NOTES

The Implied Covenant of Good Faith and Fair Dealing in Alaska: One Court's License to Override Contractual Expectations

This note analyzes the Alaska Supreme Court's application of the doctrine of the implied covenant of good faith and fair dealing. As used by the court, the covenant has evolved from a canon properly seeking to enforce and protect the reasonable expectations of contracting parties to a doctrine imbued with considerations of public policy. Such application creates uncertainty for contracting parties, foments litigation and threatens commercial development. This note offers three recommendations to counteract these effects: (1) the court should undertake a fact-specific analysis to interpret the covenant of good faith and fair dealing in accordance with the reasonable expectations of the parties; (2) the court should no longer recognize a cause of action for the tortious breach of the implied covenant; and (3) the court should adopt an objective standard for determining the breach of the implied covenant.

I. INTRODUCTION

Generally, the law of contracts can be seen as a framework to guide the enforcement of the reasonable expectations created by the making of a promise.[1] Although this is not the sole function of contract law, "an understanding of many of the existing rules and a determination of their effectiveness require a lively consciousness of this underlying purpose."[2]

1. 1 ARTHUR L. CORBIN, CORBIN ON CONTRACTS § 1, at 2 (1963).
2. *Id.*

Consistent with this intention, the covenant of good faith and fair dealing acts as an implied promise that neither party to a contract will act so as to deprive the other party of the expected benefits of the contractual bargain. As Roscoe Pound stated in his seminal work on the philosophy of law, "men must be able to assume that those with whom they deal in the general intercourse of the society will act in good faith."[3] Because the covenant necessarily emanates from the reasonable expectations of the parties to each contract, as they can be determined from the facts and circumstances of each case, the duty to deal fairly and in good faith is difficult to define as a principle across the law of contracts.

The Alaska Supreme Court's initial treatment of the implied covenant of good faith and fair dealing was consistent with the historical conceptualization of the doctrine.[4] As the covenant has evolved and progressed, however, the court has increasingly employed it as a tool to effect public policy.[5] For example, the court has issued broad statements defining the covenant as an obligation not to violate public policy,[6] not to violate the Constitution,[7] to treat like employees alike,[8] to "act in a manner which a reasonable person would regard as fair,"[9] and to exercise discretion "reasonably and in good faith."[10] In a recent decision, the court employed the doctrine in such a way as to actually override, rather than further, the explicit expectations of the contracting parties.[11]

Public policy considerations have also led the court to recognize tort liability for certain breaches of the implied covenant.[12] Because of the policy interests associated with insurance[13] and surety[14] contracts, the court has allowed breaches of the implied covenant in these agreements to sound in tort.

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3. ROSCOE POUND, AN INTRODUCTION TO THE PHILOSOPHY OF LAW 133 (1922).

4. *See infra* part III.A.

5. *See infra* part III.B.

6. Luedtke v. Nabors Alaska Drilling, Inc., 768 P.2d 1123, 1137 (Alaska 1989) [hereinafter *Luedtke I*].

7. State v. Haley, 687 P.2d 305, 318 (Alaska 1984).

8. Rutledge v. Alyeska Pipeline Serv. Co., 727 P.2d 1050, 1056 (Alaska 1986).

9. Luedtke v. Nabors Alaska Drilling, Inc., 834 P.2d 1220, 1224 (Alaska 1992) [hereinafter *Luedtke II*].

10. ARCO Alaska, Inc. v. Akers, 753 P.2d 1150, 1156-57 (Alaska 1988).

11. *See* CHI of Alaska, Inc. v. Employers Reinsurance Corp., 844 P.2d 1113 (Alaska 1993).

12. *See infra* part III.C.

13. State Farm Fire & Casualty Co. v. Nicholson, 777 P.2d 1152 (Alaska 1989).

14. Loyal Order of Moose, Lodge 1392 v. International Fidelity Ins. Co., 797 P.2d 622 (Alaska 1990).

However, violation of the covenant in employment[15] and other general, commercial contracts[16] has not given rise to this type of liability.

The court also has had difficulty resolving the standard for a breach of the implied covenant, thus leaving the test uncertain. In some cases, the court has assessed both subjective and objective good faith to determine whether there has been a breach.[17] More recently, however, and particularly in instances of tortious breaches of the implied covenant, the court has held that the standard is entirely objective.[18]

Such judge-made uncertainty—both in the potentially broad obligation to act in good faith in accordance with public policy and in the lack of precision in defining a standard for a breach—not only frustrates the intent of the parties but also poses serious consequences for commercial activity in Alaska. According to one commentator, an expansive obligation to act in good faith "extends the responsibilities of commercial actors beyond bargained-for risk allocations, subjects bargains to inconsistent and uncertain enforcement, and does not produce offsetting benefits in commercial conduct."[19] The developing economy of Alaska is particularly vulnerable to the effects of uncertainty in commercial activity.

Part II of this note briefly surveys academic interpretations of the covenant. Part III examines both the Alaska Supreme Court's proper and flawed use of the covenant over time, and the court's increasing tendency to consider public policy in its analysis of the covenant. Part IV outlines the potential adverse consequences of broad and ambiguous good faith requirements in the performance of contracts. This note then recommends certain actions to the court for the future application of the implied covenant of good faith and fair dealing. By heeding these recommendations, the Alaska Supreme Court would bring greater certainty to contractual relationships in the state and alleviate litigation about the meaning of the implied covenant of good faith and fair dealing in the commercial context.

II. THE HISTORY AND MEANING OF "GOOD FAITH"

Although courts and commentators historically have had difficulty defining the implied obligation of good faith and fair

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15. ARCO Alaska, Inc. v. Akers, 753 P.2d 1150 (Alaska 1988).

16. State v. Transamerica Premier Ins. Co., 856 P.2d 766 (Alaska 1993).

17. *See infra* part III.D.

18. Hillman v. National Mut. Fire Ins. Co., 855 P.2d 1321, 1325 (Alaska 1993).

19. Clayton P. Gillette, *Limitations on the Obligation of Good Faith*, 1981 DUKE L.J. 619, 620; *see infra* text accompanying notes 158-160.

dealing, the covenant has always been a vehicle in the law of contracts to advance the expectations of the contracting parties. The concept of good faith enjoys a long history in the law.[20] Greek society viewed good faith as a "universal social force that governed their social interrelationships—that is, each citizen had an obligation to act in good faith toward all citizens."[21] Under Canon Law, the duty of good faith was a universal moral norm, individually determined by each person's honesty and his or her duty to God.[22] According to Roman Law, the obligation to act in accordance with good faith bound contracting parties "'not only by the terms they had actually agreed to, but by all the terms that were naturally implied in their agreement.'"[23]

In the eighteenth century, the notion of good faith took on greater importance. As equity, natural law and the law merchant flourished, the common law became infused with a commercial doctrine that "evaluated a party's conduct in contracting by trade customs and 'natural equity.'"[24] From the equitable standard of good faith and conscience evolved a narrow duty to disclose in the agreement process.[25]

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20. *See generally* Friedrich Kessler & Edith Fine, *Culpa in Contrahendo, Bargaining in Good Faith, and Freedom of Contract: A Comparative Study*, 77 HARV. L. REV. 401 (1964) (tracing the concept of good faith and fair dealing through various doctrines in American contract law); Ralph A. Newman, *The Renaissance of Good Faith in Contracting in Anglo-American Law*, 54 CORNELL L. REV. 553 (1969) (surveying the concept of good faith across different cultures). Several authors have traced the concept back to the Bible. For instance, one scholar cites the Old Testament, *Leviticus* 19:18—"Thou shalt love thy fellow-man as thyself"—as an early reference to the obligation to act with good faith. Russell A. Eisenberg, *Good Faith Under the Uniform Commercial Code—A New Look at an Old Problem*, 54 MARQ. L. REV. 1, 10 (1971).

21. Eric M. Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381 (1978) (citing F. PRINGSHEIM, THE GREEK LAW OF SALE 87 (1950)).

22. *Id.* at 402-03; Monique C. Lillard, *Fifty Jurisdictions in Search of a Standard: The Covenant of Good Faith and Fair Dealing in the Employment Context*, 57 MO. L. REV. 1233, 1235 (1992) (discussing general history of good faith).

23. E. Allan 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)). Corbin also traces the concept of good faith and fair dealing "back to the writings of Cicero, who wrote late in the days of the Roman Republic the earliest known treatises on law." 3A CORBIN, *supra* note 1, § 654A, at 89 (Supp. 1993).

24. Holmes, *supra* note 21, at 450.

25. *Id.* at 424-31 (citing Carter v. Boehm, 97 Eng. Rep. 1162 (K.B. 1766)).

