist policy because company in effect defends liability of uninsured motorist).
The Braesch court rejected this view, citing the Seventh Circuit opinion in Craft v. Economy Fire & Cas. Co.\textsuperscript{33} as the better view.\textsuperscript{34} In Craft, a case that interpreted Indiana's common law policies allowing first party bad faith tort claims, the Seventh Circuit noted that a liability insurance company's control over litigation is only one aspect of the insurance relationship that obligates insurers to good faith and fair dealing.\textsuperscript{35}

Braesch quoted Craft as follows:

Under third party liability coverage, when the insured is sued by a third party, the insurance company takes over the defense of the suit and the insured cannot settle the matter without the permission of the insurer. It is this control of the litigation by the insurer coupled with differing levels of exposure to economic loss which gives rise to the "fiduciary" nature of the insurer's duty... In the uninsured motorist situation there is no element of "control" of the insured's side of the litigation by the insurance company which would give rise to a "fiduciary" duty. It does not necessarily follow that the insurer is completely free of any obligation of good faith and fair dealing to its insured, since the latter duty is based on the reasonable expectations of the insured and the unequal bargaining positions of the contractants, rather than the insurance company's "control" of the litigation.\textsuperscript{36}

The Craft court rejected the notion that the adversary relationship in uninsured motorist claims was inconsistent with the duty of good faith:

This does not make the insurance company an insurer in fact of the uninsured motorist... Moreover, it does not make the insurer a stranger to its insured. After all, the insured is the one who pays the premiums for the uninsured motorist protection and the "reasonable expectation" that he will be dealt with fairly and in good faith by his insurer is still present.\textsuperscript{37}

Rather than premising liability on a fiduciary relationship, the Nebraska Supreme Court attempted to justify application of tort liability in insurance contracts, but not in other commercial settings.

The Braesch court identified three factors that distinguish the relationship between the insurer and the insured from other voluntary commercial associations: 1) the public interest in insurance contracts 2) the non-commercial aspects of the insurance contract and 3) the inequity of the bargaining power between the insurer and the policyholder.\textsuperscript{38}

The three factors identified by the Braesch court are closely inter-related. Insurance is subject to the public interest because the nature of the transaction is of vital importance to society. Additionally, as one commentator has noted, insurance has always had special rules

\textsuperscript{33} 572 F.2d 565, 69 (7th Cir. 1978).
\textsuperscript{35} Craft v. Economy Fire & Cas. Co., 572 F.2d 565, 569 (7th Cir. 1978).
because of its "quasi-monopolistic nature" and its potential for "exploitation" and "oppression."  

The public nature of insurance is demonstrated by its high level of regulation. The Nebraska Legislature expressly recognized the public character of insurance by stating:

The business of apportioning and distributing losses arising from specified causes among all those who apply and are accepted to receive the benefits of such service, is public in character, and requires that all those having to do with it shall at all times be actuated by good faith in everything pertaining thereto.

Additionally, society encourages setting aside earnings to insure against an uncertain future because such insurance coverage for risk reduces survivors' dependence on government aid.

A. Special Nature of Insurance Contracts: Security and Peace of Mind

The second rationale the Nebraska Supreme Court used to distinguish insurance contracts from other commercial contracts was the non-commercial aspects of the insurance contract. The special nature of the insurance contract is highlighted by the divergent goals of the parties. The insurer enters the transaction bargaining for premiums it hopes to avoid repaying. Moreover, the insurer bases its decision upon actuarial tables of risk. The insurance consumer, however, is seeking more than the fulfillment of purely economic

39. See Eric M. Holmes, Is There Life After Gilmore's Death of Contracts?—Induc- tions From a Study of Commercial Good Faith in First Party Insurance Con- tracts, 65 CORNELL L. REV. 330, 352 (1980): "Today, the common carrier or public utility rather than the smith or ferryman is affected with a public interest be- cause of its monopoly or quasi-monopoly power."

40. NEB. REV. STAT. § 44-101 (Reissue 1988): "In view of the statutory requirement that all automobile liability policies include coverage for uninsured motorists, the public interest is of the highest order in [the] case of [uninsured motorist cases]." Braesch v. Union Ins. Co., 237 Neb. 44, 52, 464 N.W.2d 769, 774 (1991).

