

The Covenant of Good Faith and Fair Dealing in Nevada

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I. INTRODUCTION

The Restatement (Second) of Contracts¹ and the Uniform Commercial Code² each create a duty or covenant on parties entering into a contract to act in good faith in the execution of that contract. The application of this covenant to contracts, especially non-insurance contracts, and the question of exactly what is meant by the term “good faith” has proved confusing in application.³ The distinction between cases where tort and/or punitive damages may be available and those for which they are not escapes many practitioners;⁴ furthermore, attempts to specify a single definition of the concept have proved unavailing.

The concept of what actually constitutes “good faith” has been de-

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1. Restatement (Second) of Contracts § 205 provides, “[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and in enforcement.” See Also *K-Mart Corp. v. Ponsock*, 103 Nev. 39, 48 n.8, 732 P.2d 1364, 1370 (1987) (citing Restatement (Second) of Contracts).

2. U.C.C. § 1-203, codified in Nevada at NRS 104.1203, provides “[e]very contract or duty within this chapter imposes an obligation of good faith in its performance or enforcement.”

3. Uncertainty in the law leads to insecurity of bargainers, uncertainty in the marketplace, and litigiousness.

The need for predictable results is magnified by the litigiousness of society. We are a litigious people, but our litigiousness need not produce a mass of vague rules capriciously applied to produce unpredictable results. Our litigiousness argues instead for clear rules consistently applied to produce predictable results. This would discourage frivolous litigation, encourage prompt settlement of well-founded litigation, and facilitate the just resolutions of those few lawsuits that did not settle.

Thomas A. Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: a Framework for Resolving the Mystery*, 47 HASTINGS L. J. 585, 591, n.28 (1996) (citing John H. Robinson & Mary E. Huber, *The Law of Higher Education and the Courts: 1993 in Review*, 21 J.C. & U.L. 157, 303 (1994)).

4. The allure of possible punitive damages for an action which clearly sounds in contract law is apparently too tempting to pass up. Including a cause of action for breach of the good faith covenant has almost risen to the level of sport in Nevada. Practitioners in Nevada are certainly not alone in either their zeal or confusion, however. Consider the titles of the following articles from respected legal periodicals, and the confusion implied therein. Thomas A. Diamond & Howard Foss, *Proposed Standards for Evaluating When the Covenant of Good Faith and Fair Dealing Has Been Violated: a Framework for Resolving the Mystery*, 47 HASTINGS L. J. 585, 591, n.28 (1996); Monique C. Lillard, *50 Jurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context*, 57 Mo. L. Rev. 1233 (1992); Michael H. Cohen, Note, *Restructuring Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 Cal. L. Rev. 1291 (1985).

scribed as an amorphous one.⁵ E. Allen Farnsworth commented that “[w]hile the varieties of good faith are not quite as infinite as those of religious faith, it would be quite extraordinary if this protean concept were used in the same sense in all ...instances.”⁶ Furthering Farnsworth’s theory that the definition has an ad hoc nature, Justice Springer has indicated that the term “good faith” can only be properly defined when placed in context and in contrast with the forms of bad faith which judges have decided to prohibit.⁷

In contract law, good faith is an “excluder.” “It is a phrase without general meaning of its own and serves to exclude a wide range of heterogenous forms of bad faith. In a particular context the phrase takes on a specific meaning, but usually this is only by way of contrast with the specific form of bad faith actually or hypothetically ruled out.” ... “Good faith, then, takes on specific and variant meanings by way of contrast with the specific and variant forms of bad faith which [based on the law’s standard of fairness which all people ought to observe in their dealings with each other], judges decide to prohibit.”⁸

A less circular approach was taken by the drafters of the Uniform Commercial Code, which defines good faith as “honesty in fact in the conduct or transaction concerned.” “Good faith performance or enforcement of a contract is said to require, at its core, faithfulness to the agreed-upon common purpose of the parties, and seeks to protect their justified expectations.”¹⁰

The purpose of this article is to review the origin of the covenant of good faith and fair dealing¹¹ and its eventual adoption by the Nevada Supreme Court. Part I reviews the early California cases which first recognized the covenant and spawned similar decisions nationwide. Part II explores the status of the application of the covenant in insurance, employment and commercial cases, as well as those situations in which punitive damages are available.

5. Lillard, *supra* note 4, at 1235-36.

6. E. Allen Farnsworth, *Good Faith Performance and Commercial Reasonableness Under the Uniform Commercial Code*, 30 U. CHI. L. Rev. 666, 669 (1963) (quoting Frederick Lawson, *A Common Lawyer Looks At The Civil Law*, 124-25 (1955)).

7. *Aluevich v. Harrah's*, 99 Nev. 215, 660 P.2d 986 (1983) (Springer, J., dissenting).

8. *Id.* (quoting R. Summers, “Good Faith” in *General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 Va. L. Rev. 195, 201 (1968)). With one of Nevada’s Justices espousing such an oblique and circular definition of what constitutes good faith, there can be little doubt as to why confusion exists.