The concept of good faith was eliminated from contract doctrine, however, with the advent of the pure theory of contracts during the late nineteenth century, which was a period characterized by the notions of freedom to contract, freedom from contract performance, judicial nonintervention, *caveat emptor*, and bargained-for-exchange. Contracting parties were seen as equals, free from social duties and authorized to strike the best possible deal at the expense of each other.[26] Yet the notion of good faith performance continued to underlie contract doctrine well into the early part of this century.

> In an effort to keep the pure theory of contracts *pure*, courts in the early part of this century twisted existing legal concepts and rules to accomplish fair results between contracting parties. Analysis thus was driven underground and the legal profession was misled by the courts which failed to articulate the real grounds for decisions. Their fictions led to inequity, uncertainty and unpredictability. Rather than recognizing the lack of good faith as an appropriate invalidating device, courts masked their decisions in the guise of interpretation and construction, implication, want of mutuality, particularized rules of offer and acceptance, mutual mistake and lack of consideration. . . . Because of this covert process, the standard of good faith kept its separate identity hidden within traditional doctrines.[27]

As the twentieth century progressed, the duty to act fairly and in good faith in contractual matters was once again explicitly recognized. In his prominent treatise on contracts, Corbin asserted that "when the parties have themselves so far satisfied legal requirements that the court is willing to hold that a contract has been made, it will compel performance in accordance with what it believes to be required by good faith and fair dealing."[28] Corbin elaborated that:

> When unforeseen contingencies occur, not provided for in the contract, the courts require performance as men who deal fairly and in good faith with each other would perform without a law suit. It is thus that unanticipated risks are fairly distributed and a party is prevented from making unreasonable gains at the expense of the other. This is not making a contract for the parties; it is declaring what the legal operation of their own contract shall be, in view of the actual course of events, in accordance with those business mores known as good faith and fair dealing.[29]

With the promulgation of the Uniform Commercial Code ("U.C.C.") in 1958, the covenant of good faith and fair dealing

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26. *Id.* at 385-88.
27. *Id.* at 388-89 (citations omitted).
28. 3 CORBIN, *supra* note 1, § 541, at 95 (1960).
29. *Id.* at 97.

gained greater prominence in contract law. The U.C.C. did not impose an overreaching code of ethics in the formation of contracts. Instead, implying terms to a contract remained the principal function of the covenant.[30] The General Provisions of Article 1 of the U.C.C. declare that "[e]very contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."[31] The U.C.C. defines "good faith" as "honesty in fact in the conduct or transaction concerned."[32] However, when a transaction involves merchants the U.C.C. raises the standard of good faith to "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."[33]

The U.C.C. definition of "good faith" has been subsequently criticized as being overly-restrictive: "Good faith . . . is best understood as an 'excluder'—it is a phrase which has no general meaning or meanings of its own, but which serves to exclude many heterogeneous forms of bad faith."[34] Under this construction of "good faith," an attorney can grasp its meaning only by comparison to corresponding instances of bad faith as identified by courts in earlier cases.[35] Despite formulating the obligation of good faith by negative implication, under this theory the basis of the duty of

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30. Persuasive evidence that the obligation to act in good faith was inserted into the U.C.C. to ensure the performance of the expected benefits of the contract, rather than to impose a code of ethical behavior on the merchant community, can be seen in the 1956 American Law Institute recommendations of the editorial board: "The reference to 'fair dealing' in the definition of good faith was added to [§2-103] (1)(b) at the suggestion of the New York Commission to eliminate the possibility that the definition might be read as imposing on merchants a standard of due care." 1956 ALI RECOMMENDATIONS OF THE EDITORIAL BOARD FOR THE UNIFORM COMMERCIAL CODE 21 (1957). For a greater discussion of a non-expansive obligation of good faith under the U.C.C., see Gillette, *supra* note 19.

31. U.C.C. § 1-203 (1990).

32. *Id.* § 1-201(19). Alaska has adopted this provision at ALASKA STAT. § 45.01.201(20) (Supp. 1993).

33. *Id.* § 2-103(1)(b) (1990). Alaska has adopted this provision at ALASKA STAT. § 45.02.103(a)(2) (Supp. 1993).

34. Robert S. Summers, "Good Faith" *in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195, 196 (1968) (footnote omitted).

35. One scholar compiled a list of such prohibited bad-faith conduct from prior cases: a seller concealing a defect in his goods; a builder willfully failing to perform in full, although otherwise substantially performing; a contractor openly abusing bargaining power to coerce an increase in the contract price; hiring a broker and then deliberately preventing him from consummating the deal; a conscious lack of diligence in mitigating the damages of the other party; arbitrarily and capriciously exercising a power to terminate a contract; adopting an overreaching interpretation of contractual language; and harassing the other party for repeated assurances of performance. *Id.* at 203.

good faith and fair dealing in contractual expectations cannot be avoided: "In most cases the party acting in bad faith frustrates the justified expectations of another."[36]

Adopting this proposed "excluder" definition of good faith, the drafters of the Restatement (Second) of Contracts adopted an obligation of good faith considerably broader than that required under the U.C.C. The Restatement provides that "[e]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[37] The Restatement definition of "good faith and fair dealing" continues to reflect a concern with the expectations of contracting parties: "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."[38] Additionally, the Restatement adopts an even more descriptive definition of the obligation of good faith: "Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty."[39]

Subsequent analysis has attempted to refine the obligation of good faith by developing approaches to assess the reasonable expectations of the parties. Commentators have criticized the "excluder" approach on grounds that it "presupposes that the legal phrase 'good faith' cannot be comprehensively known in the first instance, that judges are to apply intuitively the good-faith obligation, and that their decisions are to be taken as correct and will give the correct meaning to this term prospectively."[40] The argument continues that good faith "has a common core of meaning consisting of a spectrum of related, objective qualities."[41] It has been argued that good faith encompasses an elastic standard, depending on analysis of objective elements that include the informal behavior of contracting parties and their individual expectations; the nature and requirements of the particular transaction; the fairness of the customary commercial or social standard for measuring conduct; the modern policy of flexibility in commercial intercourse; the effect of the decision of the court on

36. *Id.* at 263.
37. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).
38. *Id.* cmt. a.
39. *Id.* cmt. d.
40. Holmes, *supra* note 21, at 401.
41. *Id.* at 402 (footnote omitted).

commerce or society; and the conceptual history of good faith from sources such as the law merchant, common law, equity and civil law systems.[42] The meaning of good faith in a particular transaction would therefore depend on the analysis of these objective factors.

Another perspective advocates a further expansion of the analysis of good faith in contracts, suggesting that the cost of performance to the promisor be used as an additional factor to be considered.[43] One scholar notes that:

> [T]he courts employ the good faith performance doctrine to effectuate the intentions of the parties, or to protect their reasonable expectations. Standards expressed in these terms, however, are of little aid in applying the doctrine. They direct the inquiry away from duties imposed upon the parties irrespective of their assent. But they direct attention to the amorphous totality of the factual circumstances at the time of formation, and fail to distinguish relevant from irrelevant facts within that realm. The analysis would be advanced further by an operational standard that respects the autonomy of contract parties and calls the relevant facts to the foreground of the totality of the circumstances.[44]

The promisor's expected cost of performance provides such an operational standard: "Bad faith performance occurs precisely when discretion is used to recapture opportunities forgone upon contracting—when the discretion-exercising party refuses to pay the expected cost of performance."[45]

This analytical framework is consistent with the modern doctrine of the implied covenant of good faith and fair dealing. As stated by Corbin, "good faith in contracting is . . . a group of specific rules which evolved to insure that the basic purpose of contract law is carried out, the protection of reasonable expectations of parties induced by promises."[46] In determining the meaning of the obligation to act in good faith in a given instance, a judge needs only to ensure that performance of the contract reflects the other party's expectations.[47] Criticizing the hesitancy of some courts to recognize the implied covenant of good faith and fair dealing out of fear that they would be opening a "Pandora's Box," Corbin recites the basic principle of the covenant: "Such an

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42. *Id.* at 405-06.

43. Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369 (1980) [hereinafter Burton, *Breach of Contract*]. *See also* Steven J. Burton, *More on Good Faith Performance of a Contract: A Reply to Professor Summers*, 69 IOWA L. REV. 497 (1984).

44. Burton, *Breach of Contract*, *supra* note 43, at 371-72 (footnotes omitted).

45. *Id.* at 373.

46. 3A CORBIN, *supra* note 1, § 654A, at 87 (Supp. 1992).

