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# Insurance Bad Faith Law: The Need for Legislative Intervention

GLENN L. ALLEN\*

In 1958, the California Supreme Court first recognized a tort of insurance bad faith.<sup>1</sup> Since then, the scope and use of this tort has expanded dramatically, markedly increasing the vulnerability of insurers to large verdicts. In many situations, insurers are now faced with what approaches strict liability. Ambiguous standards of conduct serve as an open invitation to litigation. This article will review how insurance bad faith law has developed in California, note some of the problems that have been created, and conclude by proposing interim legislation designed to help correct some of the inequities which have developed.

## BACKGROUND

Prior to *Royal Globe Insurance Co. v. Superior Court*,<sup>2</sup> bad faith cases could be divided into two basic *common law* types: "third party bad faith" and "first party bad faith." This nomenclature can be a source of confusion. Before *Royal Globe*, the third party bad faith action occurred when an insured was sued by a third party, the insurer failed to settle within the policy limits after being given an opportunity to do so, the third party obtained an award in excess of the limits, and the insured then sued the insurer for the "bad faith" failure to settle within the policy limits. Although the term "third party bad faith" was used

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1. *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

2. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

in this situation because the original claim was by a third party, the third party claimant had no right to sue the insurer for its alleged bad faith failure to settle. Frequently, however, the insured assigned his right to sue to the third party, although the right to sue for emotional distress and punitive damages could not be assigned. The third party action arose in the context of a liability insurance policy. The first party action was brought by the insured against the insurer because of the insurer's alleged failure to reasonably handle or pay claims submitted by the insured. These actions usually arose in health, disability, life, theft, fire or title insurance policies.

In 1979, the court in *Royal Globe* held that in third party cases the claimants, who are not parties to the insurance contract, can nevertheless sue the insurer directly for the insurer's commission of certain unfair claims settlement practices prohibited by Section 790.03(h) of the California Insurance Code.<sup>3</sup> Although *Royal Globe* did not involve an action by an insured, it can be assumed the decision provides insureds with the right to sue their insurers for alleged violations of Section 790.03(h) in both first and third party situations.

#### IMPORTANT DECISIONS IN DEVELOPMENT OF BAD FAITH LAW

##### A. *The Beginning: Third Party Bad Faith*

The first type of insurance bad faith action recognized by the California Supreme Court was the third party action. This occurred in 1958 in the case of *Comunale v. Traders & General Insurance Co.*<sup>4</sup> It is not surprising the bad faith cause of action originated with a third party case in view of the significant differences between the first and third party cases. In the third party situation, the liability insurer normally has control over both the litigation and settlement. The insurer has an obvious duty to the insured in this context and the need for the protection of the rights of the insured was recognized. In *Comunale*, the insurer refused to accept a reasonable settlement offer within the insured's policy limits and an excess verdict resulted.<sup>5</sup> The insured assigned his rights against the insurer to the third party claimant who had

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3. *Id.* at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845. It has been argued the court's statements regarding private causes of action in Section 790.03(h) were unnecessary to the decision and were, strictly speaking, dictum. See Catapano-Friedman, *Civil Liability Under the California Practices Act in the Aftermath of Royal Globe*, 21 FOR THE DEFENSE 61 (1980). Because of the general acceptance of *Royal Globe* as holding that Section 790 creates private causes of action, however, this article will assume *Royal Globe* so held. Catapano-Friedman also argues persuasively the interpretation of Section 790 by the court was incorrect and that this interpretation raises serious constitutional questions. Unfortunately, these arguments have not yet received the attention which they deserve.

4. 50 Cal. 2d 654, 328 P.2d 198 (1958).

5. *Id.* at 657, 328 P.2d at 200.

obtained the excess verdict.<sup>6</sup> The claimant then sued the insurer for the amount in excess of the policy limits and won.<sup>7</sup> The *Comunale* court held that in every insurance contract there is an implied covenant of good faith and fair dealing that prohibits either party from doing anything which will injure the right of the other to receive the benefits of the agreement.<sup>8</sup> The implied covenant requires the insurer to settle cases where appropriate although the express terms of the policy do not impose such a duty.<sup>9</sup> In deciding whether to settle a claim, the insurer must give the interests of its insured at least as much consideration as it gives its own interests.<sup>10</sup> The court held a breach of the implied covenant sounded both in contract and in tort,<sup>11</sup> but focused most of its attention on the contract aspect of the action.<sup>12</sup> The court concluded the measure of damages for breach of contract was the amount that would place the plaintiff in the same position as if the contract had been performed, which, necessarily, would be an amount in excess of the policy limits.<sup>13</sup> More importantly for the law of insurance bad faith, the recognition of the tortious aspect of the action was of great potential significance because it provided insureds with a means of obtaining tort damages.

The scope of damages available from this new tort cause of action became clear in 1967 in *Crisci v. Security Insurance Co.*<sup>14</sup> A third party bad faith judgment was won by Mrs. Crisci, the insured, which included an award of \$25,000 for her mental suffering.<sup>15</sup> The insurer had rejected a \$9,000 settlement offer by the third party claimants at a time when Mrs. Crisci had offered to pay \$2,500 of the settlement.<sup>16</sup> Her policy had a \$10,000 limit and the subsequent verdict against her was for \$101,000.<sup>17</sup> The court noted that after arranging a settlement with the plaintiffs,

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6. *Id.* at 658, 328 P.2d at 200.

7. *Id.*

8. *Id.*

9. *Id.* at 659, 328 P.2d at 201.

10. *Id.*

11. *Id.* at 663, 328 P.2d at 203.

12. See *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 432 n.3, 426 P.2d 173, 178 n.3, 58 Cal. Rptr. at 13, 18 n.3 (1967) regarding the possible reason for this:

*Comunale v. Traders & General Insurance Company* (citation omitted) was mainly concerned with the contract aspect of the action. This may be due to the fact that the tort duty is ordinarily based on the insurer's assumption of the defense and of settlement negotiations (citations omitted) and that in *Comunale* the insurer did not undertake defense or settlement but denied coverage. In any event *Comunale* expressly recognizes that wrongful refusal to settle has generally been treated as a tort.

13. 50 Cal. 2d at 661, 328 P.2d at 202.

14. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

15. *Id.* at 427, 426 P.2d at 175, 58 Cal. Rptr. at 15.

16. *Id.* at 428, 426 P.2d at 176, 58 Cal. Rptr. at 16.

17. *Id.*

Mrs. Crisci, an immigrant widow of 70, became indigent. She worked as a babysitter, and her grandchildren paid her rent. The change in her financial condition was accompanied by a decline in physical health, hysteria, and suicide attempts.<sup>18</sup>

The court stated the general rule of damages in tort is that the injured party may recover for all detriment incurred whether it could have been anticipated or not.<sup>19</sup> This includes the right to recover for mental suffering when it constitutes an aggravation of damages.<sup>20</sup> The court believed that although the case did not include a claim for physical injuries, the property damage apart from the mental distress was substantial, thereby reducing the risk of a fictitious claim. Even though the decision was somewhat ambiguous, this was the apparent justification for permitting recovery for mental distress.<sup>21</sup> The court matter-of-factly concluded Mrs. Crisci could recover for mental distress resulting only from the interference with a property right and that this was consistent with prior decisions. Nevertheless, this award for mental distress in the absence of an invasion of one's physical integrity was actually a landmark decision.<sup>22</sup>

### *B. The Emergence of First Party Bad Faith*

After establishing tort remedies including emotional distress for the insured in the third party situation, the California Supreme Court, in the 1973 case of *Gruenberg v. Aetna Insurance Co.*,<sup>23</sup> held that a bad faith cause of action existed in first party cases despite the inherent differences between third and first party situations.<sup>24</sup> In the first party

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18. *Id.* at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.