9. NRS 104.1201(19). U.C.C. § 2-103(1)(b), codified in Nevada at NRS 104.2103(1)(b), imposes a higher standard of good faith on merchants, requiring “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”

10. Matthew J. Barrett, Note, “Contort”: *Tortious Breach of the Implied Covenant of Good Faith in Fair Dealing in Non-Insurance Commercial Contracts—Its Existence and Desirability*, 60 Notre Dame L. Rev. 510, 512 (1985); see also *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1040 (Cal. 1973).

11. Hereinafter referred to as the “good faith covenant”.

II. THE GOOD FAITH COVENANT IN CALIFORNIA

Some argue the good faith covenant has always existed and has been recognized by American courts since the early 1900s.¹² The implied good faith covenant in Nevada, as in our nation, finds its genesis in insurance law. The first courts in the United States to recognize that the breach of the good faith covenant is a tort were in California. In the seminal case of *Commale v. Traders General Co.*,¹³ an insured sued after his insurer refused to defend him in a third-party action. The insurer refused to accept what the Plaintiff, and ultimately the court, deemed to be a reasonable settlement offer. The court recognized for the first time in the United States that insurance contracts contain an implied good faith covenant and that a breach of that covenant constitutes a tort.¹⁴

Later, in *Crisci v. Security Insurance Co.*,¹⁵ the California Supreme Court recognized that a plaintiff could recover for mental suffering caused by an insurer's wrongful refusal to settle a third-party's claim against the insured in bad faith. In 1973, the California Supreme Court expanded the reach of the bad faith tort by declaring that the action will also lie when an insurer unreasonably and in bad faith re(uses to settle a first-party claim.¹⁶

In 1978, the California court declared that punitive damages would be available for breach of the good faith covenant upon proof of malicious intent beyond had faith.¹⁷ In 1980, it first suggested that the breach of the good faith covenant extends to employment contract situations,¹⁸ and in the landmark decision, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*,¹⁹ the court held that the tort could be expanded to other commercial contracts. The court recognized that a party to a contract may incur tort liability if, after breaking the contract, it seeks to shield itself from liability by denying, in bad faith, that the contract exists.²⁰

The overwhelming majority of jurisdictions in the United States have now followed California's lead and recognized the good faith covenant in all contracts.²¹ Whatever the definition of the term "good faith," its implied in-

12. Judge Cardozo, in his famous decision, *Wood v. Lucy, Lady Duff-Gordon*, 118 N.E. 214 (N.Y. 1917), declared that a contract to pay profits resulting from an exclusive agency included "a promise to use reasonable efforts to bring profits and revenues into existence." *Id.* at 215 (cited in Lillard, *supra* note 4, at 1234).

13. 328 P.2d 198 (Cal. 1958).

14. This tort is commonly referred to as the bad faith tort.

15. 426 P.2d 173 (Cal. 1967).

16. *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973); *See also Silberg v. California Life Ins. Co.*, 421 P.2d 1103 (Cal. 1974).

17. *Neal v. Farmers Ins. Exch.*, 582 P.2d 980 (Cal. 1978).

18. *Tameny v. Atlantic Richfield Co.*, 610 P.2d 1330 (Cal. 1980).

19. 686 P.2d 1158 (Cal. 1984).

20. *Id.* at 1167.

21. *See, generally, Diamond & Foss, supra* note 4, at 585, n.1; Lillard, *supra* note 4, at appendix.

clusion in contracts has introduced a modicum of morality into contract law²² when compared with traditional contract theories.²³ Traditionally, the motive behind a breach of contract was irrelevant; courts have focused instead on placing the non-breaching party in as good a position as he would have been had the breach not occurred.²⁴ By imposing a duty to act in good faith upon parties to a contract, courts are now forced to explore the motivation behind the breach.²⁵ They are forced to discover and enforce the original intent of the parties. Some courts have even demonstrated a willingness to use the covenant to circumvent express contract terms that may violate the courts' view of an equitable arrangement between the parties.²⁶ The covenant applies as a gap-filler when the propriety of the conduct in question is not resolved by the terms of the contract itself.²⁷

By imposing a duty to act in good faith, courts accomplish two related and important goals. The first is to award compensatory damages which approach a true measure of the expectations of the non-breaching party. This goal recognizes that traditional contract damages are not always adequate to make a non-breaching party whole, and therefore justifies the recognition of tort-type damages. The second is to deter conduct arising in the contractual relationship which the courts deem detrimental to our social fabric.²⁸ These two goals, one founded in contract theory and the other sounding in tort, give rise to the application of the breach as both a tort and a contract claim, and thus the oft-used title, "contort."

III. EMERGENCE OF THE GOOD FAITH COVENANT IN NEVADA

In *Fisher v. Executive Fund Life Insurance Co.*,²⁹ the Nevada Supreme Court considered an appeal from a motion to dismiss claims against an insurer under a home confinement benefit rider. The majority decided the case on purely procedural law. In his concurring opinion, Justice

22. Sandra Chutorian, Note, *Tort Remedies for breach of Contract: The Expansion of Tortious Breach of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 380 (1986).