47. *Id.*

implied term does nothing more than enforce ordinary commercial standards in contracts that, for whatever reason, do not specify particular terms regarding the *procedure* of the deal, as opposed to the *substance* of the deal."[48]

III. THE COVENANT OF GOOD FAITH AND FAIR DEALING IN ALASKA

A. The Alaska Supreme Court's Initial Use of the Doctrine

The Alaska Supreme Court' initial application of the implied covenant of good faith and fair dealing was straightforward. In *Guin v. Ha*,[49] the court recognized the doctrine, holding that "[i]n every contract, including policies of insurance, there is an implied covenant of good faith and fair dealing that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."[50] Consistent with its definition of the covenant in accordance with the expectations of the parties, the court held that in the context of insurance contracts the covenant encompasses an insurer's obligation "to accept reasonable offers of settlement in a prompt fashion,"[51] and the insured's obligation to "cooperat[e] fully with his insurer."[52] Thus, assuming that these expectations arise in every insurance contract, the Alaska Supreme Court properly used the covenant to further the expectations of the parties.[53]

The court has readily employed the implied covenant of good faith and fair dealing in ordinary commercial disputes.[54] The court's analysis in *Gordon v. Foster, Garner & Williams*[55] reflects the intensely factual nature of the inquiry when invoking the doctrine in the commercial context. *Gordon* involved a dispute over the breach of a lease. The potential lessee had allegedly failed to make a good faith effort to satisfy a lease contingency to

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48. *Id.*

49. 591 P.2d 1281 (Alaska 1979).

50. *Id.* at 1291 (citing Crisci v. Security Ins. Co. of New Haven, 426 P.2d 173 (Cal. 1967); Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 200-01 (Cal. 1958)).

51. *Id.*

52. *Id.*

53. For a similarly correct analysis of the covenant in the context of the obligation of an insurance company to settle claims fairly, see Alyeska Pipeline Serv. Co. v. H.C. Price Co., 694 P.2d 782 (Alaska 1985).

54. *See, e.g.*, Fairbanks Builders, Inc. v. Morton DeLima, Inc., 483 P.2d 194 (Alaska 1971).

55. 785 P.2d 1196 (Alaska 1990).

renegotiate the lease's insurance provisions.[56] In reversing the grant of summary judgment for the lessor, the Alaska Supreme Court held that there were genuine issues of material fact regarding whether the lessee satisfied the obligation to act in good faith.[57] Because the lessee did in fact undertake an effort to obtain insurance, resolution of these issues turned on whether "the insurance renegotiation provision is construed to require [the lessee] to 'negotiate' with third party insurance agents" or whether that provision "is construed to require [the lessee] successfully to renegotiate the insurance provisions of the lease."[58] The duty to act fairly and in good faith could not be defined until the intentions of the contracting parties were adequately determined.

In ordinary, non-commercial contract disputes, the court has continued to apply the covenant to ensure that the end result accords with the expectations of the contracting parties. A recent example of such a correct application of the doctrine can be found in *Keffer v. Keffer*.[59] *Keffer* involved the terms of a divorced couple's spousal support agreement. The agreement required the ex-husband to make support payments to his ex-wife twice a month based on his income. However, income earned "outside of [his] primary place of employment," would not be included in the calculation of support.[60] When his job was eliminated, the ex-husband became eligible for retirement benefits and elected to receive one lump-sum payment.[61] He then claimed that his retirement terminated his obligation to make support payments and that interest earnings on his retirement payment were not to be included in calculation of spousal support.[62] Interpreting the contract as an expression of the parties' expectations regarding how support would be calculated, the court agreed with the ex-husband, holding that "[h]is salary included only what he earned from his primary place of employment. As long as [the ex-husband], acting in good faith, is not employed, he is not obligated to support [his former spouse]."[63] The court noted that if the ex-husband had quit his job, he would have violated the implied covenant of good faith and fair dealing,[64] because such action would have deprived the ex-wife of her expected benefits under the contract. According

56. *Id.* at 1198-99.
57. *Id.* at 1199.
58. *Id.*
59. 852 P.2d 394 (Alaska 1993).
60. *Id.* at 395.
61. *Id.* at 396.
62. *Id.* at 397.
63. *Id.* at 399.
64. *Id.* at 398.

to the court, however, the ex-husband could not be faulted for discontinuing support of his ex-wife due to his forced retirement.[65] The court stated that the implied covenant of good faith and fair dealing prohibits only discretionary actions outside the realm of party expectations.[66]

The Alaska Supreme Court has also linked the covenant of good faith and fair dealing to the reasonable expectations of the parties in the context of employment contracts. For example, in *Mitford v. de Lasala*,[67] the court held that the implied covenant prohibited employers from firing an employee to prevent that individual from sharing in future profits, pursuant to the employment agreement.[68] Stating that it seeks to "give effect to . . . the reasonable expectations of the parties" in interpreting contracts,[69] the court again took an expectation-oriented approach.

Similarly, in *Jones v. Central Peninsula General Hospital*,[70] the court defined the covenant of good faith and fair dealing in accordance with contractual intentions as determined from the circumstances of the case. In *Jones*, a terminated nurse sued her former employer for wrongful termination and breach of the implied covenant of good faith and fair dealing. The nurse alleged that the employer had denied her access to grievance procedures that had been provided to other employees.[71] The Alaska Supreme Court upheld the trial court's grant of summary judgment for the employer, ruling that the implied covenant of good faith and fair dealing had not been breached.[72] The court held that an employee manual was the embodiment of expectations pertaining to grievance procedures, and that "[t]he 1978 manual clearly excludes supervisory personnel from grievance procedures. Thus,

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65. *Id.*

66. For other cases involving the Alaska Supreme Court's appropriate use the implied covenant to prevent the deprivation of the expected benefits of one party under a contract, see Frontier Cos. of Alaska v. Jack White Co., 818 P.2d 645 (Alaska 1991) (finding breach of the covenant where sale of property during period of exclusive listing agreement was not disclosed to broker); Ranier Fund, Inc. v. Blomfield Real Estate Co., 717 P.2d 850 (Alaska 1986) (holding that building manager breached the covenant by refusing to pay broker commission for lease of office space after initiation of performance by broker had created option contract for broker); A & G Constr. Co. v. Reid Bros. Logging, 547 P.2d 1207 (Alaska 1976) (holding that the covenant would be breached where one party was forced to agree by means of wrongful threat, thus precluding exercise of free will).

67. 666 P.2d 1000 (Alaska 1983).

68. *Id.* at 1007.

69. *Id.* at 1005.

70. 779 P.2d 783 (Alaska 1989).

71. *Id.* at 784.

72. *Id.* at 789.

[the plaintiff] has not been denied any benefit of her employment agreement."[73] The court, thus, again interpreted the implied covenant as emanating from the expectations of the parties in an employment relationship.[74]

B. Evolution of the Covenant to "Act Ethically"

The Alaska Supreme Court has, on occasion, strayed from its "expectations" standard, as first prescribed in *Guin v. Ha*,[75] for invoking the implied covenant of good faith and fair dealing. The court has increasingly used the implied covenant as a tool for furthering social policy. In so doing, the court has imposed something of a code of ethics into the law of contracts above and beyond the reasonable expectations of the parties.

The origin of this trend can be found in *State v. Haley*.[76] In *Haley*, a legislative research assistant brought an action against the state seeking back pay, reinstatement and declaratory relief. She had been discharged because of a statement she made concerning a matter before the legislature and for her refusal to refrain from making similar future public statements.[77] The court determined that a termination based on the past statement of an employee or her refusal to refrain from making further public statements was unconstitutional.[78] The court extended its analysis, however, by stating "that when the State fires an employee for an unconstitutional reason, this amounts to unfair dealing as a matter of law and gives rise to contract remedies."[79] By introducing the law of contracts to this situation and holding that a termination in violation of the Constitution amounts to unfair dealing as a matter of law, regardless of the expectations of the parties, the court exposed the covenant of good faith and fair dealing to improper considerations.[80]

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73. *Id.*

74. See also Klondike Indus. v. Gibson, 741 P.2d 1161, 1170 (Alaska 1987) (holding that employer could not be found to have breached the implied covenant based on "the totality of the circumstances").

75. 591 P.2d 1281 (Alaska 1979). *See supra* notes 49-53 and accompanying text.

76. 687 P.2d 305 (Alaska 1984).

77. *Id.* at 308-10.

78. *Id.* at 314-15.

79. *Id.* at 318.

80. The general principle that a public employee cannot be fired for an unconstitutional reason was embraced again in Wickwire v. State, 725 P.2d 695 (Alaska 1986). *See also* Reed v. Municipality of Anchorage, 782 P.2d 1155 (Alaska 1989) (holding that claim of retaliatory discharge gives rise to cause of action for breach of implied covenant of good faith and fair dealing).