19. *Id.* at 433, 426 P.2d at 178, 58 Cal. Rptr. at 18.

20. *Id.*

21. *Id.* at 433-34, 426 P.2d at 178-79, 58 Cal. Rptr. at 18-19. The court noted one reason the plaintiff had purchased the insurance policy was to protect herself against the mental distress of an accidental loss, and that recovery of damages for mental suffering has been permitted for breach of contracts which directly concern the comfort, happiness or personal esteem of one of the parties (citations omitted). *Id.*

22. See Note, *Molien v. Kaiser Foundation Hospitals: Negligence Actions for Emotional Distress and Loss of Consortium without Physical Injury*, 69 CALIF. L. REV. 1142, 1151-53 (1968). In discussing the traditional limitation on recovery of damages for mental distress to situations involving actual or imminent physical harm and the gradual movement of courts toward compensation for mental distress resulting from the invasion of protected interests other than physical integrity, the note stated at footnote 54:

The California Supreme Court broke new ground in this area by allowing a plaintiff to claim emotional distress when her insurance company failed to settle within her liability policy limits, so that her health and finances were ruined (citations omitted). Her other claims against the insurer for breach of covenants to insure and defend and for breach of covenant of good faith and fair dealing were considered adequate guarantees of the genuineness of the claim for emotional distress, especially considering the sensitive nature of an insurance contract, which is designed to protect the insured from crushing personal losses (citations omitted) (emphasis added).

23. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

24. *Id.* at 575, 510 P.2d at 1037-38, 108 Cal. Rptr. at 485-86; see *Spencer v. Aetna Life & Cas.*

situation, the insurer is not working to defend or settle a claim against the insured. Instead, the insured is in an adversary relationship with the insurer who has denied to pay his claim. The insured can normally sue the insurer for breach of contract as soon as the claim is denied. Furthermore, the number of potential first party situations is monumental compared to the few third party situations where an excess verdict has occurred. Finally, the potential injury in the denial of most first party claims is small compared to the commonly serious losses to an insured when a third party obtains an excess verdict against the insured. In the relatively few first party situations where actual damages are large, even if the implied covenant tort were not available, the insured, according to *Comunale*, could sue for breach of contract and obtain damages in excess of the contractually obligated amount that would be necessary to place him in the same position as if the contract had been performed.<sup>25</sup> In addition, the insured could also sue for fraud,<sup>26</sup> intentional infliction of emotional distress,<sup>27</sup> or intentional interference with a property right<sup>28</sup> where such actions are applicable.

Unfortunately, a few first party cases in which the facts were quite appealing from a plaintiff's standpoint created a comfortable atmosphere for the supreme court to apply third party law to the first party situation. The court of appeal cases of *Wetherbee v. United Insurance Co. of America*<sup>29</sup> and *Fletcher v. Western National Life Insurance Co.*<sup>30</sup> are two examples of such cases. Both cases involved the wrongful denial of disability benefits. In *Wetherbee*, the jury awarded actual damages of \$1,050 and punitive damages of \$500,000.<sup>31</sup> Although the appellate court held that the insured was entitled to punitive damages for the insurer's fraudulent misrepresentation,<sup>32</sup> it reversed the punitive award as excessive and remanded the case for trial on the punitive damages issue only.<sup>33</sup> In *Fletcher* the appellate court concluded that the facts presented at the trial justified the jury's finding that the defendant insurer was liable for the intentional infliction of emotional distress,<sup>34</sup> the only cause of action that went to the jury.<sup>35</sup> The court

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Ins. Co., 227 Kan. 914, 611 P.2d 149, 154, 155 (1980), refusing to recognize the tort of bad faith in Kansas, for an excellent discussion of the distinctions between third and first party bad faith.

25. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 661, 328 P.2d 198, 202 (1958).

26. *Weatherbee v. United Ins. Co. of Am.*, 265 Cal. App. 2d 921, 923, 71 Cal. Rptr. 764, 770 (1968).

27. *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 401-02, 89 Cal. Rptr. 78, 94 (1970).

28. *Id.*

29. 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

30. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

31. 265 Cal. App. 2d at 927, 71 Cal. Rptr. at 767.

32. *Id.* at 927-31, 71 Cal. Rptr. at 767-70.

33. *Id.* at 933-35, 71 Cal. Rptr. at 771-72.

34. 10 Cal. App. 3d at 401, 89 Cal. Rptr. at 93.

went further to state an implied-in-law duty of good faith and fair dealing exists in the first party situation just as it did in the third party area, and that the violation of this duty sounds in tort.<sup>36</sup> The court also concluded the defendant insurer's conduct amounted to a tortious interference with a protected property interest of its insured.<sup>37</sup> The jury had awarded damages of \$60,000 for emotional distress and \$640,000 punitive damages against the insurer.<sup>38</sup> The trial court reduced the punitive damages to \$180,000<sup>39</sup> and the appellate court upheld the awards of \$60,000 for emotional distress and \$180,000 punitive damages.<sup>40</sup>

Following *Fletcher*, the supreme court ruled in *Gruenberg v. Aetna Insurance Co.*<sup>41</sup> that a cause of action for the breach of the covenant of good faith and fair dealing was a valid tort cause of action in the first party situation. *Gruenberg* involved the review of a judgment of dismissal following successful demurrer to the complaint.<sup>42</sup> The case involved a suit by an insured against his fire insurers.<sup>43</sup> The insurers denied liability after the plaintiff had failed to appear for an examination under oath (required by the insurance policies) while arson charges were pending against him.<sup>44</sup> The insured's complaint alleged the insurers had encouraged criminal charges by falsely implying the insured had a motive to commit arson, knowing the plaintiff would not appear for an examination during the pendency of the criminal charges against him.<sup>45</sup> The court held the tort of bad faith existed in the first party situation and the plaintiff's pleadings adequately alleged bad faith.<sup>46</sup> The court also concluded that the plaintiff had adequately pleaded emotional distress because he had alleged substantial damages for loss of property apart from damages for emotional distress.<sup>47</sup> Specifically, the plaintiff alleged loss of earnings, being compelled to go out of business, inability to pay business creditors and the cost of resulting litigation with them, and medical expenses.<sup>48</sup> The court cited *Crisci's* position that when substantial damages exist apart from those due to mental distress, the danger of fictitious claims is reduced.<sup>49</sup>

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35. *Id.* at 385, 89 Cal. Rptr. at 82.

36. *Id.* at 401, 89 Cal. Rptr. at 93.

37. *Id.*

38. *Id.* at 385, 89 Cal. Rptr. at 82.

39. *Id.*

40. *Id.* at 408-09, 89 Cal. Rptr. at 98-99.

41. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

42. *Id.* at 569, 510 P.2d at 1034, 108 Cal. Rptr. at 482.

43. *Id.* at 570-72, 510 P.2d at 1034-36, 108 Cal. Rptr. at 482-84.

44. *Id.* at 570-71, 510 P.2d at 1035, 108 Cal. Rptr. at 483.

45. *Id.* at 575, 510 P.2d at 1039, 108 Cal. Rptr. at 486.

46. *Id.*

47. *Id.* at 580, 510 P.2d at 1041-42, 108 Cal. Rptr. at 489-90.

48. *Id.*

49. *Id.* at 579, 510 P.2d at 1041, 108 Cal. Rptr. at 489.