23. Traditional contract theory permits those entering into a contract to elect, with impunity, whether they will perform their contractual obligation. *Id.*

24. See, generally, Chutorian, *supra* note 22, at 378-81.

25. Restatement (Second) of Contracts § 105 cmt. a (1979) provides:
Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving "bad faith" because they violate community standards of decency, fairness, or reasonableness.

26. Chutorian, *supra* note 22, at 379-80 (citing 5 S. Williston, *A Treatise on the Law of Contracts*, § 670, at 157; *Sylvan Crest Sand & Gravel Co. v. United States*, 150 F.2d 642 (2d Cir. 1945)).

27. Diamond & Foss, *supra* note 4, at 587. The covenant may not, however, override or contradict the express terms of the contract.

28. Chutorian, *supra* note 22, at 391.

29. 88 Nev. 704, 704 P.2d 700 (1972).

Gunderson referred to *Communale* and its progeny³⁰ and suggested that the plaintiff may have stated a cause of action for mental distress caused by "bad faith refusal to pay policy proceeds."³¹ From this suggestion by Justice Gunderson, the law surrounding the good faith covenant in the State of Nevada has evolved.

A. *The Bad Faith Tort in Insurance Contracts*

Three years after deciding *Fisher*, the Court in *United Crater Widely and Guaranty Co. v. Peterson*, adopted the rule that allows recovery of damages in tort upon a showing of bad faith refusal or delay of an insurer in paying claims.³² During the course of improvement of a 5.41 mile stretch of existing road and construction of an additional 2.63 miles of road for the United States Forest Service, damage occurred to a water pipe and trestle owned by the Nevada Power Company. The water line and trestle ran alongside and adjacent to a portion of the construction project. The construction company that caused the damage submitted claims to its insurer under a liability policy. Despite knowledge of the construction company's increasingly precarious financial condition, the insurance company delayed and refused to pay on the claims.³³ The refusal eventually caused the principal to lose both his business and his credit.³⁴ The Court held:

[w]here an insurer fails to deal fairly and in good faith with its insured by refusing without proper cause to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of the implied covenant of good faith and fair dealing.³⁵

Citing authority from California, as well as Justice Gunderson's concurring opinion in *Fisher*, the Court declared that the duty to conduct oneself in good faith and deal fairly in a contract arises not from the terms of the contract itself,³⁶ but is a duty imposed by the law, the violation of which is a tort.³⁷ Limiting the scope of the new tort, however, the Supreme Court de-

30. See *supra* text accompanying notes 12-28.

31. *Fisher*, 88 Nev. at 706, 704 P.2d at 702 (Gunderson, J., concurring).

32. 91 Nev. 617, 619-20, 540 P.2d 1070, 1071 (1975).

33. *Id.* at 619, 540 P.2d at 1071.

34. *Id.* at 619, 540 P.2d at 1071.

35. *Id.* at 620, 540 P.2d at 1071.

36. A claim for bad faith is a separate tort action apart from the breach of the insurance contract because the duty arises out of an implied covenant and not the contract itself.

37. 91 Nev. at 620, 540 P.2d at 1071. Strangely, beside its reference to California cases, the Nevada Supreme Court did not explain its rationale behind the recognition of this new tort. It only declared a new "rule" without explaining why the new rule was necessary or desirable. Declaring the existence of a new tort without explaining the parameters of its application or the reasoning for its existence can certainly lead to confusion among practitioners and to inconsistent application by trial judges.

clared that although there was sufficient evidence to find bad faith and to justify a jury instruction on the availability of consequential damages, the necessary requisites to support punitive damages were not present in *Peterson*.³⁸ Thus, the Court implied that punitive damages require conduct beyond bad faith.³⁹

In *Aluevich v. Harrah's*,⁴⁰ Chief Justice Manoukian, writing for the majority, explained that the tort recognized by the court in *Peterson* arose out of a need for special protection of insureds because of the quasi-public nature of the insurance industry and because of the insured's heavy reliance upon the insurer's credibility.⁴¹ He declared that the covenant had been applied in other jurisdictions mainly in contractual relations which involved a special element of reliance such as those found in partnerships, insurance agreements and franchise agreements.⁴² Justice Manoukian in *Aluevich* emphasized that the special relationship between the insured and insurer is characterized by elements of the quasi-public nature of the industry.⁴³ As additional proof of the existence of a special relationship, the Court cited the fact that most insurance policies are adhesion contracts and that the insurer has a fiduciary responsibility to act on the behalf of the insured.