41. See, e.g., KEETON & WIDISS supra note 5, § 8.6(c)(2) at 974 (governments en- courage participation in insurance programs to reduce costs to aid programs that are funded from general appropriations); MARK S. RHODES, COUCH ON INSUR. § 45:682 at 321 (2d ed. rev. 1981)(effective implementation of mandatory automobile insurance laws eases burden on state funds).


43. KEETON & WIDDIS, supra note 5, § 1.3(b)(2) at 12-13. The insurer calculates its premium by estimating a number of factors, including (1) the proportion of the total estimated cost a particular insured could claim from the "pool of risks" to which that insured belongs, (2) an additional amount to compensate for underestimation of the total risk to which the insurer is exposed, and (3) a profit for the insurer.
goals such as protecting against financial loss. The typical insured also seeks the security of knowing that if some unexpected tragedy occurs, she will have mitigated her personal hardship, suffering and grief by having the foresight to invest in an insurance policy.\textsuperscript{44} Thus, because of the special non-economic goals of insurance consumers, courts have been more willing to impose higher duties and extracontractual liabilities upon insurers.

In addressing the special nature of the insurance contract, the \textit{Braesch} court cited the Arizona Supreme Court decision in \textit{Rawlings v. Apodaca}\textsuperscript{45} with approval, noting that the purchaser of insurance seeks security and peace of mind rather than commercial advantage.

Although courts have been very reluctant to recognize actions in tort for bad faith breach of contract outside the realm of insurance contracts, an extension of this reasoning could lead to further crumbling of the walls between tort and contract. One could argue that peace of mind and security are the motivation of many contracts.

One might apply this reasoning to employment contracts, residential leases and many other consumer contracts. Such reasoning could crumble the walls between tort and contract, especially if it was applied to employment contracts, residential leases or other consumer contracts. For instance, in \textit{Wallis v. Superior Court},\textsuperscript{46} a California appellate court held that the tort of bad faith breach of contract applied to non-insurance contracts if the relationship had "similar characteristics" to an insurance contract.\textsuperscript{47} The California Supreme Court, however, has not recognized tort liability for breach of the implied covenant in the "usual employment relationship."\textsuperscript{48}

\footnotesize
\textsuperscript{44} Id. "The policy holder purchasing insurance . . . pays . . . a premium which is calculated by estimating a number of factors . . . In exchange for the premium, the insured receives a measure of certainty . . . [in which even] in the absence of a loss . . . the insured has still enjoyed the certainty that if the insured event had occurred, insurance . . . would have been available. . . ." Keeton, supra note 4, at § 1.3(b)(2) at 12.
\textsuperscript{46} 207 Cal. Rptr. 123 (1984). The California Court of Appeals set forth the following test to determine if tort liability may be imposed on the parties to a noninsurance contract for bad faith:

1. The contract must be such that the parties are in inherently unequal bargaining positions.
2. The motivation for entering the contract must be a nonprofit motivation, that is, to secure peace of mind, security or future protection.
3. Ordinary contract damages are not adequate because they do not require the party in the superior bargaining position to account for its actions, and so they do not make the inferior party "whole."
4. One party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other party to perform.
5. The other party is aware of this vulnerability.

Id. at 123.

\textsuperscript{48} See Foley v. Interactive Data Corp., 765 P.2d 373 (Cal. 1988).
The Nebraska Supreme Court recognized the implied covenant of good faith in an employment contract but did not hold that tort remedies were available. Rather, the court applied the covenant in its traditional form as a gap-filling tool to interpret ambiguous contract terms.

B. Unequal Bargaining Power

The third distinguishing factor cited by the Nebraska Supreme Court in Braesch was the unequal bargaining position between insurance companies and insureds. This distinction does little to distinguish insurance contracts from other commercial contracts which involve unequal bargaining power and standardized adhesion contracts.

C. Public Interest and Incentive Structure

The Braesch court expended considerable effort explaining why in-
Insurance contracts are different from other commercial contracts.\textsuperscript{52} However, the court never addressed the heart of the policy rationale for imposing the duty of good faith and fair dealing upon insurers. The crux of the matter is that insurers are torn by a conflict of interest in settling claims at the same time that consumers place a great deal of trust in insurance companies for their well-being and security. Courts have dealt with this conflict of interest by implementing a strong incentive structure to compel insurers to deal in good faith with the insured.