*Gruenberg* was followed in 1974 by *Silberg v. California Life Insurance Co.*,<sup>50</sup> a California Supreme Court decision reviewing a trial of a first party bad faith case wherein bad faith had been specifically alleged.<sup>51</sup> The case involved the refusal of an insurer to pay hospital and medical benefits to an insured pending the outcome of the insured's workmen's compensation proceedings.<sup>52</sup> The insured's workmen's compensation claim was of questionable validity.<sup>53</sup> He apparently had no other accident or disability insurance,<sup>54</sup> had serious financial and medical problems,<sup>55</sup> and the insurer had represented in its application form its insurance could protect against medical bills that could ruin him.<sup>56</sup> The supreme court held the insurer violated its implied duty of good faith and fair dealing and that the jury's award of \$75,000 compensatory damages was not excessive.<sup>57</sup> In regard to the jury's award of \$500,000 punitive damages,<sup>58</sup> the supreme court upheld the trial court's decision to grant a new trial on this issue because there was insufficient evidence to justify an award of punitive damages.<sup>59</sup>

### C. The Test of Liability in Third Party Cases

With the third party cases of *Comunale* and *Crisci* having cleared the way for the first party cases of *Gruenberg* and *Silberg*, the right to sue in tort for bad faith in both the third and first party situations was established. However, the test(s) of liability in bad faith cases, and whether there would be strict liability, was still unclear, as the 1975 case of *Johansen v. California State Automobile Association Inter-Insurance Bureau*<sup>60</sup> demonstrated.<sup>61</sup> In *Johansen*, the insurer refused to settle a personal injury action against its insureds after a reasonable

50. 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1971).

51. *Id.* at 456, 521 P.2d at 1106, 113 Cal. Rptr. at 714.

52. *Id.*

53. *Id.* at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

54. *Id.*

55. *Id.* at 457-59, 521 P.2d at 1106-08, 113 Cal. Rptr. at 714-16.

56. *Id.* at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

57. *Id.* at 462, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

58. *Id.* at 456, 521 P.2d at 1106, 113 Cal. Rptr. at 714.

59. *Id.* at 463, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

60. 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975).

61. In the third party area, *Comunale* provided that "when there is a great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim." *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 201 (1958). In *Crisci*, the court accepted the trial court's test of "considerable risk of substantial recovery" beyond the policy limits. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 432, 426 P.2d 173, 178, 58 Cal. Rptr. 17, 18 (1967) (emphasis added). In the first party area, the *Gruenberg* court held that "when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort." *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 575, 510 P.2d 1032, 1038, 108 Cal. Rptr. 480, 486 (1973). In *Silberg*, the court appeared to accept the aforementioned language of *Gruenberg* although the language of the holding was somewhat unclear. 11 Cal. 3d at 460-62, 521 P.2d at 1108-10, 113 Cal. Rptr. at 716-18.



settlement demand within the policy limits.<sup>62</sup> The insurer's reason for refusing to settle was that the policy did not provide coverage.<sup>63</sup> After the personal injury action had been initiated and before the settlement demand was made, the insurer had filed a declaratory relief action to obtain a judicial determination of whether the policy afforded coverage.<sup>64</sup> Despite the insurer's efforts to have the declaratory relief action expedited, the personal injury action went to trial first and an excess verdict was returned against the insureds.<sup>65</sup> In the subsequent trial of the declaratory relief action, the trial court ruled for the insurer on the coverage question but this determination was reversed on appeal.<sup>66</sup> A third party bad faith action followed.<sup>67</sup> The trial court rendered a judgment for the insurer, finding it had denied coverage in good faith.<sup>68</sup> In reversing the trial court, the supreme court stated:

an insurer's "good faith," though erroneous, belief in noncoverage affords no defense to liability flowing from the insurer's refusal to accept a reasonable settlement offer.

. . . .

[i]n deciding whether or not to compromise the claim, the insurer must conduct itself as though it alone were liable for the entire amount of the judgment (citations omitted). Thus, the only permissible consideration in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim's injuries and the probable liability of the insured, the ultimate judgment is likely to exceed the amount of the settlement offer. Such factors as the limits imposed by the policy, a desire to reduce the amount of future settlements, or a belief that the policy does not provide coverage, should not affect a decision as to whether the settlement offer in question is a reasonable one.<sup>69</sup>

In reaching its decision that the rejected settlement offer was a reasonable one,<sup>70</sup> the *Johansen* court adopted dictum from *Crisci* to the effect that hindsight was appropriate in determining the reasonableness of the settlement offer:

The size of the judgment recovered in the personal injury action when it exceeds the policy limits, although not conclusive, furnished an inference that the value of the claim is the equivalent of the amount of the judgment and that acceptance of an offer within those

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62. 15 Cal. 3d at 13, 16, 17, 538 P.2d at 746, 748, 749, 123 Cal. Rptr. at 290, 292, 293.

63. *Id.* at 13, 538 P.2d at 746, 123 Cal. Rptr. at 290.

64. *Id.*

65. *Id.*

66. *Id.* at 13, 14, 538 P.2d at 746, 123 Cal. Rptr. at 290.

67. *Id.* at 14, 538 P.2d at 747, 123 Cal. Rptr. at 291.

68. *Id.*

69. *Id.* at 16, 538 P.2d at 748, 123 Cal. Rptr. at 292.

70. *Id.* at 16-17, 538 P.2d at 748-49, 123 Cal. Rptr. at 292-93.

limits was the most reasonable method of dealing with the claim (citations omitted).<sup>71</sup>

Although purportedly using a test of reasonableness, the language of *Johansen* left the insurer subject to a standard which approaches strict liability in the third party bad faith situation.<sup>72</sup>

#### D. Neal

In 1978, the supreme court, in the first party case of *Neal v. Farmers Insurance Exchange*,<sup>73</sup> referred to the test of reasonableness set forth in *Gruenberg* in approving a jury finding of bad faith by the insurer. As in *Silberg*, the test of liability upon which the supreme court based its decision was unclear.<sup>74</sup> No mention was made of the *Johansen* case. The facts of the case involved an insurer that refused to pay the maximum benefits available (\$15,000) under an uninsured motorist provision.<sup>75</sup> Apparently there was a legitimate question of whether the uninsured motorist was negligent and the insured's husband was cited for making an illegal left turn in the path of the uninsured motorist's oncoming vehicle.<sup>76</sup> The insurer was willing to settle the claim prior to arbitration for \$5,000, claiming that \$5,000 in medical benefits already paid under a medical payments provision (\$5,000 limit) of the same automobile insurance policy should be an offset against any amounts due under the uninsured motorist provision.<sup>77</sup> The insurer's attorney had advised the insurer the law was unclear on the question of the offset, the negligence of the husband could not be imputed to the insured, and that "at best" the case was "50-50" on liability.<sup>78</sup> The \$5,000 offer was rejected and an arbitrator subsequently awarded the full \$15,000.<sup>79</sup> A first party bad faith action followed. At trial, the jury awarded approximately \$1,500,000 punitive damages, compensatory damages be-

71. *Id.* at 17, 538 P.2d at 749, 123 Cal. Rptr. at 293.

72. See Comment, *Johansen v. California State Automobile Association: Has California Adopted Strict Liability for an Insurer's Failure to Settle?*, 27 HASTINGS L.J. 895, 896 (1976):

In the recent case of *Johansen v. California State Automobile Association Inter-Insurance Bureau*, the court answered plaintiff's arguments which urged the adoption of strict liability by saying that it was not necessary to resolve the issue. This note, however, will argue that *Johansen* and other decisions since *Crisci* have in fact resolved the issue in favor of an unannounced policy of strict liability for failure to settle within the policy limits. Although this result may in some respects be consistent with good public policy and, most important, may minimize the conflict of interest problems described above, it also raises a variety of practical problems, perhaps the most important of which is the possibility that this new leverage could be abused by a plaintiff acting in bad faith.

73. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

74. *Id.* at 920-22, 582 P.2d at 985-86, 148 Cal. Rptr. at 394-95.