The Court has also emphasized that a consumer buys insurance for security, protection and peace of mind, thereby fostering the fiduciary relationship.⁴⁴ Because negotiations between the large, wealthy and sophisticated insurance industry and a naive or at least less sophisticated customer are not and cannot be of equal strength,⁴⁵ the good faith covenant must therefore be imposed by law.⁴⁶

In *Pemberton v. Farmers Insurance Exchange*,⁴⁷ the Court expanded the application of the bad faith tort to first-party claims under an uninsured or underinsured motorist⁴⁸ provision. In Nevada, all insurance policies covering motor vehicles must offer UM coverage.⁴⁹ In *Pemberton*, the insurance company refused to pay proceeds under a UM provision because the claim-

38. *Id.* at 620, 540 P.2d at 1071. For discussion of the necessary requisites to support punitive damages in Nevada, see text accompanying notes 111-119.

39. *See infra* text accompanying notes 111-119.

40. 99 Nev. 215, 660 P.2d 986 (1983).

41. *Id.* at 217, 660 P.2d at 987.

42. *Id.* The Court refused to extend the tort to the breach of a commercial lease where both parties had relatively equal bargaining strength because of the lack of the special element of reliance. This reluctance to extend the doctrine to apply to non-insurance contracts was consistent with the mood of other jurisdictions in the mid-1980s, the majority of which had still refused to apply the doctrine in the commercial context approximately twenty five years after the *Comunale* decision. Chutorian, *supra* note 22, at 390.

43. *Aluevich*, 99 Nev. at 217, 660 P.2d at 987.

44. *K-Mart*, 103 Nev. at 49, 732 P.2d at 1371 (quoting *Seaman's*, 686 P.2d at 1166).

45. *Id.* at 49, 732 P.2d at 1371.

46. *Ainsworth v. Combined Ins. Co.*, 104 Nev. 587, 592, 763 P.2d 673, 676 (1988).

47. 109 Nev. 789, 858 P.2d 380 (1993).

48. Hereinafter referred to as "UM."

49. NRS 687B.145(2).

ant had not first obtained a judgment against the tortfeasor, claiming that Nevada's statute requires the claimant to obtain a judgment against the tortfeasor in order for the claimant to be legally entitled to the UM proceeds.⁵⁰ The Court declared that "legal entitlement" means that although the insured must establish fault on the part of the uninsured motorist, the insured need not obtain a judgment to prove entitlement. However, until the insured has established legal entitlement, no claim for bad faith will lie.⁵¹ The *Pemberton* decision marked an important milestone in Nevada's development of law regarding the covenant of good faith. Thereafter, insurers were on notice that they may be held liable in tort for bad faith denial of both third-party and first-party claims.

In *Guaranty National Insurance Co. v. Potter*,⁵² the Court again expanded the application of the tort to insurance law. In *Potter*, the insurer refused to pay for an independent medical examination of its party claimant. When the insured sued, the insurer contended that a tort against insurer for breach of the good faith covenant is limited to "unreasonable or delay in payment of a valid claim," and since the insurer had paid the full policy limits under the UM coverage, it could not have breached the implied covenant.⁵³ The Court noted that generally the breach of the good faith covenant has been addressed for an insurer's unreasonable denial or delay in payment of a valid claim; however, the Court commented, the bad faith tort is not limited to cases where an insurer has unreasonably denied or delayed payment of valid claim.⁵⁴ Bad faith is established where any act of the insurer is unreasonable and is made with knowledge that there is no reasonable basis for the conduct.⁵⁵ The Court held that the insurer's refusal was in bad faith.

Although originally limited to delay or refusal to pay on a third-party insurance claim, the Nevada Supreme Court has expanded the bad faith tort to first-party insurance situations. It has recently opened the door even wider by declaring that the insurer breaches the covenant *by any reasonable act* for which the insurer knows there is no reasonable basis. The application of this rule seems limited only by the imagination of plaintiffs' attorneys and the capacity of the insurance industry to act unreasonably.

50. NRS 687.145(2) provides the following:

Uninsured and underinsured vehicle coverage must include a provision which enables the insured to recover up to the limits of his [her] own coverage any amount of damages for bodily injury from his [her] insurer which he [she] is legally entitled to recover from the owner or operator of the other vehicle to the extent that those damages exceed the limits of the coverage for bodily injury covered by that owner or operator.

51. *Pemberton*, 109 Nev. at 796, 858 P.2d at 384.

52. 112 Nev. 199, 912 P.2d 267 (1996).

53. *Id.*, 912 P.2d at 272.

54. *Id.*, 912 P.2d at 272 (citing *Pemberton*, 109 Nev. at 793, 858 P.2d at 382; *Falline v. GNLV Corp.*, 107 Nev. 1004, 823 P.2d 888, 891 (1991)).

55. *Id.*, 912 P.2d at 272 (citing *American Excess Ins. Co. v. MGM Grand Hotels, Inc.*, 102 Nev. 601, 605, 729 P.2d 1352, 1354-55 (1986)).

