

NEGOTIATING AND SETTLING INSURANCE BAD FAITH CASES¹

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BACKGROUND

I've been handling bad faith insurance cases for almost my entire career. Initially the majority of cases encompassed the “duty to settle—excess liability cases” wherein the insurer became responsible for the entire amount of a judgment against its insured because the insurer acted imprudently or unreasonable by failing to accept a demand from a plaintiff for the policy limits or less. The basis for this liability was the implied covenant of good faith and fair dealing which exists in all contracts, but which has a special meaning in insurance policies. This covenant of good faith serves as the foundation for the expansion of insurers’ legal responsibility into the realm of tort liability stemming from its “bad-faith” conduct.² If the insurer breaches the covenant of good faith by wrongfully handling an insurance claim under the applicable standard, a tort is committed.³

¹ Some of this material was taken from *Negotiating and Settling Tort Cases*, co-authored by Mr. Kornblum and Matt Garretson, published by the Thomson West Publishing Company and the American Association for Justice in 2007, and supplemented in 2008 and 2009. See Chapter 12A. Mr. Kornblum has co-authored two books on insurance bad faith litigation, *California Practice Guide: Bad Faith*, published by The Rutter Group (1986), and *Litigating Insurance Claims: Coverage, Bad Faith, and Business Disputes*, published by Wiley & Sons (1993).

² The term “bad faith” is a generic reference to actions seeking recovery beyond the policy, regardless of the theory of recovery. The term “bad faith” can also refer specifically to the theory of violation of the implied covenant of good faith and fair dealing.

³ An insurance “bad faith” claim involves a breach of the insurance contract which also constitutes a tort based on a violation of the implied covenant of good faith and fair dealing that is implicit in the contractual relationship of insurer and insured, and governs that relationship. It involves more than just a breach of the specific contractual duties or simply mistaken judgment but is based on unreasonable conduct by the insured as well. *Congleton v. National Union Fire Ins. Co.* (1987) 189 Cal.App.3d 51, 59.

In the early 70's, the California Supreme Court applied these concepts to first party insurance relationships, i.e. where the insurer has promised to pay an insured for a covered loss. This type of coverage is found in all types of insurance relationships: commercial and personal property insurance, medical pay insurance, life, health and medical insurance, and other "direct reimbursement" insurance situations.

When the insurer's conduct constitutes a tort, the plaintiff can recover damages for injuries that were proximately caused by that conduct, whether or not the injuries could have been anticipated when the contract was executed. Thus, in addition to contract damages, the insured may be able to recover *extra-contractual* damages, which are damages beyond those usually permitted for a breach of contract using the tort measure of damages.⁴ These include compensatory damages, damages for emotional distress, economic losses, and even attorneys' fees. Moreover, punitive damages may be awarded in certain instances tort claims where a higher degree of misconduct is proven.

The potential exposure to punitive or exemplary damages is the greatest danger to an insurer defending an extra-contractual claim.⁵ For example, courts have allowed the recovery of punitive damages when the insurer's breach is accompanied by an independent tort or where a serious wrong of a tortious nature has been committed and the public interest would be served by the deterrent effect of punitive damages.⁶

⁴ Damages for breach of contract are usually measured by those that are foreseeable at the time of the formation of the contract, while those resulting from a tort are measured by the injuries that are a proximate result of the tortious conduct. See, e.g., *Erllich v. Menezes* (1999) 21 Cal.4th 543, 550.

⁵ *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal. 3d 809; see also, *Neal v. Farmers Ins. Exchange* (1978) 21 Cal.3d 910.

⁶ See *White v. Unigard Mut. Ins.* (1986) 112 Idaho 94, 97; see also, *Waters v. United Services Auto. Ass'n.* (1996) 41 Cal.App. 4th 1063, 1069-70 ("The gravamen of a first-party lawsuit is a breach of the implied covenant of good faith and fair dealing by refusing, without proper cause, to compensate the insured for a loss covered by the policy...or by unreasonably delaying payments due under the policy"); *Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566; *Sparks v. Republic Natl. Ins. Co.* (1982) 1332 Ariz. 529.

GENERAL PRINCIPLES

Insurance bad faith cases fall primarily into two categories: first-party and third-party cases. *First-party cases* evolve from coverage in which the insurance company is obligated to indemnify or reimburse its insured directly. *Third-party cases* involve underlying claims which trigger an insurer's obligations to protect an insured against lawsuits by others. It involves the basic obligations of the insurer to *defend* and *indemnify* the insured, and to *settle* such cases when a reasonable opportunity to do so is presented. The right to coverage is triggered by strangers to the insurance relationship who bring a suit against the insured. It draws on traditional tort concepts of fault, proximate cause and duty. "In liability insurance, by ensuring personal liability, and agreeing to cover the insured for his own negligence, the insurer agrees to cover the insured for a broader spectrum of risks."⁷