75. *Id.* at 917-20, 582 P.2d at 983-85, 148 Cal. Rptr. at 392-94.

76. *Id.* at 934, 582 P.2d at 994, 148 Cal. Rptr. at 403 (Richardson, J., dissenting).

77. *Id.* at 918-19, 582 P.2d at 983-84, 148 Cal. Rptr. at 392-93.

78. *Id.* at 919, 582 P.2d at 984, 148 Cal. Rptr. at 393.

79. *Id.* at 919-20, 582 P.2d at 984, 148 Cal. Rptr. at 393.

ing \$9,573.65.<sup>80</sup> The trial court reduced the punitive award to approximately \$750,000,<sup>81</sup> which was upheld by the supreme court.<sup>82</sup> Although the supreme court did not state specifically how stringently the reasonableness test would be applied to insurers, Justice Clark, dissenting, gave his own opinion:

The majority's holding, that a first party insurer may not "guess wrong," effectively abolishes the present statutory scheme for handling uninsured motorist claims. We may anticipate arbitration, pursuant to Insurance Code Section 11580.2, will no longer be used to resolve these disputes because the penalty for losing in arbitration will be an automatic second proceeding in superior court for "bad faith" breach of the insurance policy. Thus, all claims must necessarily be paid regardless of how frivolous. And who is it that will ultimately bear the burden? Obviously, it is the general motoring public through massive increases in premium. Today, 25 percent of the public cannot afford car insurance. Tomorrow, under the majority's strict liability holding, the percentage must increase, thus creating more uninsured motorists, consequently more uninsured motorist claims. When this cycle has run its course even fewer motorists will exist who can afford insurance.<sup>83</sup>

#### E. Egan

*Neal v. Farmers Insurance Exchange* was followed in 1979 by *Egan v. Mutual of Omaha Insurance Co.*,<sup>84</sup> involving a directed verdict against the insurer for first party bad faith in failing to properly investigate the insured's disability claim.<sup>85</sup> The supreme court upheld the directed verdict, reiterating the reasonableness test of *Gruenberg* without any significant elaboration.<sup>86</sup> The jury found the insurer liable for \$45,600 in general damages, \$78,000 for emotional distress, and \$5,000,000 in punitive damages.<sup>87</sup> The jury was allowed to include future policy benefits within the compensatory damage award.<sup>88</sup> The supreme court upheld the compensatory award, specifically approving the jury's right to include future contract benefits in the compensatory award.<sup>89</sup> The supreme court reversed the punitive award, concluding it was the result of passion and prejudice by the jurors and was excessive as a matter of

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80. *Id.* at 920, 582 P.2d at 985, 148 Cal. Rptr. at 394.

81. *Id.*

82. *Id.* at 929, 582 P.2d at 991, 148 Cal. Rptr. at 400.

83. *Id.* at 942, 582 P.2d at 999-1000, 148 Cal. Rptr. at 408-09.

84. 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1978).

85. *Id.* at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485.

86. *Id.* at 818-19, 598 P.2d at 456, 157 Cal. Rptr. at 486.

87. *Id.* at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485.

88. *Id.* at 824 n.7, 598 P.2d at 460 n.7, 157 Cal. Rptr. at 490 n.7.

89. *Id.*

law.<sup>90</sup>

#### F. Royal Globe

Insurers were staggered in 1979 by the *Royal Globe*<sup>91</sup> decision. The 4-3 majority ignored the intent of Section 790.03(h) of the California Insurance Code<sup>92</sup> and held certain acts prohibited in that section, specifically the acts set forth in Section 790.03(h)(5) and (h)(14),<sup>93</sup> could be the basis for private actions by third party claimants.<sup>94</sup>

The knowing commission of one of the proscribed acts in a single instance *or* the performance of one of the acts with such frequency as to indicate a general business practice was sufficient to permit an action.<sup>95</sup> *Royal Globe* is completely unilateral in the dispensation of benefits to claimants because no corresponding obligations are imposed upon the third-party adversary to act in good faith in dealing with the insurer. Although the facts of *Royal Globe* were such that the decision dealt specifically with only two of the fifteen proscribed Section 790.03(h) practices, the language of the opinion appears to permit claims based on other subsections of 790.03(h) as well as subsections of 790.03 other than 790.03(h). Further, despite the fact *Royal Globe* concerned a plaintiff who was a third party claimant, actions by insureds for Section 790.03(h) violations in both first and third party situations will presumably now be permitted.

### PRESENT STATUS OF INSURANCE BAD FAITH LAW IN CALIFORNIA

#### A. Third Party Common Law Bad Faith

In the third party situation, insureds can sue under the common law for breach of the implied covenant of good faith and fair dealing if the insurer's failure to settle results in an excess verdict. Strict liability

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90. *Id.*

91. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

92. See generally Comment, *Royal Globe Ins. Co. v. Superior Court: Right to Direct Suit Against an Insurer by a Third Party Claimant*, 31 HASTINGS L.J. 1161 (1980).

93. CAL. INS. CODE §790.03: Prohibited Acts

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

.....  
(h) Knowingly committing or performing with such frequency as to indicate a general business practice any of the following unfair claims settlement practices:

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

.....  
(14) Directly advising a claimant not to obtain the services of an attorney.

94. 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.

95. *Id.* at 890, 891, 592 P.2d at 336, 153 Cal. Rptr. at 849.

probably exists in this area in view of the language of *Johansen v. California State Automobile Association*.

### *B. First Party Common Law Bad Faith*

In the first party area, insureds can sue under the common law for breach of the implied covenant of good faith and fair dealing in handling and settling claims. As will be explained more fully below, something approaching strict liability exists as a practical matter in many first party bad faith cases as a result of the practical problems created by the supposed test of reasonableness referred to in *Gruenberg, Silberg, Neal and Egan*.

### *C. Royal Globe Bad Faith*

*Royal Globe* has left numerous questions unanswered regarding the magnitude and variety of future *Royal Globe* actions. Questions exist as to the test of liability, standing to sue, the extent of recoverable damages, the extent to which *Royal Globe* applies to the various subsections of 790.03, and other issues.<sup>96</sup> Because of the many uncertainties, only a few observations about the potential scope of *Royal Globe* will be made here. In the third party cases, third party claimants now are able to sue directly rather than only as the assignee of the insured's rights. This allows the third party claimant to recover damages for emotional distress and punitive damages which were not available to an assignee. Numerous actions will presumably be brought not only where there are excess verdicts, but also where there are plaintiff's verdicts within the policy limits that are as great or greater than rejected settlement demands by the third party claimant.

In first party actions under *Royal Globe* (assuming *Royal Globe* will apply in this area), insureds have been given additional means of establishing insurer liability as a result of the laundry list of proscribed practices in Section 790.03(h). *Royal Globe* causes of action are already commonly being pleaded alongside causes of action for violation of the implied covenant of good faith and fair dealing in lawsuits resulting from the denial of contract benefits. For the most part, first party *Royal Globe* causes of action will just add another dimension to the problems already existing for insurers as a result of first party implied covenant law.

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96. For an excellent discussion of many of the questions raised by *Royal Globe*, see generally Kornblum, *Royal Globe v. Superior Court: Its Impact on Litigation Involving Insurers*, 15 FORUM 967 (1980).

## PROBLEMS WITH PRESENT LAW

In terms of unfairness to insurers, the problems in bad faith law at present are primarily in two areas: (1) first party implied covenant cases; and (2) first and third party *Royal Globe* actions.

As for third party implied covenant law, it is certainly something an insurer should be wary of because excess verdicts after insurers refuse to settle within the policy limits will, in most cases, be the full responsibility of the carrier or carriers (primary and possible excess carriers). However, the number of potential third party implied covenant cases is very small compared with the number of potential first party implied covenant cases. Insurers have at least become aware of the dangers of failing to settle and can prevent the third party implied covenant action by settling before trial.