B. The Good Faith Covenant in Employment Contracts

In *Aluevich*, the majority refused to extend the good faith covenant to contracts in which there was no special relationship.⁵⁶ Justice Springer, in his dissenting opinion, declared that there is “no reason to restrict actions” arising from a breach of the good faith covenant to contracts involving insurance, partnership and franchise agreements.⁵⁷ Although the majority had not then recognized it, Justice Springer declared that the duty recognized by the Court in *Peterson* arose from the premise that the implied covenant exists in every contract, and that neither party should be permitted to do anything that will injure the right of the other to receive the benefits of the agreement.⁵⁸ He further argued that since the Court had already applied the obligation of good faith and fair dealing set forth in the U.C.C.,⁵⁹ it had already recognized the existence of the obligation in all contracts. Given the premise upon which the Court recognized the bad faith tort in *Peterson*, and given the acceptance of that premise by other courts, Justice Springer argued that the majority should not maintain their restricted approach to bad faith actions and should extend the application of the covenant to all contracts.⁶⁰

Justice Springer’s dissent in *Aluevich* opened the door for the expansion of the tort from contracts involving insurance to those in the employment arena. In *Hansen v. Harrah’s*,⁶¹ employees of two different employers were fired after on-the-job injuries. Each employee had filed a worker’s compensation claim which eventually led to an order for payment of benefits. The employees sued their respective employers for failure to pay the benefits due and for retaliatory discharge, and they sought compensatory and punitive damages.⁶² Nevada had not yet adopted the public policy exception to the at-will employment doctrine recognizing a cause of action for retaliatory discharge for filing a worker’s compensation claim.⁶³ Electing to support the established public policy of the State of Nevada of protecting injured workers, the Court adopted a narrow exception to the at-will employment doctrine, recognizing “that retaliatory discharge by an employer stemming from the filing of a workman’s compensation claim by an injured employee is actionable in tort.”⁶⁴ At the core of this exception is yet another

56. See *supra* text accompanying notes 40-43.

57. *Aluevich*, 99 Nev. at 220, 660 P.2d at 988.

58. *Id.* at 220, 660 P.2d at 988.

59. *Id.* at 220, 660 P.2d at 989. Justice Springer cited *Mitchell v. Bailey & Selover*, 96 Nev. 147, 605 P.2d 1138 (1980), in which the Supreme Court confirmed that NRS 104.1203 and 104.1102(3) provides an obligation of good faith under the Uniform Commercial Code.

60. 99 Nev. at 220, 660 P.2d at 989.

61. 100 Nev. 60, 675 P.2d 394 (1984).

62. *Id.* at 62, 675 P.2d at 395.

63. *Id.* at 62, 675 P.2d at 396.

64. *Id.* at 64, 675 P.2d at 39a. In *Shoen v. Amerco*, 111 Nev. 735, 896 P.2d 496 (1995), the Court

infusion of morality into the area of contract law, requiring employers to deal in good faith with their employees. This new cause of action in Nevada became known as tortious discharge, retaliatory discharge, or the public policy tort. The Court held that although punitive damages are appropriate in public policy tort cases upon the proper demonstration of malicious, oppressive or fraudulent conduct, it refused to extend punitive damages to these employers because it would be unfair to punish them (or conduct which they could not have known beforehand was actionable).⁶⁵

In the seminal case of *K-Mart Corp. v. Ponsock*,⁶⁶ the Court was asked to extend the application of the tort to a situation where an employee was hired "until retirement" and for "as long as economically possible."⁶⁷ After nine and one-half years of employment at K-Mart, Ponsock, who was characterized by his immediate supervisor as an "excellent" employee, was discharged under suspicious circumstances approximately six months prior to the vesting of his retirement Benefits. K-Mart had promised the employee that if there were any deficiencies in his performance, it would provide assistance to him and would release him only after a series of correction notices. No notices were provided prior to Ponsock's termination.⁶⁸

The Court found that Ponsock had definite rights of employment tenure and was contractually entitled to be retained until dismissal for cause.⁶⁹ The Court explained that an employer still has the absolute right to dismiss an employee at will or at whim, but cannot do so for reasons which offend public policy.⁷⁰ Following the California case of *Koehrer v. Superior Court*,⁷¹ the Court distinguished the facts of *K-Mart* from those found in *Hansen*, which were applicable to the so-called public policy tort of retaliatory discharge. In so doing, the Court carved out the "bad faith discharge" tort.⁷²

The Court justified tort remedies because K-Mart's conduct went beyond the bounds of ordinary liability for breach of contract.⁷³ It declared that, by prior legislative codification of the U.C.C., the good faith covenant is implied in every contract in the State of Nevada.⁷⁴ Although the duty is

declared that the public policy tort is not recognized when a comprehensive statutory remedy exists. A statutory remedy that does not provide for tort-type damages is not comprehensive under the *Shoen* standard.

65. *Id.* at 65, 675 P.2d at 397.

66. 103 Nev. 39, 732 P.2d 1364 (1987).

67. *Id.* at 42, 732 P.2d at 1366.

68. *Id.*

69. *Id.* at 45, 732 P.2d at 1368.

70. *Id.* at 47, 732 P.2d at 1369.

71. 181 Cal. App. 3d 1155, 1163 (1986).