Within the framework of the third-party claim is the "duty to defend" case, which involves claims by an insured against an insurer for breach of the obligation to defend the insured when suit is brought against it. This case may arise even if the insurer has no duty to indemnify under the same coverage since the duty to defend is broader than the duty to indemnify. The former is triggered by the potential for coverage; the latter is triggered by actual coverage.⁸

⁷*Garvey, supra*, n. 7, at 407. Third-party cases result from claims "arising out of the insurer's mishandling of a third party claims against its insured, such as by unreasonably refusing to settle within policy limits. . .or unreasonably refusing to provide a defense. . . ." *Waters v. United Services Auto. Ass'n., supra*, n. 6, at 1070. As noted in this Chapter, the failure to settle cases often result in the insured assigning its claims to the insurance policy proceeds plus any right to recovery any excess judgment to the third-party claimant in return for insulation from execution by that claimant on the insured's assets through a covenant not to execute.

⁸ For a good summary pertaining to the basic rules regarding the duty to defend, see *Buss v. Superior Court (Transamerica Ins. Co.)* (1997) 16 Cal. 4th 35.

Many types of property and casualty policies contain both first and third-party coverage. For example, an auto policy which protects the insured against the risk of property damage to its vehicle, may also provide for medical expense coverage (called medical payments coverage), and normally contains uninsured and underinsured motorist coverage. The latter allows the insured to bring a claim against its own insurer if the insured is the victim of an accident in which the offending driver's vehicle has no insurance or the applicable liability insurance limits are insufficient to compensate the insured for the injuries suffered in the accident. Unreasonable conduct in the processing or handling of these claims may expose an insurer to a "bad faith" claim.⁹

The focus of a third-party case is on the insurer's refusal to settle a claim or lawsuit against its insured within the limits of liability of the insurance policy and a judgment in excess of the liability limits results from a trial. As a result, the insured's personal assets are exposed because of the insurer's failure to settle within the framework of the liability protection when it was prudent to do so.

The classic breakdown of the first-party insurance bad faith case is represented by a three-tiered analytical framework: 1) breach of the insurance contract; 2) the tort of insurance bad faith (or other tort converting the contract action to a tort claim); and 3) the punitive damage claim. Theoretically, this is a mixture of legal theories and remedies.¹⁰

The first tier involves whether a breach of the policy's terms has occurred (i.e., a breach of contract) and, if so, what policy benefits (i.e., contract damages) are owed. Contract damages are limited to those damages reasonably contemplated by the parties at the time the

⁹ See *Garvey, supra*, n. 7; *Neal, supra*, n. 5.

¹⁰ The first tier is based on the contract theory of recovery, the second on a tort theory, and the third on a remedy (i.e., punitive damages) which is available only if a tort is proven. See, e.g., *Transportation Ins. Co. v. Moriel* (Tex. 1994) 879 S.W.2d 10; *Erie Ins. Co. v. Hickman* (Ind. App. 1993) 622 N.E.2d 515.

bargain is struck.¹¹ Such damages are ordinarily limited to the payments or benefits due under the policy and do not include future contract benefits or damages for emotional distress or punitive damages.¹²

The second tier involves looking at the *conduct* of the insurer in handling the claim or matters entrusted to it; has the *tort* of insurance bad faith been committed? If so, what *extra-contractual compensatory* damages (financial injury resulting in economic losses coupled with emotional distress and attorneys' fees) have resulted from this conduct?

The punitive damage claim is not a separate legal claim but a remedy appended to a tort claim. In insurance bad faith law, the right to pursue punitive damages exists only if an underlying tort, such as insurance bad faith, is established. Without the underpinning of the tort claim, no punitive damages are available.

The third tier requires examining again the conduct of the company and determining, by the requisite burden of proof,¹³ if punitive damages would be awarded under the applicable standard.¹⁴ In California, that requires proof of “malice, fraud or oppression”¹⁵ by “clear and convincing” evidence.¹⁶

¹¹ Cal. Civ. Code § 3300; see also, *Erie, supra*, n. 35; *Indiana & Mich. Elec. Co. v. Terre Haute Industries, Inc.* (Ind.App. 1987) 507 N.E.2d 588; *Indiana University v. Indiana Bonding & Surety Co.* (Ind.App. 1981) 416 N.E.2d 1275, 1288.

¹² But see *Frazier v. Metropolitan Life Ins. Co.* (1985) 169 Cal.App.3d 90. The court found that the plaintiff had proved damages sufficient to entitle her to claim emotional distress on a breach of contract theory but rejected her request for exemplary damages.

¹³ Cal. Civ. Code § 3295(a); see also, *Linthicum v. Nationwide Ins. Co.* (1986) 150 Ariz. 326, 332.