#### A. *Insurer Problems in the First Party Area*

The first party implied covenant situation creates serious and inequitable problems for insurers. Particularly in areas such as health insurance, massive numbers of claims are processed on a daily basis. Because of the massive volume, relatively large numbers of seemingly unjustified claims should be denied by those processing them. The courts have created, however, a situation where large penalties can easily result from the denial of these claims.

##### 1. *Contract Interpretation*

The vulnerability of insurers to bad faith allegations in the processing of mammoth numbers of claims by insureds exists for several reasons. First, the courts have created rules of contract interpretation which consistently favor the insured and can result in the resolution of contract disputes with insureds in ways difficult for insurers to anticipate and protect against.<sup>97</sup> In addition to the rules of interpretation applicable to all insurance contracts, additional rules of interpretation favorable to insureds exist where the insurance contract is defined as an

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97. See *Maxon v. Security Ins. Co. of New Haven*, 214 Cal. App. 2d 603, 611, 29 Cal. Rptr. 586, 590 (1963):

We must also take cognizance of certain well-established rules of construction applicable to insurance contracts, to wit: that any ambiguity or uncertainty in an insurance policy is to be resolved against the insurer; if semantically permissible, the contract will be given such construction as will fairly achieve its object of securing indemnity to the insured for the losses to which the insurance relates; if the insurer uses language which is uncertain any reasonable doubt will be resolved against it; if the doubt relates to the extent or fact of coverage, whether as to peril insured against, the amount of liability of the person or persons protected, the language will be understood in its most inclusive sense, for the benefit of the insured; and, where two interpretations equally fair may be made, that which affords the greatest measure of protection to the insured will prevail (citations omitted).

adhesion contract.<sup>98</sup> Because insurance contracts in California are commonly found to be adhesion contracts, this additional burden is one insurers can anticipate facing if a contract dispute with an insured occurs. Because of these rules of contract interpretation, an insurer can also anticipate that whenever a court can find an ambiguity in the contractual provision leading to the denial of benefits, the insured will probably prevail.

## 2. *Test of Reasonableness*

Once a contract is interpreted in favor of the insured under the aforementioned weighted rules of interpretation, the insured under present bad faith law can immediately claim the losing insurer violated the implied covenant of good faith and fair dealing by denying a legitimate claim. All the insured need then prove to show insurer bad faith is that the insurer's interpretation of the contract was an unreasonable one. Who decides whether the insurance company's mistake was unreasonable? A jury. It is well known insurance companies are not favored by the average juror,<sup>99</sup> and the ease with which a jury can interpret the insurance company's refusal to pay contract benefits as unreasonable is obvious.

## 3. *Damages for Emotional Distress*

Once unreasonableness ("bad faith") is found, the whole panoply of damage possibilities under California law is then available for the

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98. See *Jones v. Crown Life Ins. Co.*, 86 Cal. App. 3d 630, 638-39, 150 Cal. Rptr. 375, 379-80 (1978):

As noted above, the contract under consideration is a contract of adhesion. It is now well established that when an insurance policy is deemed an adhesion contract, the 'express provisions of the insurance contract must be considered in light of the insured's normal expectations of the extent of the coverage of the policy, and notice of noncoverage in a situation where coverage may be reasonably expected must be conspicuous, plain and clear (citations omitted).' The court in *Gyler* also expressed this principle as follows: 'The meaning of an insurance policy is determined by the insured's reasonable expectation of coverage, and all doubts are resolved against the insurer. [Citation.] Any uncertainty or ambiguity in the peril insured against will be resolved in favor of imposing liability (citations omitted).'

Defendant also asserts that this instruction was improper because the instruction stated that defendant owed a duty to notify the insured of the exclusion. Since the contract in question was an adhesion contract, defendant did have a duty to notify the insured of the exclusion. 'In the case of standardized insurance contracts, exceptions and limitations on coverage that the insured could reasonably expect, must be called to his attention, clearly and plainly, before the exclusions will be interpreted to relieve the insurer of liability or performance (citation omitted).'

But see generally *Madden v. Kaiser Found. Hosp.*, 17 Cal. 3d 699, 552 P.2d 1178, 131 Cal. Rptr. 882 (1975) (not a contract of adhesion).

99. See Comment, *Egan v. Mutual of Omaha Ins. Co.: The Expanding Use of Punitive Damages in Breach of Contract Actions*, 15 SAN DIEGO L. REV. 287, 304, 305 (1978).

plaintiff-insured.<sup>100</sup> Particularly where the nature of the defendant tends to make jurors receptive to a plaintiff's arguments concerning damages, the liberal nature of California damage law is a dangerous problem, especially in the areas of emotional distress and punitive damages.<sup>101</sup>

As discussed above, the court in *Crisci* held that damages for emotional distress could be claimed in a bad faith case where there was substantial property damage apart from emotional distress.<sup>102</sup> Subsequent appellate decisions<sup>103</sup> have permitted much more modest economic losses than those recited in *Crisci* or *Gruenberg* to support an award for emotional distress. At present, the cost of employing an attorney to represent the insured in the initial claim dispute is apparently the only economic loss necessary to substantiate a claim for emotional distress.<sup>104</sup> In effect, then, emotional distress can be claimed in almost any first party bad faith action.

In the recent case of *Molien v. Kaiser Foundation Hospitals*<sup>105</sup> the court found negligent infliction of emotional distress actionable without extreme and outrageous conduct, physical impact or injury, or any financial loss apart from the emotional distress. In light of the diluted requirement of economic loss in recent bad faith cases and the philosophy expounded in *Molien*, the requirement of any economic loss at all may soon disappear if it has not already.<sup>106</sup>

100. See LEVINE, DAMAGES ALERT (1981). The book begins with a five-page checklist of the myriad forms of damages that plaintiffs can now sue for. At the end of the checklist it is stated: The checklist should also be utilized in drafting any settlement demand letter to the defendant's insurance carrier. It is now clear that an insurer must attempt in good faith to effectuate a 'prompt, fair and equitable settlement of claims in which liability has become reasonably clear.' [Insurance Code Section 790.03(h)(5)] If it fails to do so, the insurance company itself may be liable for damages to the claimant. *Royal Globe Ins. Co. v. Superior Court* (1979) 23 C.3d 880, 153 C.R. 842.

101. See Kornblum, *The Defense of the First Party Extra-Contract Case: Strategy in Negotiations and Discovery*, 12 FORUM 721 (1977):

From the first *Wetherbee v. United Insurance Company* decision in 1968 through 1975, there were 36 first-party, extra-contract cases tried to verdict in California. Of this number, 31, or 86 percent, resulted in a verdict of extra-contract compensatory or punitive damages. In 25, or 69 percent of the cases, the jury awarded punitive damages ranging from \$550 to \$8,000,000. More significantly, among these 36 cases, there were only three defense verdicts (i.e., where the jury found the insurer owed no contract benefits) and only two cases where the jury awarded contract benefits only (i.e., no extra-contract compensatory or punitive damages were awarded).

102. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 433-34, 426 P.2d 173, 179, 58 Cal. Rptr. 13, 19 (1967).

103. See, e.g., *Delos v. Farmers Ins. Group, Inc.*, 93 Cal. App. 3d 642, 15 Cal. Rptr. 843 (1979); *Pistorius v. Prudential Ins. Co.*, 123 Cal. App. 3d 541, 176 Cal. Rptr. 660 (1981).

104. 123 Cal. App. at 550, 176 Cal. Rptr. at 665.

105. 27 Cal. 3d 916, 616 P.2d 813, 167 Cal. Rptr. 831 (1980).