72. Although similar to breach of the good faith covenant in an employment context, tortious discharge for public policy cases are not founded in the implied covenant, but rather in some other public policy. *Id.*

73. *K-Mart*, 103 Nev. at 48, 732 P.2d at 1370.

74. *Id.*

created by law in all cases, it is only in rare and exceptional cases that the duty is of such a nature as to give rise to tort liability. The kind of breach of duty that brings into play the bad faith tort arises only when there are special relationships between the tort-victim and the tortfeasor.⁷⁵

The Court found that the contract, as well as the relationship between the parties, was analogous to the special relationship in an insurance contract because the employee was just as dependent in specially relying upon K-Mart's commitment to his extended employment and his subsequent retirement benefits, as would be any insurance policy holder.⁷⁶ To permit contract damages as the sole remedy for the kind of conduct engaged in by K-Mart would render K-Mart unaccountable for its actions. Therefore, the Court agreed to recognize the bad faith discharge tort in the very "fact-specific instance of discharge by a large, nationwide employer of an employee in bad faith for the improper motive of defeating contractual retirements."⁷⁷ Although Nevada is the only jurisdiction to recognize ter damages for breach of an employment contract,⁷⁸ recent Tenth Circuit and Wyoming decisions have praised the Court's holding.⁷⁹

In *Martin v. Sears, Roebuck and Co.*,⁸⁰ the Court announced the specific elements necessary to prove bad faith discharge: first, there must be an enforceable contract;⁸¹ second, the tortfeasor and the tort victim must have a relationship of trust and special reliance;⁸² and third, the employer's conduct must go "well beyond the bounds of ordinary liability for breach of contract."⁸³ The Court also pointed out that the mere breach of an employment contract by a large and powerful employer does not, by itself, give rise to tort damages.⁸⁴ Tort damages, it declared, are appropriate in bad faith discharge cases because ordinary contract damages do not adequately compensate or make the victim whole."

C. The Good Faith Covenant in Commercial Contracts

As in other states, Nevada subsequently expanded the good faith covenant to apply to non-insurance, non-employment contracts. The first sig-

75. *Id.* at 49, 732 P.2d at 1370.

76. *Id.* at 51, 732 P.2d at 1372.

77. *Id.* at 48, 732 P.2d at 1370.

78. *Lillard*, *supra* note 4, at 1286.

79. *McIlravy v. Kerr-McGee Corp.*, 74 F.3d 1017, 1026 (10th Cir. 1996); *Wilder v. Cody County Chamber of Commerce*, 868 P.2d 211, 221-22 (Wyo. 1994).

80. 111 Nev. 923, 927, 899 P.2d 551, 555 (1995).

81. *Id.* at 927, 899 P.2d at 555.

82. *Id.* at 927, 899 P.2d at 555 (citing *K-Mart*, 103 Nev. at 49, 732 P.2d at 1370).

83. *Id.* at 927, 899 P.2d at 555 (citing *K-Mart*, 103 Nev. at 48, 732 P.2d at 1370).

84. *Id.* at 927, 899 P.2d at 555.

85. *Id.* at 927, 899 P.2d at 555. (citing *K-Mart*, 103 Nev. at 49, 732 P.2d at 1371).

nificant step in this expansion was taken by the Court in 1980. It declared in *Mitchell v. Bailey & Selover, Inc.*,⁸⁶ “it is clear that the obligation of good faith applies to the enforcement of a [contract governed by the Uniform Commercial Code].”⁸⁷ In so doing, the Court recognized that the good faith covenant exists in all commercial contracts.⁸⁸ Justice Springer’s dissent in *Aluevich*⁸⁹ opened the door for the Court to declare that the covenant was available under all contracts, regardless of their subject. The Court in *Ainsworth*⁹⁰ followed Justice Springer’s dissent and recognized that the good faith covenant applies to every contract.

For non-insurance, non-employment contract cases, *Hilton Hotels Corp. v. Butch Lewis Productions, Inc.*,⁹¹ is a landmark case in Nevada. Prizefight promoters Butch Lewis and Don King⁹² contracted with the Hilton Hotel in Las Vegas to exhibit the last four contests in a series of professional prize fights called the “Unification Series.”⁹³ The intention of the fight promoters was to select an undisputed heavyweight champion of the world.⁹⁴ When the contract was executed, Michael Spinx was the International Boxing Federation⁹⁵ heavyweight champion. Although the contract did not specify that Spinx himself would be a contestant in the second, third or fourth Hilton events, Hilton claimed that the parties intended that Spinx would be available to participate as the IBF Champion in all four events. Prior to the final event, Spinx forfeited his IBF Championship, thereby becoming ineligible to fight in the series. Lewis and King then arranged more lucrative fight for Spinx. Hilton sued Lewis and King for breach of contract, civil conspiracy and intentional interference with contractual relations.⁹⁶

Lewis and King did not breach the express terms of the contract with Hilton.⁹⁷ The Court held, however, that Hilton could still be able to recover damages for breach of the good faith covenant, “[w]here the terms of a contract are literally complied with but one party to the contract deliberately contravenes the intention and spirit of the contract, that party can incur liability for breach of the good faith covenant.”⁹⁸ The Court was careful to point out that the tort action for breach of the good faith covenant requires

86. 96 Nev. 147, 605 P.2d 1138 (1980).