The court further expanded the boundaries of the implied covenant of good faith and fair dealing in *Knight v. American Guard & Alert, Inc.*[81] In affirming the lower court's refusal to grant a directed verdict for the employer in a claim of wrongful termination, the court explicitly recognized that violations of public policy in the employment context may violate the implied covenant. Specifically, the court stated that:

> [A]lleged termination in violation of public policy, is in accord with a theory of recovery accepted in many states. We have never rejected the public policy theory. Indeed, it seems that the public policy approach is largely encompassed within the implied covenant of good faith and fair dealing . . . .[82]

By injecting notions of public policy into the analysis of the covenant, the court moved the doctrine down a path of uncertainty.[83]

The court's inconsistent application of the implied covenant is further illustrated by *Rutledge v. Alyeska Pipeline Service Co.*[84] In affirming a directed verdict for the employer against an employee's claim for wrongful termination for fighting, the court appeared to have used the implied covenant of good faith to protect the expressed expectations in the contract: "Alyeska's company rules expressly state that discipline, including termination, will result from fighting on Alyeska property. The trial court correctly determined that reasonable jurors must conclude that Rutledge fought on company property and that fighting was a terminable offense."[85] Such an explicit company policy would necessarily seem to be included in the expectations of the employee, thus supporting the court's analysis. However, the court further stated that, "Rutledge also alleges that the trial court erred in refusing to allow evidence of Alyeska's previous discipline in prior incidents of fighting. Such evidence would have been relevant as tending to show a breach of the covenant of good faith and fair dealing."[86] The court was correct in its assertion that evidence of how other similarly-situated employees were disciplined would affect the reasonable expectations of the employee. *Rutledge* is objectionable, though, because it has been subsequently characterized as standing

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81. 714 P.2d 788 (Alaska 1986).

82. *Id.* at 792 (citations omitted).

83. *See generally* Thomas P. Owens, Note, *Employment at Will in Alaska: The Question of Public Policy Torts*, 6 ALASKA L. REV. 269 (1989).

84. 727 P.2d 1050 (Alaska 1986).

85. *Id.* at 1056.

86. *Id.* (citing Toussaint v. Blue Cross & Blue Shield of Mich., 292 N.W.2d 880, 897 (Mich. 1980); Rulon-Miller v. IBM Corp., 162 Cal. App. 3d 241, 208 Cal.Rptr. 524 (Cal. App. 1984), for the duty to treat like employees alike).

for the idea that the implied covenant requires an employer to treat all similarly-situated employees alike;[87] however, interpretation of the implied covenant demands a greater factual inquiry into the expectations of the parties, not a standard definition that an employer must treat all similarly-situated employees alike. Thus, the court incorrectly broadened the scope of the implied covenant beyond the specific expectations of the contracting parties.

The court introduced even greater uncertainty into the implied covenant of good faith and fair dealing in *Luedtke v. Nabors Alaska Drilling, Inc.* ("*Luedtke I*").[88] In that case, two former employees brought an action against their former employer challenging their dismissal for refusing to submit to urinalysis screening for drug use.[89] Although holding that the implied covenant had not been breached in this particular case, the court further subjected the covenant to general considerations of public policy by concluding that:

> [T]here is a public policy supporting the protection of employee privacy. Violation of that policy by an employer may rise to the level of a breach of the implied covenant of good faith and fair dealing. However, the competing public concern for employee safety present in the case at bar leads us to hold that [the employer's] actions did not breach the implied covenant.[90]

The court further stated that "[w]here the public policy supporting the [employees'] privacy in off-duty activities conflicts with the public policy supporting the protection of the health and safety of other workers, and even the [employees] themselves, the health and safety concerns are paramount."[91] However, the court could have reached the same result, based on the factual record of the case, by merely looking to the parties' reasonable expectations and not considering notions of public policy. *Luedtke I* illustrates the

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87. *See* Jones v. Central Peninsula Gen. Hosp., 779 P.2d 783, 789 n.6 (Alaska 1989).

88. 768 P.2d 1123 (Alaska 1989).

89. *Id.* at 1124-25.

90. *Id.* at 1130.

91. *Id.* at 1136. The court even defined "public policy" so as to illustrate the arbitrariness that the concept can have when imposed in the implied covenant of good faith and fair dealing: "'There is no precise definition of the term [public policy]. In general, it can be said that public policy concerns what is right and just and what affects the citizens of the State collectively. It is to be found in the State's constitution and statutes and, when they are silent, in its judicial decisions.'" *Id.* at 1132 (quoting Palmateer v. International Harvester Co., 421 N.E.2d 876, 878 (Ill. 1981)). For a general criticism of the court's expansive notion of "public policy," see Scott J. Nordstrand & Paul D. Seyferth, *Private Rights Versus Public Power: The Role of State Action in Alaska Constitutional Jurisprudence*, 7 ALASKA L. REV. 299, 329 (1990).

problematic ramifications of an expansive obligation of good faith, as practitioners analyzing the holding are forced to use only their judgment in determining whether a court will decide that the actions of contractually-bound parties are in accordance with public policy.

Returning to the same factual dispute in *Luedtke II*,[92] the court again painted the obligation of good faith and fair dealing in broad strokes. After discussing prior Alaska cases dealing with the doctrine, the court stated that "the covenant of good faith and fair dealing . . . requires the parties to act in a manner which a reasonable person would regard as fair."[93] Consistent with this conception of good faith as incorporating a broad obligation of fairness, the court held that the suspension of the employee due to the results of a drug test breached the covenant of good faith and fair dealing.[94] The court reasoned that the suspension of the employee was "objectively unfair" because (1) the employee was tested for drug use without prior notice, (2) no other employee was similarly tested and (3) the employer suspended the employee immediately upon learning the results of the test.[95] The court could have reached the same result by interpreting the contract in light of the parties' reasonable expectations and finding that an employee could reasonably expect to have notice of a drug-testing program that could violate his or her right to privacy.[96]

Bauer v. Blomfield Co.[97] also illustrates the court's inconsistent use of the covenant. In *Bauer*, the plaintiff had entered into a loan agreement with certain members of a partnership, under which default by the partners would entitle the plaintiff to receive all of the partners' "right, title, and interest" in the Blomfield Company/Holden Joint Venture.[98] Upon default, the partners assigned to the plaintiff "that part of the partnership contract that entitled [them] to receive distributions."[99] The plaintiff filed suit against the Blomfield Company, however, when the partnership, without his consent, paid one partner a commission for negotiating lease extensions. The plaintiff claimed a breach of the implied

92. 834 P.2d 1220 (Alaska 1992).

93. *Id.* at 1224. The court also stated that "an employer's discretion must be 'exercised *reasonably and* in good faith' and that the employer's decisions must be made '*fairly and* in good faith.'" *Id.* at 1224 (quoting ARCO Alaska, Inc. v. Akers, 753 P.2d 1150, 1156 (Alaska 1988)).

94. *Id.* at 1226.

95. *Id.*

96. *See infra* part IV.A.

97. 849 P.2d 1365 (Alaska 1993).

98. *Id.* at 1366.

99. *Id.* at 1369 (Matthews, J., dissenting).

covenant of good faith and fair dealing in his contract to receive partnership distributions.[100] The court held, by a three-to-two decision, that the plaintiff had not been made a de facto partner, and that, therefore, he was entitled to receive only those partnership profits that the prior partners would have otherwise received.[101] The majority refused to consider whether the partnership had acted in bad faith by deciding to issue a commission. The court stated that to examine the propriety of the partnership's decision-making process would undermine the legislative intent to insulate partners from the influence of those parties with minimal or no interest in the business.[102] Thus, the court found that there had been no breach of the covenant.

In a dissenting opinion, Justice Matthews, joined by Chief Justice Rabinowitz, argued that the majority had erred by refusing to determine whether the partnership had breached the implied covenant of good faith and fair dealing.[103] Describing the covenant as "'a hybrid of social policy and an effort to further the expectations of the contracting parties that the promises will be executed in good faith,'"[104] the dissent pointed out that the only evidence on the issue of good faith was the testimony of the recipient of the commission, who claimed that his commission was at the standard rate.[105] The dissenting justices argued that a greater factual inquiry was necessary and that the case should be remanded "for a . . . determination of whether or not the decision by the partners to pay [the] 'commission' was made in good faith."[106] Such a detailed, fact-specific inquiry would have been the appropriate course for the court to take in *Bauer*, as the covenant derives from the expectations of the parties—here, the plaintiff's expectation being that the partners would not deprive him of his share of the profits by making unreasonable commission payments.

The Alaska Supreme Court's flawed use of the covenant reached a pinnacle in *CHI of Alaska, Inc. v. Employers Reinsurance*

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100. *Id.* at 1366-67.

101. *Id.* at 1367 (citing ALASKA STAT. § 32.05.220(a) (1993)).

102. *Id.* at 1367 n.2 (citing ALASKA STAT. § 32.05.220(a) (1993)).

103. *Id.* at 1369-70 (Matthews, J., dissenting).

104. *Id.* at 1369 (Matthews, J., dissenting) (quoting Alaska Pac. Assurance Co. v. Collins, 794 P.2d 936, 947 (Alaska 1990)). Although the approach of the dissenting justices in making a factual inquiry is appropriate, the description of the covenant in terms of social policy again potentially expands the obligation of good faith into uncertain territory.

105. *Id.* at 1369 n.7 (Matthews, J., dissenting).

106. *Id.* at 1370 (Matthews, J., dissenting).