106. See Note, *Molien v. Kaiser Foundation Hospitals: Negligence Actions for Emotional Distress and Loss of Consortium without Physical Injury*, 69 CALIF. L. REV. 1142, 1153 n.52 (1981). After citing the *Crisci*, *Silberg* and *Gruenberg* cases, the footnote states:

Since these supreme court cases dealt only with insurers, a question remained whether the court would allow mental distress claims accompanying other tort or contract claims



Emotional distress damages are particularly problematic to an unpopular defendant because their definition is necessarily unclear and the guidelines for a jury are vague. In this context large and unwarranted awards for emotional distress can result. When punitive damages are also an issue the large emotional distress award is even more damaging because it can help to justify an even larger punitive award because the ratio between compensatory and punitive damages is one of the factors used in determining whether the punitive award is excessive.<sup>107</sup>

#### 4. Punitive Damages

##### a. Prejudice

Punitive damages, just as with emotional damages, can easily be the subject of abuse by jurors prejudiced against insurance companies.<sup>108</sup> The problems confronting insurers in regard to punitive damages can be illustrated by examining the guidelines used in determining the appropriate amount of a punitive damage award. *Neal v. Farmers Insurance Exchange* set forth the three established factors: the degree of reprehensibility of the defendant's acts, the amount of compensatory damages, and the wealth of the defendant.<sup>109</sup> One can assume whatever reprehensibility exists in the acts performed is easily magnified in the eyes of a jury when performed by an insurance company. As for the amount of compensatory damages, where damages for emotional distress can be awarded, the compensatory damages can be very substantial even though the defendant has little out-of-pocket loss. As for the wealth of the defendant, the substantial size of most insurance companies provides access to large punitive awards.

The recent court of appeal decision in *Pistorius v. Prudential Insurance Co.*<sup>110</sup> is an example of the problem insurers are faced with in the

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with a likelihood of serious emotional consequences. Also, the insurance cases dealt with parties in contractual relationships to one another. They might be explained as extending the contract notion of contemplated special damages. See *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854). But *Molten* allows claims for foreseeable emotional injury even when the claim is not tied to an invasion of another protected interest of the plaintiff. It clearly adopts a tort theory of broad liability for harm to a separate protected interest in freedom from serious mental disturbance.

107. *Neal v. Farmers Ins. Exch.*, 21 Cal. 3d 910, 928, 582 P.2d 980, 990, 148 Cal. Rptr. 389, 399 (1978).

108. See Kornblum, *The Defense of the First Party Extra-Contract Case: Strategy in Negotiations and Discovery*, 12 FORUM 721, 723 (1977).

Within the last eight years, juries have awarded punitive damages of \$1.5 million, \$2.5 million, \$4 million, \$5 million, \$5.3 million and \$8 million against insurers. Despite the publicity surrounding these punitive verdicts, the highest verdict to survive trial and appellate court review in California is the \$200,000 punitive damages awarded in the second appellate decision in *Wetherbee v. United Insurance Company* (footnotes omitted).

109. 21 Cal. 3d at 928, 582 P.2d at 990, 148 Cal. Rptr. at 399.

110. 123 Cal. App. 3d 541, 176 Cal. Rptr. 660 (1981).

area of damages. Disability payments were withheld over five months during a dispute between the insurer and insured, during which time the insured had another source of income and was able to purchase an automobile.<sup>111</sup> In examining the compensatory award of \$45,000, the appellate court assumed a breakdown of \$450 for attorneys' fees, present cash value of future policy benefits of \$17,200, and \$27,350 for emotional distress.<sup>112</sup> The court did not view the emotional distress award as being so grossly disproportionate as to raise a presumption of passion and prejudice requiring action by the reviewing court.<sup>113</sup> Having found the compensatory award was proper, the court held that the jury award of \$1,000,000 punitive damages was not excessive as a matter of law in view of the size of the compensatory award, the wealth of the defendant, and the defendant's conduct.<sup>114</sup>

### *b. Acts of Employees*

The ongoing liberalization of the law of punitive damages is creating even greater problems for insurers in bad faith cases. In *Egan*, the court held the insurer could be liable in punitive damages for the actions of a claims adjuster because he could dispose of an insured's claim with little or no supervision.<sup>115</sup> The critical inquiry in determining whether an employee acted in a managerial capacity depended upon the degree of discretion the employee possessed "in making decisions that will ultimately determine corporate policy."<sup>116</sup> The court apparently considered an employee's decision regarding a single claim to be within this definition. With an unprecedented<sup>117</sup> definition of managerial capacity of this breadth, large numbers of corporate employees will obviously be able to perform acts which can be attributed to the insurer and possibly result in the award of punitive damages.

Given the nature of the insurance business, insurers must permit their lower echelon employees to exercise a great deal of discretion. This necessity arises because of the volume of claims processed by the insurers. Specifically, much of this discretion is exercised by adjusters as they attempt to settle claims. *Egan* appears to state the unauthorized and unratified discretionary act of an adjuster makes company policy and is therefore managerial in nature. This is a novel view of how an

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111. *Id.* at 552, 176 Cal. Rptr. at 667.

112. *Id.* at 550, 176 Cal. Rptr. at 665.

113. *Id.* at 552, 176 Cal. Rptr. at 667.

114. *Id.* at 553-55, 176 Cal. Rptr. at 667-69. See also *Chodos v. Insurance Co. of N. Amer.*, 126 Cal. App. 3d 81, — Cal. Rptr. — (1981).

115. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 823, 598 P.2d 452, 459, 157 Cal. Rptr. 482, 489 (1979).

116. *Id.* at 822-23, 598 P.2d at 458-59, 157 Cal. Rptr. at 488-89.

117. *Id.* at 832-34, 598 P.2d at 465-66, 157 Cal. Rptr. at 495-96 (Clark, J., dissenting).

insurer's corporate policy is made and such "logic" places almost anyone performing a discretionary act for an insurer in a managerial role.

*c. Nature of Act*

The danger to the insurer resulting from the *Egan* definition of managerial capacity is heightened by the increasingly liberal definition of acts sufficient to permit an award of punitive damages. Increasingly, acts of negligence are seen as sufficient grounds.<sup>118</sup> *Egan* provides an excellent example. In that case, punitive damages were assessed against the insurer following a finding by the trial court that as a matter of law the insurer had violated the covenant of good faith and fair dealing where a disability claim was denied without having the insured examined by one of its own physicians or by consulting the insured's treating physicians and surgeon.<sup>119</sup> The adjusters had mistakenly relied on the physicians' written reports alone instead of making an effort to discuss the case with them.<sup>120</sup>

As in the case of the liberalization of the requirements for obtaining damages for emotional distress, the liberalization in regard to punitive damages will likewise increase the impact of bad faith law on insurers.

*B. Insurer Problems With Royal Globe*

In first party cases, the addition of a *Royal Globe* cause of action broadens the insurer's existing liability and increases the insurer's exposure for denying claims. A basic problem insurers will have in defending against *Royal Globe* causes of action is the broad language used in Section 790.03. It is completely understandable that the section was broadly written in view of the fact that the real purpose of the act was to allow the Insurance Commissioner to prevent unfair practices by insurers. It was designed so the Commissioner would have the maximum amount of flexibility in implementing Section 790 for the prospective benefit of the public. To take this broad language and allow private parties to use it in private actions against insurers exposes them to unfair results. When the language is as all-encompassing as it is in Section 790, the jury passing judgment on a disfavored defendant is given an unparalleled opportunity to find liability. Once this is done, the tort damages already discussed become available.