87. *Id.* at 149, 605 P.2d at 1139.

88. See NRS 104.1203 and 104.1102(3).

89. See *supra* text accompanying notes 56-60.

90. 104 Nev. 587, 592, n.1, 736 P.2d 673, 676 (1988), *cert. denied*, 439 U.S. 958 (1989) (“*Hilton I*”).

91. 107 Nev. 226, 808 P.2d 919 (1991).

92. Through their corporation, Dynamic Duo, Inc.

93. So-called because the settee was designed to select one champion from among those recognized as champion by each of the respective three world boxing organizations.

94. 107 Nev. at 228, 808 P.2d at 920.

95. Hereinafter referred to as “IBF.”

96. 107 Nev. at 228, 808 P.2d at 920.

97. *Id.* at 232, 808 P.2d at 922.

98. *Id.* at 232, 808 P.2d at 923.

a special element of reliance or fiduciary duty. The *contract* breach does not.⁹⁹

The Court has declared that “[t]he law would be incongruous if the covenant is implied in every contract, and yet the only remedy for breach of that covenant is if tort damages are alleged and there exists a special relationship between the tort-victim and the tortfeasor.”¹⁰⁰ The Court found that even though Lewis and King did not have a strict contractual duty to furnish Spinx at the contests, they had a legal duty not to interfere with his capacity to be a contestant, and a duty not to prevent him from participating in the Hilton events. Moreover, they had a duty to promote the events in a fair manner and to not manipulate who would or would not be the champion in order to advance their own interests in a way that would compromise Hilton’s benefits under the contract.¹⁰¹ The Court cited the following jury instruction with approval:

In every contract or agreement there is an implied promise of good faith and fair dealing. This means that each party impliedly agrees not to do anything to destroy or injure the right of the other to receive the benefits of the contract. Thus, each party has the duty not to prevent or hinder performance by the other party.¹⁰²

The Court made it clear that when one performs a contract in a way that is unfaithful to the underlying purpose of that contract and is unfaithful to the justified expectations of the other party, damages may be awarded.¹⁰³ Further, whether the controlling party’s actions fall outside the reasonable expectations of the non-breaching party is determined by the circumstances surrounding those expectations¹⁰⁴ and is a question of fact for a jury to decide.¹⁰⁵ The second time the Court heard *Hilton Hotels Corp. v. Butch Lewis Productions, Inc.*,¹⁰⁶ it declared that a wrongful act which is committed during the course of a contractual relationship may give rise to *both* tort and contract remedies at the same time.¹⁰⁷

The Court provides us with an illustrative example of a claim for contract damages for breach of the good faith covenant in *Hilton I*. If a lessee agrees to pay his lessor a percentage of his gross sales receipts as rental and then deliberately alters his business in a way that reduces his expected sales,

99. *Id.* at 232, 808 P.2d at 923.

100. *A.C. Shaw Constr. v. Washoe County*, 105 Nev. 913, 915, 784 P.2d 9, 10 (1989).

101. *Hilton I*, 104 Nev. at 234, 808 P.2d at 923.

102. *Id.* at 234, 808 P.2d at 923.

103. *Id.* at 234, 808 P.2d at 923.

104. *Id.* at 234, 808 P.2d at 924 (citations omitted).

105. *See, e.g., Mitchell*, 96 Nev. at 148, 605 P.2d at 1139.

106. 109 Nev. 1043, 862 P.2d 1207 (1993) (“*Hilton II*”).

107. *Id.* at 1046, 862 P.2d at 1209 (citing *Tameny*, 610 P.2d 1330 (Cal. 1980)).

the lessee would not be acting in good faith.¹⁰⁸ Another illustrative example of a claim for contract damages for breach of the good faith covenant can be found in requirements contract cases. If a buyer agrees to purchase all of his requirements of products A and B from seller and later begins purchasing goods elsewhere which are substitutes for products A and B, the buyer is not acting in good faith, although he has not necessarily breached the express terms of the contract.

*Perry v. Jordan*¹⁰⁹ provides an example of breach of the good faith covenant in a real estate transaction. The seller knew the purchaser was unable to manage the day to day operations of the store and assured the purchaser she would continue to run the business successfully under a management contract. After the sale, however, the seller abandoned the store before completing the management contract, despite the payment of an advanced salary. The Court declared that the seller denied the purchaser's reasonable expectation of the store's continued success, and therefore breached the good faith covenant sounding in contract.

In summary, although breach of the good faith covenant in contract does not require a special relationship between the parties similar to the requirement for the breach sounding in tort, it is clear that some special circumstances beyond a simple non-performance breach is necessary to sustain the action.¹¹⁰ The non-breaching party must have some reasonable reliance that the breaching party will not perform an act which, although not in breach of the letter of the contract, breaches its spirit and the core intention of the parties. Without that reliance, there can be no breach of the good faith covenant.