Focusing on the unique conflict of interest involved in the settlement of insurance claims is the most rational basis for distinguishing insurance contracts from other commercial contracts. Most commercial contracts contain built-in mechanisms which provide disincentives to breaching the agreement since the consumer does not complete payment before any obligation arises to the other party. For instance, a rental agreement has a built-in disincentive to prevent a landlord from breaching his duty to provide habitable dwelling units, in that the tenant may refuse to pay rent.\textsuperscript{53} Similarly, employment contracts have a built-in incentive for employers to pay their employees because unpaid employees will quit work and seek other employment.

However, the insurance contract is unique in that the consumer has completely performed all obligations under the contract by paying premiums. Thus, the insurer stands in a position of considerable economic power and discretion by virtue of the trust the insured placed in him to perform his side of the bargain in the event of a substantial loss. The potential for the insurer to save money on the policy by delaying and pressuring the insured to settle for less or litigating and defeating liability creates a severe conflict of interest. Moreover, under traditional contract principles, the insurer has nothing to lose but the policy amount plus interest. The rewards of avoiding substantial liability through bad faith conduct dwarf the insignificant damages an insurer risks under traditional contract rules. The conflict of interest which permeates the settlement of insurance claims is common throughout both third party and first party bad faith actions. This unique conflict provides a more rational way of explaining why decisions like \textit{Braesch} have imposed an incentive structure involving tort remedies upon insurance contracts, but not upon other commercial contracts which have built-in disincentives against breach of the agreement.

The \textit{Braesch} court came closest to identifying the "conflict of interest" policy rationale when it cited the public character of insurance


\textsuperscript{53} See NEB. REV. STAT. § 74-1425 (1990)(tenant may terminate rental agreement for landlords' material breach of duty to provide habitable premises).
contracts.\textsuperscript{54} The Nebraska Supreme Court seemed to be saying that the insurance business resembles a publicly regulated utility, an enterprise so vital to the public interest that the court must impose on its practitioners a strong incentive structure to conform their conduct to benefit the public interest.\textsuperscript{55}

However, the court's public interest analysis is incomplete. The court should have gone a step farther and recognized that the rationale underlying public regulation of insurance is the conflict of interest inherent in settling insurance claims. This conflict is more severe than in other commercial contracts due to the lack of any built-in disincentives that might prevent insurers from breaching the duty to settle in good faith.

The \textit{Braesch} court relied in part on \textit{Rawlings v. Apodaca} to determine that insurers should be held liable for tortious breaches of the implied covenant of good faith where the contract creates a special, partly non-commercial relationship in which the insured "seeks something more than commercial advantage or profit from the [insurer]."\textsuperscript{56}

The Nebraska Supreme Court stopped short of recognizing the more compelling rationale in \textit{Rawlings}. The \textit{Rawlings} court recognized that the incentive structure underlying the tort of bad faith exists primarily because of the unique conflict of interest which attends the insurer's decision to pay insurance claims:

\begin{quote}
If the only damages an insurer will have to pay upon a judgement of breach are the amounts that it would have owed under the policy plus interest, it has every interest in retaining the money. . . . Thus, we conclude that one of the prime reasons for the recognition of tort actions for breach of the implied obligations raised by certain contractual relationships is that any other rule provides more of an incentive for breach of the contract than its performance.\textsuperscript{57}
\end{quote}

III. DAMAGES: FROM HADLEY V. BAXENDALE TO TORT OF BAD FAITH

In \textit{Braesch}, the court allowed damages for mental anguish, though the court recognized that "Damages for mental anguish are not as a general rule, recoverable in actions for breach of contract unless the breach amounts in substance to a willful or independent tort."\textsuperscript{58}

\begin{flushleft}
\textsuperscript{55} Id.
\textsuperscript{56} Id, at 52-53, 464 N.W.2d at 775 (quoting Rawlings v. Apodaca, 726 P.2d 565, 575 (Ariz. 1986).
\textsuperscript{57} Rawlings v. Apodaca, 726 P.2d 565 at 575-76 (Ariz. 1986).
\end{flushleft}
The notion that damages recoverable in breach of contract actions do not include mental anguish damages is based on the Hadley v. Baxendale\textsuperscript{59} rule that limits contractual damages to those sums which compensate the party for losses "such as may reasonably be supposed to have been in the contemplation of the parties at the time they made the contract and were the probable result of the breach of it."\textsuperscript{60}