Corp.[107] CHI, an insurance company, was sued by a customer claiming negligent and intentional misrepresentation.[108] Employers, which had sold liability insurance to CHI that covered negligence, agreed to defend CHI but reserved its right to deny coverage for any intentional misrepresentation uncovered at trial.[109] CHI rejected Employers' offer and filed suit, claiming that the reservation of rights created a conflict of interest that entitled it to select independent counsel at the insurer's expense.[110]

Adapting the implied covenant of good faith and fair dealing to achieve an equitable solution, the court agreed with CHI, holding "that the insured should have the unilateral right to select independent counsel" because of the potential conflicts of interest that could arise where the interests of the insured and the insurer were contrary to one another.[111] The insured's selection of independent counsel, however, would be governed by the implied covenant of good faith and fair dealing, the court held, requiring "that the insured select an attorney who is, by experience and training, reasonably thought to be competent to conduct the defense."[112] As a measure to prevent over-billing and over-litigation, the insurer would be required to pay only the reasonable costs of the insured's defense.[113] According to the court, "such a result, *in our view*, *fairly balances* the interest of the insured—being defended by competent counsel of undivided loyalty—with the interests of the insurer—having the defense of the insured conducted by competent counsel."[114]

While striving to strike a "fair balance" between competing interests, the court failed to use the implied covenant of good faith and fair dealing to further the expectations of the parties, and thus nullified a contractual right. The insurance policy in *CHI* had provided:

> The *Corporation*, in the Insured's name and behalf, *shall have the right to* investigate, *defend* and conduct settlement negotiations in *any* claim *or suit* . . . .
> The *Insured shall not* admit liability for, or *make any voluntary settlement*, or incur any costs or expenses in connection with any

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107. 844 P.2d 1113 (Alaska 1993). For a more detailed analysis of the court's decision in *CHI*, see Earl M. Sutherland, *One Client, One Defense: Revisiting* CHI *with the Alaska Rules of Professional Conduct*, 11 ALASKA L. REV. 1 (1994).

108. *Id.* at 1114.

109. *Id.*

110. *Id.*

111. *Id.* at 1121.

112. *Id.*

113. *Id.*

114. *Id.* (emphasis added).

> claim involving payment by the Corporation, *except with the written consent of the Corporation.*[115]

Based on this language, it is apparent that the insurance company had a contractual expectation of participating, at least to some extent, in the selection of counsel for the insured. Yet the court's interpretation of the implied covenant entirely disregarded this expectation in the name of furthering public policy and fairness.[116]

In his partial concurrence and partial dissent, Justice Moore explained that "[e]ven if the right to defend provision is deemed ambiguous and is therefore construed against the insurer, it is not necessary to extinguish the right entirely."[117] Consistent with the purpose of contract interpretation—to effect the expectations of the contracting parties—"Employers' right to participate in CHI's defense should encompass, at a minimum, the right to have a role in the selection of defense counsel."[118] As Justice Moore pointed out, the court should have held "that the insurer has the right to approve the counsel selected by the insured, but that the insurer may not unreasonably withhold such approval."[119] Applied in this manner, the covenant of good faith and fair dealing would give effect to Employers' expectation that it would participate in the selection of counsel. Instead, the court used the covenant to modify an expressed right, and thus trumped the explicit expectations of the parties.

In short, the implied covenant of good faith and fair dealing in Alaska has become increasingly concerned with notions of furthering social policy. The covenant, in its correct usage, is an implied obligation of both parties to refrain from acting to deprive the other of the reasonably expected benefits of the contract. That is, it acts to obligate each party to perform the expected duties emanating from the contract, rather than, as the Alaska Supreme

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115. *Id.* at 1129 (Compton, J., dissenting).

116. The holding that the insured shall have the right to select independent counsel is not, in and of itself, objectionable. *But see* Sutherland, *supra* note 107. Certainly, the court could have recognized such a right on the grounds of contractual unconscionability. The use of the implied covenant of good faith and fair dealing to modify and override the explicit intentions and expectations of the parties, however, is inconsistent with the conception of the implied covenant as deriving from and defined by the expectations of the parties.

117. *CHI*, 844 P.2d at 1124 (citations omitted) (Moore, J., concurring in part, dissenting in part).

118. *Id.* at 1125 (Moore, J., concurring in part, dissenting in part).

119. *Id.* at 1122 (Moore, J., concurring in part, dissenting in part).

Court sometimes states, to "impos[e] duties above and beyond express contractual duties."[120]

C. Recognition of the Tort of Breach of the Implied Covenant of Good Faith and Fair Dealing

Through the evolution of the implied covenant of good faith and fair dealing in the state, the Alaska Supreme Court has held that, in certain circumstances, a breach of the implied covenant sounds in tort. The court first recognized this tort in *State Farm Fire & Casualty Co. v. Nicholson.*[121] Drawing upon cases from California,[122] Arizona,[123] Idaho[124] and Texas[125] that recognize tort liability for bad faith breach in the insurance context, the court reasoned that this type of contract merits greater public policy concern, and thus should be accorded greater protection through the implied covenant:

> "The adhesionary aspects of the insurance contract, including the lack of bargaining strength of the insured, the contract's standardized terms, the motivation of the insured for entering into the transaction and the nature of the service for which the contract is executed, distinguish this contract from most other non-insurance commercial contracts. These features characteristic of the insurance contract make it particularly susceptible to public policy considerations."[126]

Sounding in tort rather than contract, breach of the implied covenant is not limited to damages foreseeable at the time of breach, but instead, includes a reasonable amount to compensate the injured plaintiff for all the detriment caused by the defendant's wrongful conduct.[127] Given that statutory remedies were also inadequate in *Nicholson*,[128] the court stated that "[t]he availability

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120. Hillman v. Nationwide Mut. Fire Ins. Co., 855 P.2d 1321, 1329 (Alaska 1993) (Compton, J., concurring in part, dissenting in part).

121. 777 P.2d 1152 (Alaska 1989).

122. Gruenberg v. Aetna Ins. Co., 510 P.2d 1032 (Cal. 1973).

123. Noble v. National Am. Life Ins. Co., 624 P.2d 866 (Ariz. 1981).

124. White v. Unigard Mut. Ins. Co., 730 P.2d 1014 (Idaho 1986).

125. Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165 (Tex. 1987).

126. State Farm Fire & Casualty Co. v. Nicholson, 777 P.2d 1152, 1157 (Alaska 1989) (quoting Charles M. Louderback & Thomas W. Jurika, *Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187, 200-01 (1982)).

127. *Id.* at 1156 (citing *White*, 730 P.2d at 1017-18).

128. *See* ALASKA STAT. §§ 21.36.010-21.36.420 (1993) (the court stated that the statutory remedies failed to compensate the insured for damages incurred due to a bad faith denial of coverage, and that the statutory scheme enacted by the legislature failed to provide sufficient incentive to insurers to honor the implied covenant).

of a tort action for breach of the duty of good faith and fair dealing will provide needed incentive to insurers to honor their implied covenant to their insureds."[129]

Following *Nicholson*, the Alaska Supreme Court has expanded the tort of bad faith breach slightly beyond the insurance context. In *Loyal Order of Moose, Lodge 1392 v. International Fidelity Insurance Co.*,[130] the court recognized the existence of an implied covenant of good faith and fair dealing between a surety and its obligee on payment and performance bonds. Relying on *Nicholson* and Arizona precedent,[131] the court reasoned that in both the insurance and surety contexts:

> "[T]here is a great disparity of financial resources. Additionally, issuers of financial responsibility bonds are companies clearly affected with a public interest. Moreover, to insulate the issuer of a financial responsibility bond from liability for the deliberate refusal to pay its obligations arising from the bond is to encourage the routine denial of payment of claims for as long as possible."[132]

Consequently, policy concerns also supported tort liability for breach of the implied covenant of good faith and fair dealing between a surety and its obligee.

Prior to *Nicholson*, the court had declined to recognize tort liability for a breach of the implied covenant between an insurer and a third-party claimant. In *O.K. Lumber Co. v. Providence Washington Insurance Co.*,[133] a lumber company sought damages from an insurance company for the poor handling of two prior claims. The court affirmed the granting of summary judgment against the lumber company, concluding that the duty of good faith "is a product of the fiduciary relationship created by the contract between the insurer and the insured."[134] Distinguishing the policy concerns in the first-party insurance context later identified in *Nicholson*, the court in *O.K. Lumber* reasoned that "[w]hile liability insurance is intended to benefit one who is injured under circumstances giving rise to liability, it does not follow that the contractual

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129. *Nicholson*, 777 P.2d at 1157. For other cases affirming the tort of bad-faith breach in the insurance context, see Hillman v. Nationwide Mut. Fire Ins. Co., 855 P.2d 1321 (Alaska 1993) and Alaska Pac. Assurance Co. v. Collins, 794 P.2d 936 (Alaska 1990).