D. Punitive Damages for Breach of the Good Faith Covenant

Proof of bad faith, by itself, does not establish liability for punitive damages.¹¹¹ Footnote three in *K-Mart* makes the application of punitive damages to this area of law confusing. It states that the course of action taken by K-Mart was malicious and oppressive and "more than a mere breach of contract and ... rises to the level of what is termed a bad faith tort."¹¹² If the standard needed to prove bad faith is a showing that the action was malicious

108. *Hilton I*, 104 Nev. at 234, 808 P.2d at 923.

109. 111 Nev. 943, 900 P.2d 335, 338 (1995).

110. *Loonis v. Lang LFinanFina Corp.* 109 Nev. 1121, 1129, 865 P.2d 1161, 1166 (1993).

111. *United Fire Ins. Co. v. McLelland*, 105 Nev. 504, 512, 780 P.2d 193, 198 (1989). However, bad faith implies a degree of malice. Black's Law Dictionary explains that the "[t]erm 'bad faith' is not simply bad judgment or negligence, but rather it implied A conscious doing of wrong because of dishonest purpose or moral obliquity." Black's Law Dictionary 127 (5th Ed. 1979). If bad faith can only be proved by showing malice or a conscious wrong prompted by a dishonest purpose, punitive damages should be available upon the showing of bad faith alone, without an Additional burden.

112. *K-Man*, 103 Nev. at 45 n.3, 732 P.2d at 1368 n.3.

and oppressive, to what extra level must the conduct rise to justify punitive damages?¹¹³ It seems likely that the Court did not mean to define the conduct necessary to justify regular tort damages as “malicious and oppressive;” however, the answer remains unclear.¹¹⁴

The starting point for proving punitive damages is with the statutes. NRS 42.005 provides for punitive damages upon the showing of clear and convincing evidence of oppression, fraud or malice, expressed or implied. Punitive damages are only available after compensatory damages are awarded;¹¹⁵ however, they “need not bear any relationship to the compensatory damage award.”¹¹⁶

The Supreme Court has defined oppression as “a conscious disregard for the rights of others which constitutes an act of subjecting plaintiffs to cruel and unjust hardship.”¹¹⁷ Further, there are several factors which must be considered in a review of punitive damages awards. These factors are: (1) the financial position of the defendant; (2) the culpability and blameworthiness of the tortfeasor; (3) the vulnerability and injury suffered by the offended party; (4) the offensiveness of the punished conduct when compared to societal norms of justice and propriety; and (5) the means judged necessary to deter future misconduct.”¹¹⁸

In *K-Mart*, the Supreme Court specifically approved the use of punitive damages in appropriate cases of breach of the good faith covenant as an expression of society’s disapproval of exploitation by a superior power.¹¹⁹ The application of punitive damages to a breach of the good faith covenant in contract remains confusing and can only be made clear by further ruling of the Court explaining what action constitutes malice sufficient to show bad faith, as opposed to the malice necessary to prove punitive damages.

IV. CONCLUSION

Nevada’s Supreme Court has generally followed California’s caselaw regarding the good faith covenant. Its most notable divergence is in allowing tort and punitive damages for breach of the covenant in employment con-

112. See Lillard, *supra* note 4, at 1286-87.

113. The *K-Mart* decision may be the consequence of a result-oriented Court. It is inconsistent to declare that punitive damages require malice and oppression and then declare that although *K-Mart* conducted itself with malice and oppression, punitive damages were not appropriate. Must a plaintiff show differing degrees of malice and oppression?

114. *City of Reno v. Silver State Flying Serv., Inc.*, 84 Nev. 170, 438 P.2d 257 (1968) (cited in *Sprouse v. Wentz*, 105 Nev. 597, 602, 781 P.2d 1136 (1989)).

115. *Ace Truck v. Kahn*, 103 Nev. 503, 506, 746 P.2d 132, 134 (1987) (cited in *United Fire Ins. Co. v. McClelland*, 105 Nev. 504, 780 P.2d 193 (1989)).

116. *Ainsworth*, 104 Nev. at 590, 763 P.2d at 675.

117. *McClelland*, 105 Nev. at 514, 780 P.2d at 199 (citing *Ace Truck*, 103 Nev. at 510, 746 P.2d at 137).

118. *K-Mart*, 103 Nev. at 53, 732 P.2d at 1373.

tract cases. There remains confusion among practitioners concerning the difference between those causes of action sounding in tort and those sounding in contract. It need not exist. For tort damages to apply, the parties to the contract must have a special relationship of trust and reliance akin to a fiduciary relationship. The contract cause of action requires no special relationship, but does require more reliance on the breaching party than is exhibited in a mere non-performance breach. Punitive damages are available, but the non-breaching party must show that the breaching act was oppressive and committed with malice by a party having a special relationship with its victim, beyond that which is necessary to prove breach of the covenant.