Many courts construing Hadley have refused to allow mental anguish damages because they are considered "outside the contemplation of the parties as a matter of law."\textsuperscript{61} Thus, because most courts assume that traditional contract rules would not provide for such consequential damages in breach of contract claims, decisions like Braesch have characterized an insurer's breach of contract as sounding in tort so that consequential damages would be available for the plaintiff seeking compensation for insurers' breach of the implied covenant of good faith.\textsuperscript{62}

IV. CLASSIFYING CAUSE OF ACTION AS TORT OR CONTRACT

As long as courts continue to allow different damages in tort claims as opposed to contract claims, litigants must determine whether to characterize a cause of action as a tort or a contract. The characterization of bad faith as a tort action has been criticized as a sterile labeling process.\textsuperscript{63} Classifying an insurer's breach of contract as a tort has stra-

\begin{itemize}
  \item The damages awarded for breach of contract, and those damages must cause severe emotional distress or mental suffering. \textit{Id.} at *38. In Bailey, the court noted that the insured had been forced to beg her estranged sister for lodging and get a job against her doctors orders. The court held this type of injury could not be compensated by a damage award based on the policy. The appellate court noted that two factors to be considered in determining whether mental suffering is severe are "The intensity and the duration of the distress." \textit{Id.} at *42 (quoting \textit{RESTATEMENT (SECOND) OF TORTS} § 46 cmt. D (1965)).
  \item Holmes, supra note 39, at 338.
  \item Holmes, supra note 39. Professor Holmes reasons that the foundation of bad faith liability lies in equity and that judicial policing of overreaching by insurers is analogous to the use of the good faith principle to imply warranties of merchantability (see \textit{U.C.C.} § 2-314) and warranties of habitability. Holmes further reasons that "In the absence of any reliable criteria for making a choice between tort and contract, courts often make a result oriented distinction." Holmes \textit{supra}, note 37, at 370-71. The tort characterization will depend upon the nature of the insurer's conduct. \textit{Id.} at 371. Moreover, a study of several Georgia decisions concludes the type of conduct an insurer engages in is the most significant factor in determining whether an action will be classified as a tort. The study noted that in contract actions in which mental suffering damages were denied, there was not "sufficiently aggravated conduct" and that where the conduct justifies mental suffering the court will be able to find a "tort." Larry Ribstein, \textit{Tort} (1993) 1993
tetic significance with the foremost consideration being the availability of consequential damages. Additionally, many procedural issues arise from the otherwise artificial or "elastic" distinction between tort and contract. Depending on the styling of the cause of action, litigators involved in bad faith litigation must be aware of different statutes of limitation, the assignability of the cause of action, whether the parole rule of evidence applies and whether particular affirmative defenses are appropriate.

V. STANDARDS OF LIABILITY

A. Standard of Care

In Braesch, the insurer denied coverage in spite of clear liability

and Contract in Georgia, 30 MERCER L. REV. 303, 309 (1978). This analysis fairly characterizes Nebraska's bad faith decisions. To date, Nebraska decisions have held that an insurer's conduct must amount "in substance to a willful and independent tort" for the bad faith cause of action to apply. Braesch v. Union Ins. Co., 237 Neb. 44, 464 N.W.2d at 778 (1991).

64. Where the insured's cause of action sounds in bad faith breach of extra contractual damages, the general rule for tort recovery applies to allow the injured party to recover "all detriment caused whether it could have been anticipated or not." SHERNOFF, ET AL., supra note 1, § 7.04[1] at 7-15 (quoting Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1041 (Cal. 1973)).


66. An action upon a contract or promise in writing must be brought within five years. NEB. REV. STAT. § 25-205(1)(Reissue 1989). An action for an injury to the rights of the plaintiff, not arising on contract, and not enumerated elsewhere in the Nebraska Civil Procedure Code, must be brought within four years. NEB. REV. STAT. § 25-207(3)(Reissue 1989).