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118. See, e.g., *Taylor v. Superior Court*, 24 Cal. 3d 890, 594 P.2d 854, 157 Cal. Rptr. 693 (1979); *Nolin v. National Convenience Stores, Inc.*, 95 Cal. App. 3d 279, 157 Cal. Rptr. 32 (1979). See also a discussion of punitive damages cases not requiring intent in Note, *Taylor v. Superior Court: Punitive Damages for Nondeliberate Torts—The Drunk Driving Context*, 68 CALIF. L. REV. 911 (1980).

119. 24 Cal. 3d at 817, 598 P.2d at 455, 157 Cal. Rptr. at 485.

120. *Id.* at 832, 598 P.2d at 465, 157 Cal. Rptr. at 495 (Clark, J., dissenting).

In third party *Royal Globe* cases, problems of overbreadth of language in Section 790 and of tort damages also apply. In addition, *Royal Globe* established what approaches a fiduciary obligation upon the insurer toward its adversary, the third party claimant, in claims settlement practices. An example of the benefit to third party claimants can easily be seen by looking at the opportunities provided to the third party claimant by Section 790.03(h)(5), which requires the insurer attempt "in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear." The insurer has now been left in a situation where any time it does not settle a case and a subsequent jury award is the same as the amount of the third party claimant's settlement demand or greater, the insurer is vulnerable to a *Royal Globe* action for bad faith for failing to settle. The obvious impact on liability carriers is to encourage them to pay more in settlement because such settlements not only end the present lawsuit but may prevent a *Royal Globe* action in the future. The increased settlement costs required to settle the actual lawsuit and the potential one that hovers over most litigation involving an insured defendant will obviously result in higher premiums. In addition, those insurers that have the courage to refuse settlement where they do not feel it is warranted will necessarily be the subject of additional litigation because they will not in all instances have guessed correctly regarding the value of the case. When they have guessed incorrectly, *Royal Globe* encourages lawsuits against them.

An additional problem created by *Royal Globe* in the third party area is the inevitable conflicts of interest created by the insurer's obligations to its insured and its *Royal Globe* obligations to the insured's adversary, the third party claimant. This third party situation is different from the common law third party bad faith situation because in the latter the insurer was requested by the insured to pay the third party adversary. In the *Royal Globe* situation, the insured need not be demanding settlement, but may to the contrary want his case vigorously defended by the insurer or at least settled for the least amount possible.

In both first and third party *Royal Globe* cases, the potential for massive, invasive discovery into insurer files exists because one way to establish liability is to prove that an insurer has performed a section 790.03(h) proscribed act as a general business practice.<sup>121</sup> The costs of such discovery in time and money and the potential for abuse is readily apparent.

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121. See generally Levy & Ursin, *Tort Law in California: At the Crossroads*, 67 CALIF. L. REV. 496 (1979) [hereinafter cited as Levy & Ursin].

### THE DEVELOPMENT OF BAD FAITH LAW—WAS IT AN ATTEMPT TO REDUCE TORT SYSTEM COSTS?

The legislative remedy suggested later in this article is proposed as an attempt to cut the cost of insurance as well as the cost of administering the tort system. In a 1979 article in the California Law Review, the theory was put forth that the supreme court had this latter goal in mind in its creation of insurance bad faith law.<sup>122</sup> The article noted that in a wide variety of decisions in the 1960's and 1970's the supreme court had significantly expanded the incidence of tort liability in California and through 1976 had developed a damages doctrine which permits large awards.<sup>123</sup> The article theorized that beginning in 1977 the court has attempted in certain decisions to limit tort system costs by decreasing the size of awards and cutting the cost of administering the tort system.<sup>124</sup> One "device" used by the court to encourage settlement and thereby reduce tort system administrative costs, according to the article, is the "bad faith" award against insurers.<sup>125</sup>

The article classified bad faith law within a broader category described as "implicit damages" cases, mainly cases decreasing damage awards and therefore tort system costs.<sup>126</sup> The article concluded the "implicit damages" approach was one that muddies tort doctrine, confusing lawyers and other observers of the court, and is too inexact a method to assure proper results in varying patterns.<sup>127</sup> These criticisms can certainly be applied to California insurance bad faith law.

### THE DEVELOPMENT OF BAD FAITH LAW—ACTUALLY AN EXAMPLE OF A BROADER PROBLEM OF UNCONTROLLED EXPANSION OF THE TORT SYSTEM AND ITS COSTS

The problems growing out of the development of insurance bad faith law represent a danger inherent in creating a new form of tort liability

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122. Lévy & Ursin, *supra* note 113, at 518-19.

123. Lévy & Ursin, *supra* note 113, at 521.

124. Lévy & Ursin, *supra* note 113, at 535-36.

125. Lévy & Ursin, *supra* note 113, at 521.

126. Lévy & Ursin, *supra* note 113, at 539-40.

127. See remarks of Guy O. Kornblum in this regard in Davis, *Joint Program of the Defense Research Committee and the Defense Research Institute*, XLVIII Insurance Counsel Journal 556, 559 (1981):

I can't tell you the number of *Royal Globe* cases that are being filed. Almost every case involving a claim either with first or third party coverage now includes a *Royal Globe* statutory claim, setting forth the precise provisions. The attempt to get into the insurer's files, the discovery that is conducted, is absolutely massive because the statute requires either a knowing violation or a continuous practice. And under the continuous practice portion of 790.03(h), discovery can be conducted into other lawsuits, other claims, the types of claims that are being handled in the state, how claims are being handled nationwide, so that it's virtually unlimited as far as the potential discovery with the limitation only being what time plaintiff has to put into his lawsuit.

today, particularly because the various types of tort damages are so broad and generous. Once a new tort is established, perhaps in a case or cases where tort damages may be warranted in terms of pure equity (e.g., *Comunale* and *Crisci*), the tort may eventually be applied to countless other situations where it is often inappropriate and not in the best interest of society (e.g., the millions of health care claims now subject to common law bad faith, *Royal Globe*, and the liberal and ever-expanding damages law). The age-old adage, "bad cases make bad law," is true now more than ever in the California tort field. In earlier times when decisions such as *Molien*, for example, did not exist, the evolution of a new tort had less impact than it now has because the damages allowed by law were much more limited. Torts traditionally dealt most often with situations in which the plaintiff obtained reimbursement mainly for "hard injuries" such as quantifiable and substantial physical or economic losses. Now, in an atmosphere of relatively easy accessibility to damages for emotional distress and punitive damages, the impact of having created a new tort and then expanding it with *Royal Globe* is tremendous. In short, concomitant expansion of both tort forms of liability and tort damages has a synergistic, geometric effect on the expansion of overall tort system costs.

Long ago, Justice Traynor indicated his concern in this area. He was an early leader in the expansion of tort remedies to distribute accident losses in a society in which insurance had become widespread.<sup>128</sup> He was concerned, however, about the effect that damages could have once the incidence of liability had been significantly increased. For example, he questioned whether damages for pain and suffering should be allowed in a system based on the distribution of losses through insurance.<sup>129</sup>

Currently in bad faith law, many plaintiffs appear to be receiving large awards not because of actual injuries but because of tests of liability approaching strict liability and because of jury prejudice against insurers. These verdicts, as well as the insurers' other costs of increased litigation and the defensive payment of questionable or fraudulent claims, result in costs that are not in fact what "loss distribution" should be about. Present bad faith law has magnified claims denials both legitimate and otherwise into a cost to society much greater than any actual losses by plaintiffs.

Because actual losses by plaintiffs in bad faith cases are a relatively small part of this societal expense, the costs of the impact of bad faith

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128. Levy & Ursin, *supra* note 110, at 497-500.