130. 797 P.2d 622 (Alaska 1990).

131. Dodge v. Fidelity & Deposit Co. of Md., 778 P.2d 1240 (Ariz. 1989).

132. *Loyal Order of Moose*, 797 P.2d at 627 n.8 (quoting *Dodge*, 778 P.2d at 1243).

133. 759 P.2d 523 (Alaska 1988).

134. *Id.* at 526.

duties owed by the insurer to the insured can be equated with the obligations owed to the injured claimant."[135]

Similarly to its decision in *O.K. Lumber*, the court held in *ARCO Alaska, Inc. v. Akers*[136] that an employment-context breach of the implied covenant of good faith and fair dealing does not sound in tort. Noting that punitive damages are generally disfavored by the law, the court held that "[w]here a party's conduct in breaching a contract rises to the level of a traditionally recognized tort, such as intentional infliction of emotional distress, an action in tort would lie. Mere breach of the implied covenant of good faith and fair dealing, however, does not constitute a tort."[137]

More recently the court has also refused to expand tort liability for breach of the implied covenant to the context of ordinary commercial disputes. In *State v. Transamerica Premier Insurance Co.*,[138] a surety for a contractor sought tort damages from the State of Alaska, claiming that the State, in an attempt to destroy the contractor through expensive litigation, had denied all of the extra costs that resulted from erroneous plans and specifications.[139] Affirming the grant of summary judgment for the State, the court distinguished the commercial context from the special relationship between the insured and the insurer in *Nicholson*: "[The] exceptional features of the insurance contract justified the creation of a tort action for an insurer's bad faith breach. . . . Creating a broader tort remedy would disrupt the certainty of commercial transactions and allow parties to escape contractual allocation of losses."[140] Hence, recognition of tort liability for breach of the implied covenant of good faith and fair dealing has been limited to the insurance context and to the surety-obligee relationship, where public policy colors the meaning of the implied covenant.

D. The Court's Inconsistent Standard for Breach of the Covenant

While grappling with the boundaries of the implied covenant of good faith and fair dealing, the Alaska Supreme Court has also struggled with defining the standard required to amount to a

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135. *Id.*
136. 753 P.2d 1150 (Alaska 1988).
137. *Id.* at 1154.
138. 856 P.2d 766 (Alaska 1993).
139. *Id.* at 769.
140. *Id.* at 774. Among the insurance contract's "exceptional features" mentioned by the court were the use of standardized terms, the insurer's superior bargaining power and the fact that the insured seeks protection rather than commercial gain. *Id.*

breach of this covenant. The court has wavered between applying three seperate standards. First, the court applied a mainly subjective test for determining a breach of the implied covenant. Later, the court incorporated an objective analysis to be applied in addition to its subjective inquiry. More recently, the court has moved toward applying a purely objective standard for determining a breach of the implied covenant. As a result of the court's failure to consistently apply a single test for determining a breach of the implied covenant of good faith and fair dealing, the law has been left in a state of uncertainty.

In *Mitford v. de Lasala*,[141] the court suggested that subjective bad faith was at least partially required for a breach, holding that the covenant is violated in the employment context if an employee is terminated "for the purpose of preventing him from sharing in future profits" that he or she was entitled to under the employment contract.[142] Later, in *Hagans, Brown & Gibbs v. First National Bank of Anchorage*,[143] the court reiterated the subjective standard, holding that a client would be liable for attorney's fees "if it can be shown that the [client's] decision to settle or not settle [the case] was made with the intent of taking *advantage* of the attorney."[144] Thus, the court seemed to be establishing subjective motive as the basis for its analysis in determining a breach of the covenant of good faith and fair dealing.[145]

In *Luedtke II*,[146] the court construed *Mitford* and *Hagans* to stand for the principle that "if it is proved that an employer's motive in firing an employee is to deprive the employee of the economic benefits of the contract, it is per se a bad faith termination."[147] The court, however, expanded its analysis by interpreting Alaska Statutes section 45.02.103(a)(2) to mean that the covenant of good faith and fair dealing "imposes an objective [standard of good faith] as well as a subjective standard."[148]

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141. 666 P.2d 1000 (Alaska 1983).

142. *Id.* at 1007.

143. 783 P.2d 1164 (Alaska 1989).

144. *Id.* at 1168.

145. *See also* Stanley v. Fabricators, Inc., 459 P.2d 467 (Alaska 1969) (holding that secured party, even assuming that he owed an obligation of good faith to creditors of sublessee of certain equipment, was not acting in bad faith because no evidence of *intention* to mislead the creditors).

146. 834 P.2d 1220 (Alaska 1992).

147. *Id.* at 1224. The court also cited Jones v. Central Peninsula Gen. Hosp., 779 P.2d 783, 789 (Alaska 1989), for a general definition of the covenant.

148. *Luedtke II*, 834 P.2d at 1224 (citations omitted). Alaska Statutes section 45.02.103(a)(2) defines "good faith" to mean "honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade." ALASKA STAT.

Thus, while "subjective bad faith is not always required . . . the covenant of good faith and fair dealing . . . requires that the employer be objectively fair."[149]

A subjective component of good faith also initially appeared to be incorporated into the standard for tortious breach of the covenant of good faith and fair dealing. In *Loyal Order of Moose, Lodge 1392 v. International Fidelity Insurance Co.*,[150] for example, the court declared that subjective motive was relevant to the breach of the covenant: "The surety's demand for arbitration may not itself be made in bad faith, or serve to defeat an otherwise timely and sufficient bad-faith claim."[151] Thus, bad faith was established as a component of the inquiry into tortious breach of the covenant.

Most recently, however, the Alaska Supreme Court seems to have adopted a new, purely objective standard for tortious breach of the covenant. In *Hillman v. Nationwide Mutual Fire Insurance Co.*,[152] the court stated:

> "The tort of bad faith can be alleged only if the facts pleaded would, on the basis of an objective standard, show the absence of a reasonable basis for denying the claim, i.e., would a reasonable insurer under the circumstances have denied or delayed payment of the claim under the facts and circumstances."[153]

This objective standard allowed the court to affirm summary judgment for the insurance company because the company's "decisions to deny coverage and then to demand arbitration were reasonable."[154] In his partial dissent, however, Justice Compton pointed out that there was evidence of subjective bad faith in the conduct of the insurer: "[A] reasonable jury could conclude that by failing to investigate, lying to the policy holder and stonewalling for four years, Nationwide acted with subjective bad faith."[155] Justice Compton argued that the court's standard must recognize that "[t]he covenant of good faith and fair dealing requires that contractual rights be pursued with subjective good faith."[156] Justice Compton concluded his criticism of the standard adopted by the majority by stating that "[t]he covenant of good faith and fair dealing is meaningless if existence of a reasonable contractual basis

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§ 45.02.103(a)(2) (1993).

149. *Luedtke II*, 834 P.2d at 1225 (citations omitted).

150. 797 P.2d 622 (Alaska 1990).

151. *Id.* at 629.

152. 855 P.2d 1321 (Alaska 1993).

153. *Id.* at 1324 (quoting Anderson v. Continental Ins. Co., 271 N.W.2d 368, 377 (Wis. 1978)).

154. *Id.* at 1328.

155. *Id.* at 1331 (Compton, J., dissenting in part).

156. *Id.* at 1329 (Compton, J., dissenting in part).

for denial of liability is alone sufficient to defeat a bad faith claim."[157]

Hillman effectively left the standard required to show a breach of the implied covenant of good faith and fair dealing uncertain. The court must clarify whether a showing of subjective bad faith is still relevant, or whether it is applicable only outside of tortious bad faith claims, or perhaps only outside of the insurance context.

IV. RECOMMENDATIONS TO THE ALASKA SUPREME COURT

A particular jurisdiction's interpretation of the implied covenant of good faith and fair dealing can produce serious consequences for the regional economy. An expansive obligation subjects bargains to inconsistent and uncertain enforcement, tending to breed cumulative litigation. Moreover, because a broad principle of good faith based on public policy necessarily introduces an element of uncertainty, due to shifting policy concerns and inconsistent application, the risks and costs associated with contract formation are increased.[158] Each of these effects of an expansive and vague interpretation of the covenant could adversely inhibit the growth of a regional economy, as business leaders are likely to choose to do business in areas where the law is more certain and economically efficient. This concern is particularly salient to Alaska, where as one author points out, "[l]ike other faltering oil-based economies, Alaska's long-term prosperity hinges on industrial diversification, which, in turn, depends partly upon the influx of new business."[159] Recent economic forecasts have predicted relatively flat growth for the Alaska economy over the next twenty years.[160]

To avoid these potential ramifications of the Alaska Supreme Court's vague and expansive application of the implied covenant of good faith and fair dealing, this note recommends three courses of action: (1) the court should determine the meaning of the implied covenant from the facts of each case; (2) the court should abolish the tortious breach of the implied covenant; and (3) the court should apply an objective standard in determining a breach of the implied covenant.