67. Courts in virtually all jurisdictions have held that an insured may assign his cause of action for breach of the implied covenant of good faith. SHERNOFF ET AL., supra note 1, § 2.04[2][a][i](citations omitted).

68. The parole evidence rule when applied to insurance contracts provides that the document is the complete agreement between the parties. KEETON & WIDDIS, supra note 5, § 6.1(c)(2) at 622. If the bad faith cause of action exists independently of the contract and attaches over and above the terms of the contract, cf., Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1040 (Cal. 1973), the parole evidence rule would presumably not apply as an insured's defense that the written contract excluded bad faith damages. On the other hand the Gruenberg court states that the parties still may by the terms of the contract define their respective obligations and duties. Id.

under the policy. The *Braesch* court focused on Union's delaying tactics and Union's failure to develop any reasonable defense to the Braesches' claim to determine that Union's breach was a willful tort. Other Nebraska cases dealing with third party insurance claims provide further insight into the types of conduct that will expose an insurer to extracontractual damages.

B. The Duty to Investigate

Nebraska case law has established that a lack of due care in investigating and reviewing claims will expose an insurer to excess liability. In *Hadenfeldt v. State Farm Mut. Auto Insurance Co.*, an early third party case, the Nebraska Supreme Court held "an insurer is obligated to use due care and reasonable diligence to ascertain the facts surrounding a claim and obtain competent legal advice concerning the claims." However, one should not be misled by the reasonable dili-

70. *Braesch v. Union Ins. Co.*, 237 Neb. 44, 58, 464 N.W.2d 769, 778 (1991) See also *Bailey v. Farmers Union Cooperatives Ins. Co.*, No. A-91-1158, 1992 Neb. App. LEXIS 327 (Dec. 22, 1992). In *Bailey*, the Nebraska Appellate Court held the insurer liable for bad faith. Farmer's Union had tried to pressure the insured to settle for actual cash value as payment for her destroyed home when the policy clearly provided for replacement value. Additionally, Farmer's Union told the insured that her claim was "questionable" six weeks after an internal report stated that "the loss was covered." *Id.* at *10-11. Farmer's Union refused to pay the replacement value after two years and repeated demands. The trial court in *Bailey* "castigated Farmers Union for the almost criminal effort to force Bailey to accept actual cash value as almost total satisfaction on the claim even though she was entitled to replacement costs." *Id.* at *25. The types of conduct the trial court focused on in *Bailey* were the insurers delaying tactics, misinterpretation of policy provisions to avoid coverage, and denial of the claim in spite of an internal finding that the loss was covered by the policy. *Id.* at *17. Conduct that has subjected insurers to bad faith liability in other jurisdictions include: inadequate investigation, delay, compelling insureds to seek legal redress (in spite of no reasonable grounds for denial), deception, misinterpretation to avoid coverage, threats, false accusations, oppressive demands, conditioning payment of undisputed portion of the claim on settlement of disputed portion, nondisclosure of insured's rights under the policy, and retaliatory cancellations. *Ashley*, *supra* note 48, §§ 5.04 - 5.22.

71. See, e.g., *Olson v. Union Fire Ins. Co.*, 174 Neb. 375, 118 N.W.2d 318 (1963)(insurer was held not liable for bad faith where it used all available means to assemble the facts and determine applicable law); *Hadenfeldt v. State Farm Mut. Auto. Ins. Co.*, 195 Neb. 578, 239 N.W.2d 499 (1976)(where insurer used reasonable diligence in investigating the facts and the law, mistaken judgement was not grounds for bad faith).

72. Subsequent to the *Braesch* decision the Nebraska Supreme Court held that a sufficient cause of action for bad faith had been stated when the plaintiff alleged that the insurer had denied fire insurance coverage based on suspected arson without conducting a proper investigation and subjecting the results to a reasonable evaluation and review. *Ruwe v. Farmers Mutual United Ins. Co.*, 238 Neb. 67, 469 N.W.2d 129 (1991).

gence language used by the court. The court's standard of care is not based on negligence.