129. Levy & Ursin, *supra* note 110, at 520-21.

law might instead be termed "legal costs distribution." Attorneys, both in the plaintiffs' and defense bar, are obviously reaping the benefits of the massive impact of insurance bad faith litigation. Plaintiffs' counsel are sharing in the settlements and awards of their clients in bad faith litigation and are undoubtedly obtaining higher settlements in other areas of their practices because of the spectre of bad faith law. The defense bar, as in any situation where litigation increases in absolute numbers and in the potential exposure of the defendants, profits from the increased needs of its clients. While the evolution of bad faith law has provided increased revenues and employment for attorneys, the society, through increased insurance premiums and other costs, has had to foot the bill as it has in other areas where the creation of new law has resulted in large and burdensome societal costs resulting to a large extent from the need for legal services.

It is probably too late for the supreme court to turn back from the course it has taken in insurance bad faith law, particularly in view of the court's present composition, and a legislative remedy appears to be the only immediate answer. However, because of the power of the plaintiffs' bar as represented by the California Trial Lawyers Association, any legislative remedy is probably impossible.<sup>130</sup> Nevertheless, the following proposal is made as an initial attempt to limit the tort costs of bad faith litigation.

#### INTERIM LEGISLATION

The following proposal is basically a procedural one which follows, in many respects, the format established by the existing declaratory relief statutes, California Code of Civil Procedure Section 1060, *et. seq.*<sup>131</sup> It is primarily aimed at resolving coverage questions at an early stage in an attempt to limit the expenses of first-party litigation and, where applicable, the damages of the insured. The proposal provides for declaratory relief *as well as*, in the discretion of the court, reasonable attorney's fees and other reasonable and necessary costs of litigation. Further, where the judgment is entered against the insurer, the court may award a penalty and all actual economic damages to the insured. It is hoped that the discretionary award of legal fees and costs will encourage a party that anticipates victory to use the expedited procedure. The insurer would presumably be in this position if it chooses to deny

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130. Beginning with Senate Bill 483, introduced by Senator Beverly on March 1, 1979, no legislative bills introduced to modify the *Royal Globe* decision have become law. No bills to otherwise modify "insurance bad faith" law have ever become law.

131. See Holmes, *A Model First-Party Insurance-Excess Liability Act*, 14 GA. L. REV. 497 (1980), for an example of a comprehensive legislative proposal dealing with the first party area.

contract benefits. The additional discretionary monetary awards (penalty and economic damages) that can be awarded to the insured should encourage insureds to use the expedited procedure and discourage insurers from denying valid claims. The relief available would be cumulative to other remedies, but would provide a forum for the expeditious resolution of the underlying contract question and some ancillary issues.

The proposal does not base the court's discretionary award on either strict liability or fault liability. A strict liability standard would encourage insurers to pay more claims and be less cost-efficient if all errors in judgment resulted in liability. Such a situation would obviously raise insurance premiums to even higher levels. A fault liability standard of "bad faith" would add another issue to the proceeding and complicate what is designed to be a streamlined hearing. Instead, the court's discretion in making an award can be tailored to the individual case and given where merited. Where coverage is determined to exist, the court's evaluation of whether "bad faith" existed will probably be implicit in its decision whether to award a penalty and economic damages.

This proposal will be of the most direct benefit in the first party case. Regardless of the type of coverage in effect, the central question is whether coverage exists. Once this determination has been made, the proceedings will terminate if the decision is in favor of the insurer. If the insurer loses, there may be another action in which the question of the insurer's bad faith is litigated. The benefits of the expedited procedure should be obvious: all parties have the chance to obtain expedited review. An early decision, even though adverse to the insurer, will allow it to do whatever is appropriate under the circumstances to minimize its losses. If the decision is adverse to the insured, the insured will know at an earlier date whether to make adjustments to deal with the absence of coverage. For example, if the question pertains to coverage for medical care, the insured may forego certain elective procedures and not incur services which are not a benefit under the contract.

The legislative proposal will probably be somewhat less effective in reforming the third party situation. Coverage questions do arise occasionally, and the prompt resolution of the question of whether the carrier is obligated to defend and indemnify the insured will be mutually beneficial.<sup>132</sup> This legislative proposal will, however, probably not be of much help in the excess liability case. There the insurer's exposure is

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132. See generally *Samson v. Transamerica Ins. Co.*, 30 Cal. 3d 220, 178 Cal. Rptr. 343 (1981), as an example of a situation where declaratory relief in a third party situation might have been helpful to an insurer.



dependent on the outcome of the underlying liability action. Generally, there is no way an independent action for declaratory relief will provide any benefit to the parties since it is the outcome of the underlying liability case which is foundational to the insurer's potential exposure. Expedited declaratory relief may be of some help in the case where there is a genuine dispute whether a demand was made by the insured to settle within the policy limits.

It is impossible to say the proposal which follows will not be misused. Plaintiffs' lawyers may test the waters to determine if they have a valid bad faith action by filing a barrage of declaratory relief actions and then proceeding with a bad faith case in those cases where a favorable decision is obtained. Insurers can, however, minimize losses inherent in a situation which allows for as much as a five year wait for trial by obtaining a declaratory relief ruling. Although the statutory proposal is intended to encourage insurers to go to court and seek a declaratory judgment, the decision in the *Johansen* case may discourage insurers from taking this approach.

To meet these various needs, it is suggested that the proposed provision be enacted as Code of Civil Procedure Section 1062.6, to read:

**CODE OF CIVIL PROCEDURE SECTION 1062.6**

**(Action Respecting Rights, Duties and Obligations of Insurers,  
Hospital Service Plans and Health Care Service Plans)**

(a) Any reciprocal exchange, interinsurer, Lloyd's insurer, fraternal benefit society, fraternal fire insurer, motor clubs, or any person engaged in the business of insurance (hereinafter "insurer"), or any hospital service plan, any health care service plan, or any insured, enrollee, subscriber, beneficiary or any other potentially aggrieved person, may bring an action for a declaration of its, his, or her rights, duties and obligations under the terms of the policies or contracts under which coverage is alleged to exist.

(b) An action brought pursuant to this section shall be set for trial at the earliest possible date and shall take precedence over all other cases, except older matters of the same character and matters to which special precedence may be given by law.

(c) The court may make a binding declaration of the rights, duties and obligations of the parties under the terms of the policies or contracts under which coverage is alleged to exist. The declaration may be affirmative or negative in form and effect and shall have the force and effect of a final judgment.

(d) The court also may in its discretion award reasonable attorneys' fees and other reasonable and necessary costs of litigation to the prevailing party; and, if judgment is entered against the insurer,

hospital service plan or health care service plan, the court in its discretion may also award:

- (1) a penalty calculated not to exceed the greater of \$500.00 or 10% of the benefits at issue; and,
- (2) the amount of actual economic damages sustained as a direct result of the insurer, hospital service plan, or health care service plan's failure to furnish benefits.

(e) The remedy established by this section is cumulative, and shall not be construed as restricting any remedy established for the benefit of any party to the action by any other provision of law. No declaration under this section shall preclude any party from obtaining additional relief based upon the same facts. Any award obtained pursuant to this section shall be credited against any award obtained in another action based upon the same facts.

(f) The existence of another action between the parties to a suit brought pursuant to this section shall not preclude the court from proceeding with the action brought pursuant to this section unless the other action is also brought exclusively pursuant to the terms of this section.

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#### CONCLUSION

In addition to the procedural changes suggested by this statute, a fundamental reexamination of the law of bad faith needs to be undertaken in California. The recent trend in large awards can only result in an increase in the cost of coverage for all Californians. The cost of coverage is one shared not only by all insureds, but by all individuals who purchase goods and services from an insured. The basic notion of insurance, sharing the risk of loss, ultimately means that the public pays the costs through increased rates or, ultimately, a diminution in coverage. The legislative proposal is a modest step in the process of stabilizing the law in this area, to avoid excesses that occur when either insurers or insureds are favored under the law.