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157. *Id.* at 1330 (citations omitted) (Compton, J., dissenting in part).

158. Gillette, *supra* note 19, at 651.

159. Owens, *supra* note 83, at 306.

160. An economist with the Institute for Social and Economic Research at the University of Alaska, Anchorage, has projected growth of less than one percent annually for the Alaska economy over the next 20 years. Rose Ragsdale, *Economist: State Faces Little Growth*, ALASKA J. COM., Nov. 1, 1993, at 1. Moreover, most of the new jobs created will be lower-paying and offer fewer benefits, attracting less stable and more mobile workers. *Id.*

A. The Alaska Supreme Court Should Determine the Meaning of the Implied Covenant from the Facts of Each Case.

The court's troubles in applying the doctrine of the implied covenant of good faith and fair dealing have stemmed largely from its proclivity to announce broad and potentially ambiguous formulations of the covenant. Due to its fact-specific nature, the covenant of good faith and fair dealing does not lend itself to such broad definitions. The expansive interpretations announced by the court have only led to greater uncertainty as to what the covenant means in a given context. The implied covenant of good faith and fair dealing should always be defined contextually, deriving its meaning from the reasonable expectations and intentions of the contracting parties. In framing the implied covenant of good faith and fair dealing, the court must take a more aggressive position with these expectations by delving into the facts and circumstances of the formation of the contract at issue.

Moreover, greater reliance on a fact-specific analysis of the covenant would lend greater credibility and stability to the court's use of the covenant. In *Luedtke I*,[161] the court balanced the public policy interest of employee privacy against the public concern of health and safety in determining that urinalysis testing of employees does not violate the implied covenant.[162] The more appropriate interpretation of the covenant would have involved a determination of the expectations of the employer and the employee in the particular employment contract, rather than a balancing of public policies.

Underlying the policy discussion by the court in *Luedtke I* was a sufficient factual record to allow the court to reach the same result without probing into the ambiguities of public policy. While noting that marijuana use can result in "'impairment of psychomotor control,'"[163] the court could have determined safety to be a reasonable expectation of the employer due to the nature of the work on an oil rig. In fact, the court stated that "[w]e also observe that work on an oil rig can be very dangerous. We have determined numerous cases involving serious injury or death resulting from accidents on oil drilling rigs."[164] Thus, while the employer would have an expectation of safety which would allow the testing of employees for drug use to be a term reasonably implied in the

161. 768 P.2d 1123 (Alaska 1989).

162. *See supra* text accompanying notes 88-91.

163. *Luedtke I*, 768 P.2d at 1136 (quoting Ravin v. State, 537 P.2d 494, 506 (Alaska 1975)).

164. *Id.* (citations omitted).

employment contract, the employee would reasonably expect to have notice of the institution of a drug-testing program "so that he may contest it, refuse to accept it and quit, seek to negotiate its conditions, or prepare for the test so that he will not fail it and thereby suffer sanctions."[165] With a greater reliance on the factual record rather than public policy, the covenant of good faith and fair dealing has more readily apparent boundaries.

A greater reliance on the factual record would also prevent the court from further overriding the explicit expectations of a contract. In *CHI of Alaska, Inc. v. Employers Reinsurance Corp.*,[166] the insurance contract explicitly expressed a contractual right of the insurer to participate to some extent in the selection of counsel for the insured. The court, however, reasoned that the possibly conflicting interests of the insured and the insurer necessitated that the insured have the unilateral right to select independent counsel.[167] A more reasonable interpretation of the contract, in accordance with the expectations of the parties, would have given the insurer the right to select independent counsel subject to the implied covenant. The court's use of the doctrine as a panacea for public policy "violations," regardless of the explicit intentions in a contract, only increases uncertainty and commercial distrust of the implied covenant of good faith and fair dealing.

B. The Alaska Supreme Court Should Abolish the Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing.

The court has recognized tort liability for breach of the implied covenant of good faith and fair dealing in insurance and surety contracts.[168] The court premised such liability on the supposed special relationships present in such contracts. The analysis in these decisions has relied in large part on the reasoning of a 1982 law review article that attempts to define the specific criteria by which the tort of breach of the implied covenant can be identified.[169] The authors of that article conclude that the tort should be recognized where:

> (1) [O]ne of the parties to the contract enjoys a superior bargaining position to the extent that it is able to dictate the

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165. *Id.* at 1137 (citing Richard N. Cook, Note, *Drug Testing of Public and Private Employees in Alaska*, 5 ALASKA L. REV. 133, 138-39 (1988)).

166. 844 P.2d 1113 (Alaska 1993).

167. *See supra* text accompanying notes 107-119.

168. *See* State Farm Fire & Casualty Co. v. Nicholson, 777 P.2d 1152 (Alaska 1989); Loyal Order of Moose, Lodge 1392 v. International Fidelity Ins. Co., 797 P.2d 622 (Alaska 1992).

169. Louderback & Jurika, *supra* note 126, at 187.

> terms of the contract; (2) the purpose of the weaker party in entering into the contract is not primarily to profit, but rather to obtain financial security or peace of mind; (3) the relationship of the parties is such that the weaker party reasonably and justifiably places its trust and confidence in the larger entity; and (4) there is conduct on the part of the stronger contracting party indicating an intent to frustrate the weaker party's enjoyment of its contract rights. When these circumstances are present, public policy considerations, the foundation for a tort action, become operative and the tort of bad faith breach of contract should be recognized.[170]

Based on these four criteria, the Alaska Supreme Court has allowed for tort liability for breach of the implied covenant in insurance contracts, but not in employment or other commercial contracts. Insurance contracts, though, involve no more of a special relationship than other types of agreements. Additionally, if the breach of these contracts sounds in tort, risk allocations between the parties are effectively recast. Thus, the breach of the implied covenant in the insurance and surety contexts should not sound in tort.[171]

1. *Relative Bargaining Strength.* As discussed above, one criterion upon which tort liability in the insurance context has been premised is that the insurer enjoys a superior bargaining position over the insured, and thus can dictate the terms of the contract. However, such inequality in bargaining power also occurs in many situations where the tortious breach of the covenant is not recognized. In many employment contracts, for example, the employer may have a relatively stronger bargaining position than the employee, enabling the employer to dictate the terms of the employment contract. One might also imagine certain sale of goods transactions where a purchaser would be subject to the standardized terms provided by a large seller. This is similar to the position of a purchaser of an insurance policy, who, though not able to dictate the particular terms, can still select certain amounts and types of coverage and a deductible amount. In this way, employment and commercial agreements are susceptible to many of the same public policy considerations as insurance contracts.[172]

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170. *Id.* at 189.

171. Professor Farnsworth has generally criticized the doctrine of bad faith breach: "What better way for courts to justify an award of punitive damages than to invent a new tort: 'bad faith breach of contract.'" E. Allan Farnsworth, *Developments in Contract Law During the 1980's: The Top Ten*, 41 CASE W. RES. L. REV. 203, 204 (1990).

172. It is notable that legislation regulating labor and the workplace can be seen as a reflection of the interests of public policy within the relationship between

2. *The Desire to Obtain Financial Security.* A second factor considered relevant to establishing the tortious breach of the implied covenant in the insurance context is that the purpose of the weaker party entering into the contract is to obtain financial security rather than to profit. However, it is also not uncommon for an employee to seek minimal financial security from the employment contract. While the loss sustained by the insured when an insurer breaches the implied covenant by unreasonably denying a claim may be a greater, single catastrophic loss, the loss sustained by an employee as a result of the breach of the implied covenant in an employment contract also impinges on his or her minimal financial well-being. The loss resulting from a breach of an insurance contract is analogous to a loss of wealth of the insured. Similarly, the loss incurred as a result of a breach of an employment contract can be characterized as a loss of future wealth, as it affects the employee's stream of income.

3. *Placement of Trust in the Stronger Party.* The third factor justifying the creation of the tortious breach of the implied covenant in the insurance context is that there are significant public policy considerations for protecting a weaker party that has reasonably and justifiably placed its trust in a stronger party. Employees, like insured parties, put great confidence and trust in their employers, and thus potentially allow employers to adjust the terms of the relationship. As members of a joint enterprise with the employer, in which both the employer and the employee have a stake, employees must place trust in the employer. In this respect, the employer-employee relationship is similar to the insured-insurer relationship.