C. Unreasonable v. Reckless Conduct

Nebraska case law on bad faith litigation reflects the view that for an insurer to be held liable for extracontractual damages, some form of subjective dishonesty, fraud or concealment must be involved.74 In Braesch, the court cited with approval the language of Olson v. Union Fire Insurance Co.,75 that "neither mistaken judgement nor unreasonable judgement is the equivalent of bad faith."76

Nebraska has adopted a more subjective standard of care based on the competing policy objective of allowing insurance companies to investigate questionable or fraudulent claims with flexibility. The Braesch standard combines an objective element, the lack of any reasonable basis for denial of a claim, with a subjective element, the insurer's knowledge or reckless disregard of the lack of merit to its claim denial. This combination objectivesubjective test comes from the Wisconsin case Anderson v. Continental Ins. Co.77 In Anderson, the Wisconsin Supreme Court held that, "To show a claim for bad faith, a plaintiff must show the absence of a reasonable basis for denying benefits of the (insurance) policy and the defendant's knowledge or reckless disregard of the lack of a reasonable basis for denying the claim."78 Thus, the Anderson court concluded "that the tort of bad faith is an intentional one. 'Bad faith' by definition cannot be unintentional."79 Under the Anderson test as adopted in Braesch, subjective bad faith may be inferred by "a reckless disregard of a lack of a reasonable basis for denial or a reckless indifference to facts or to proofs submitted by the insured."80 California and some other jurisdictions have adopted lower standards of care based solely upon the objective

75. 175 Neb. 375, 118 N.W.2d 318 (1962).
80. Id. at 377. The Nebraska Supreme Court elaborated on the standard of care adopted in Braesch in a subsequent decision. Ruwe v. Farmers Mut. United Ins. Co., 238 Neb. 67, 469 N.W.2d 129 (1991). The court held that "Reckless indifference to the facts or to the proof submitted by an insured is shown by an insurer's failure to conduct a proper investigation and subject the results to a reasonable evaluation and review" and that "Ruwe's claim that Farmers denied his claim without a proper and thorough investigation of the fire scene sufficiently alleged that element of the Braesch test." Id. at 74, 469 N.W.2d at 135.
standard of whether the insurer acted "unreasonably." 81

The high standard of proof required under the Anderson test balances the twin policy objectives of 1) allowing insurers flexibility in investigating questionable claims and 2) providing insurers with an incentive to pay claims in which liability is clear. At the same time, the Anderson test does not subject insurance companies to liability based solely on "objective" standards of conduct. 82

VI. AFFIRMATIVE DEFENSES

A plaintiff who pleads a bad faith first party action in Nebraska is pleading a hybrid intentional tort. 83 The plaintiff's contributory or comparative negligence should not reduce the defendant's potential liability. 84 Further, since Nebraska has adopted the standard tort version for bad faith actions, the insured's performance of the contract terms should be irrelevant to his recovery. 85

VII. CONCLUSIONS

The Nebraska Supreme Court's rationale amounts to the imposition of a quasi-fiduciary duty upon insurers to deal fairly and in good faith with their insured. The Braesch court identified the partially non-commercial nature of insurance contracts and the vital public importance of insurance as the rationale for employing the good faith duty.

The Nebraska Supreme Court used these two factors, as well as the inequitable bargaining positions between insurers and insured, to distinguish insurance contracts from other commercial contracts. Nonetheless, the bright line the Nebraska Supreme Court tried to draw between insurance contracts and other commercial contracts may not be all that defensible. One can think of numerous other consumer

84. See supra note 69 and accompanying text.
85. Id.
adhesion contracts which are difficult to distinguish from insurance contracts using the factors cited by *Braesch*.

It seems the real policy rationale of the Court in *Braesch* is that it considers this service so infused with the public interest that it wants to provide insurers with a strong incentive to deal fairly and in good faith with insureds. The Nebraska Supreme Court should have gone a step further and explained that the inherent conflict of interest involved in paying insurance claims makes it necessary to provide an effective incentive structure for insurers to deal in good faith.

One may wonder how far the imposition of extracontractual tort remedies will invade other contractual settings. To date, courts have been extremely reluctant to extend the tort remedies of bad faith outside the realm of insurance contracts.

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