4. *Conduct Indicating an Intent to Deprive the Weaker Party of the Benefit of the Contract.* The final criterion for identifying the tortious breach of the implied covenant in the insurance context—a finding of conduct on the part of the stronger contracting party indicating an intent to deprive the weaker party of the benefit of the contract—could be satisfied just as easily in a breach of an employment or commercial contract as in an insurance contract. For example, in *Mitford v. de Lasala*,[173] the court held that

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employers and employees. *See, e.g.*, ALASKA STAT. §§ 18.60.010-.105 (1991 & Supp. 1993) (employee safety); 18.80.010-.300 (1991 & Supp. 1993) (discrimination); 23.10.015-.037 (1990) (fraud against employees); 23.10.040-.047 (1990) (wages); 23.10.500-.550 (Supp. 1993) (pregnancy, childbirth and family leave); 23.30.005-.270 (1990 & Supp. 1993) (workers' compensation); 44.21.500-.508 (1993) (equal employment opportunity).

173. 666 P.2d 1000 (Alaska 1983).

discharging an employee with the intent to deprive him from sharing in future profits in accordance with the contract breached the implied covenant. Because the breach occurred in the employment context, however, the court found that it was nontortious. The court appears merely to be expanding the scope of tort liability into the insurance context without any sensical justification.[174]

5. *Other Rationales.* Other rationales for tort recovery for breach of the implied covenant of good faith and fair dealing in the insurance context, though not discussed by the Alaska Supreme Court, are equally unsatisfying. In *Foley v. Interactive Data Corp.*,[175] the California Supreme Court declined to recognize a tort cause of action for breach of the implied covenant of good faith and fair dealing in an employment contract not only because the employer-employee relationship fails to conform to the "special relationship" found in insurance contracts, but also because it found that the insurance contract is unique for three additional reasons. First, the employee and the insured do not face the same economic dilemma as a result of a breach of the implied covenant, as the insured cannot turn to the marketplace to find another insurance company to pay for the loss already incurred, but the discharged employee can and must, in order to mitigate damages, seek alternative employment.[176] This rationale, however, does not reflect the reality that, particularly in a small labor market, an employee recently discharged from a past job may find it difficult to find alternative or commensurate employment. Consequently, a discharged employee will likely incur a loss not only to income in the short run, but also to his wealth in the long run, just as would an injured claimant in an insurance dispute.

Second, the *Foley* court claimed that the role of the employer differs from the "quasi-public" function of an insurance compa-

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174. In addition to being expansive in allowing for tort recovery for breach of the implied covenant of good faith and fair dealing, the "special relationship" test in Louderback and Jurika's article has been criticized as illusory, as it "opens the way for pleading a tort cause of action in nearly every contract case, leaving it ultimately to a jury to decide whether or not the parties had a 'special relationship.'" C. Delos Putz, Jr. & Nona Klippen, *Commercial Bad Faith: Attorney Fees —Not Tort Liability—Is the Remedy for "Stonewalling,"* 21 U.S.F. L. REV. 419, 480 (1987) (footnote omitted). *See also* Comment, *Reconstructing Breach of the Implied Covenant of Good Faith and Fair Dealing as a Tort*, 73 CAL. L. REV. 1291, 1299-1301 (1985) (criticizing the special relationship test).

175. 765 P.2d 373, 395 (Cal. 1988).

176. *Id.* at 396.

ny.[177] Although each individual employer does not fulfill an expansive role in the larger society, employers, in the aggregate, provide wages that fuel the entire economy and certainly affect public policy. The public policy considerations in the general employer-employee relationship are reflected in the immense volume of regulations affecting the workplace.[178]

Third, the *Foley* court stated that the nature of the relationship in the insurance context is markedly different from the relationship in the employment situation. The California Supreme Court stated that while "as a general rule it is to the employer's economic benefit to retain good employees," the interests of the insured and the insurer are financially at odds.[179] Again, the analysis of the court is oversimplified. Both employers and insurance companies, in general, are profit-maximizing entities. An employer will find it economically beneficial to retain "good" employees only if it is profit-maximizing. The incentive to maximize profits may conflict with the obligation to act fairly and in good faith when, for example, an employer seeks to discharge an employee to deprive him of profit-sharing or replaces him with a new employee at a lower wage. The alleged difference in the nature of the relationship does not explain why tort recovery for breach of the implied covenant of good faith and fair dealing is more appropriate in the insurance context than in the employment context.

In short, there is no persuasive reason to limit tort recovery to only the insurance context. But, allowing *any* tort recovery for breach of the implied covenant of good faith and fair dealing subjects contractual agreements to greater uncertainty, resulting in inefficient reallocation of risk.[180] Such tort recovery is also inconsistent with the public policies implicated in contractual damages.[181] At most, deprivation of rights under an insurance

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177. *Id.*

178. *See supra* note 172.

179. *Foley*, 765 P.2d at 396.

180. *See* Matthew J. Barrett, Note, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts —Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 526-27 (1985) ("When courts interject tort remedies into commercial contracts they frustrate the contracting parties' expectations because in most cases, the parties anticipate contract damages as the only remedy for purposeful breaches of contract.").

181. *See* RESTATEMENT (SECOND) OF CONTRACTS § 355 cmt. a (1981) ("The purpose[] of awarding contract damages is to compensate the injured party."); RICHARD POSNER, ECONOMIC ANALYSIS OF LAW 55 (1972) ("[I]t is not the policy of the law to compel adherence to contracts, but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform.").

policy could be recognized as a separate, identifiable tort.[182] Public policy considerations, alone, do not support the different treatment of a breach of the implied covenant in the insurance context.

C. The Alaska Supreme Court Should Apply an Objective Standard in Determining Breach of the Implied Covenant of Good Faith and Fair Dealing.

As discussed previously, the Alaska Supreme Court has offered different standards by which compliance with the implied covenant of good faith and fair dealing is to be measured.[183] In some circumstances, the court has defined a test that encompasses both subjective and objective good faith, while in others, particularly with respect to the tort of bad faith breach of the covenant, the court has espoused a completely objective standard. This inconsistency has led to greater uncertainty as to the meaning of the implied covenant of good faith and fair dealing.

Because the implied covenant aims to effectuate the reasonable expectations of the parties as determined by their objective manifestations of them, the standard of good faith logically should be an objective one. According to one scholar, an objective standard has always been the appropriate standard to measure good faith performance, even prior to the adoption of the U.C.C.:

> Good faith performance has always required the cooperation of one party where it was necessary in order that the other might secure the benefits of the contract. And the standard for determining what cooperation was required has always been an objective standard, based on the decency, fairness or reasonableness of the community and not on the individual's own beliefs as to what might be decent, fair or reasonable. Both common sense and tradition dictate an objective standard for good faith performance.[184]

An objective standard for good faith performance, does not mean, however, that subjective bad faith would be tolerated in commercial activity to any greater extent. "A court in evaluating a litigant's conduct may be required to make a factual investigation which includes but extends beyond measuring compliance with

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182. Because the basis of the tort derives principally from interests of public policy, it would be most appropriate for the legislature to define this offense. The original impetus for the judicial creation of the tort of bad faith breach of the covenant stemmed from the apparent lack of incentive provided by Alaska state law for insurance companies to honor their implied covenant. Stronger statutory remedies could easily be provided for with an amendment of the statutes. *See* ALASKA STAT. § 21.36.320(d), (e) (1993).

183. *See supra* part III.D.

184. Farnsworth, *supra* note 23, at 672.

customary commercial or social standards . . . . The standard for measuring conduct in contract formation, performance, or enforcement ought to be an elastic one."[185] In other words, the court would make a broad factual inquiry to determine the reasonable expectations of the parties to each particular contract. In almost all cases, the court would find an expectation that each party could not act with subjective bad faith to deprive the other of the benefit of the contract. Thus, subjective bad faith simply would be encompassed by the objective expectations that define the implied covenant of good faith. By measuring good faith performance according to an objective standard, the Alaska Supreme Court would not only comply with logical sense, but would bring greater certainty to the meaning of the implied covenant.

V. CONCLUSION

The implied covenant of good faith and fair dealing acts as an implied promise that neither party to a contract will act so as to deprive the other party of the expected benefits of the contractual bargain. However, the Alaska Supreme Court has applied the doctrine so as to effectuate public policy concerns. The court must refrain from this action and settle on a definition of the implied covenant of good faith and fair dealing that respects the reasonable intentions and expectations of the contracting parties. Upon adopting such a definition, the court properly could focus on the facts of each case to determine the expectations and, hence, the particular obligation of good faith. Such a focus on contractual expectations should also be accompanied by the elimination of the tort of bad faith breach of the covenant. Contractual expectations and policy implications are no different in insurance contracts than other types of contracts. Rather than expanding the field of tort liability to encompass all contracts, the court should abolish the tortious breach of the implied covenant because it leads to inefficient allocation of risk in contractual agreements generally. Finally, the focus on contractual expectations would also lend itself to an objective standard for determining a breach of the implied covenant of good faith and fair dealing, which would alleviate uncertainty in this area of the law. In order to bring stability to contract formation in the state, and thus promote the expansion of commercial activity, the court can no longer employ the doctrine to further policy goals while overriding the expectations of contracting parties.

Jason Randal Erb

185. Holmes, *supra* note 21, at 405.