¹⁴ For a recent case analyzing the standard for awarding punitive damages, see *Sloan v. State Farm Mutual Automobile Ins. Co.* (2004) 360 F.3d 1220. In that case, the court stated at p. 1235,

. . . [W]e conclude that in most cases, the plaintiff's theory of bad faith, if proven, will logically also support punitive damages. To ensure, however, that a jury only awards punitive damages for bad-faith conduct manifesting a culpable mental state, and not for conduct that may fall short of such reprehensibility, we find it necessary to augment the punitive-damagers instruction to reflect the requisite standard for a culpable mental state. Accordingly, we modify the first sentence of [just instruction] to read as follows:

Thus, a bad faith claim has these three very separate and distinct components: A breach of contract is not bad faith – there must be an examination of the conduct of the company to determine if the manner of handling the claim was consistent with “good faith” principles.¹⁷ However, proof of bad faith is not enough to impose punitive damages – “something more” is required,¹⁸ which has been expressed as an “evilness”¹⁹ in the corporate scheme of things, or the “collective corporate conduct.”²⁰

The different standards and burdens applied must be evaluated. If not, they offer the defense an excellent opportunity to “compartmentalize” the case and defeat the plaintiff’s effort to obtain relief for the wrongs done in an amount sufficient to accomplish the goal of giving notice that such conduct should be stopped.

LOOKING AT LIABILITY FOR BAD FAITH

If you find that plaintiff should recover compensatory damages for the bad faith actions of the insurance company, and you find that the conduct of the insurance company was in reckless disregard for the interests of the plaintiff, or was based on a dishonest judgment, or was otherwise malicious, willful, or wanton, then you may award punitive damages.

¹⁵ Cal. Civ. Code § 3294(a) (emphasis added).

¹⁶ *Id.*

¹⁷ For some thoughts on what the “good faith” principles require, see, Guy O. Kornblum “*Avoiding Botched Up Claims,*” Best’s Review (Property/Casualty Insurance Edition) March 1992, Vol. 92, No. 11, p. 62.

¹⁸ As Cameron, J. said in *Linthicum v. Nationwide Ins. Co.*, *supra*, n. 37, at 330: “To recover punitive damages, *something more* is required over and above the ‘mere commission of a tort’.... The wrongdoer must be consciously aware of the wrongfulness or harmfulness of his conduct and yet continue to act in the same manner in deliberate contravention to the rights of the victim (emphasis added).”

¹⁹ *Id.* at 331: “We hold that before a jury may award punitive damages there must be evidence of an ‘evil mind’ and aggravated and outrageous conduct.”

²⁰ Of course, any punitive award is susceptible to post trial review by the appellate courts. See, e.g., *State Farm Ins. Co. v. Campbell* (2003) 538 U.S. 408; see also, *Philip Morris USA v. Williams* (2007) 127 S. Ct. 1057. For a recent California case in which the trial court reduced a punitive award (from \$8.3 million to \$1.5 million) using the “Campbell” standards, see *Walker v. Farmers Ins. Exch.* (2007) 153 Cal.App.4th 965, which involved an insurer’s breach of the duty to defend. The trial court found that the ratio of punitives to compensatory damages of 5.5 to 1 was excessive and reduced the punitives to a 1 to 1 ratio even though *Campbell* approved a 9 to 1 ratio.

Assuming that there is contractual liability, the next question is whether the compensatory damages are limited to the contract standard as contemplated at the time of the agreement or the tort standard based on proximate cause and foreseeability.

While not an exhaustive list, the following are *indicia* of bad faith conduct under various standards:

- Failure to investigate a claim thoroughly;
- Failure to evaluate a claim objectively;
- Unduly restrictive interpretation of policy language or claims forms;
- Unjustified delay in payment of a claim;
- Dilatory handling of claims;
- Deceptive practices to avoid payment of a claim;
- Abusive or coercive practices to compel compromise of a claim;
- Unreasonable conduct during litigation;
- Arbitrary and unreasonable demands for proof of loss;
- Absence of a reasonable basis for delay in payment or for the denial of a claim;
- Improper refusal to defend an insured;
- Improper handling of defense of insured, resulting in loss of goodwill;²¹ and
- Deliberate misinterpretation of records or the policy to defeat coverage.²²

²¹ See, e.g., *Bodenhamer v. Superior Court (St. Paul Fire & Marine Ins. Co.)*, *supra*, n. 7.

²² While there is no formal “affirmative defense” of “bad faith” [by the insured] (*Kransco v. Am. Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4th 390), the conduct of the insured is admissible on the question of whether the insurer met its obligations of good faith and fair dealing. For example, an insurer may claim the insured failed to cooperate in the investigation of a claim or failed to provide necessary information to a claim’s evaluation, which resulted in the inability of the insurer to process the claim fully.

The duty to investigate is an important duty of an insurer. Hence, it can be an important part of a bad faith case. The erroneous withholding of policy benefits based on the insurer's failure to investigate a claim may constitute a breach of the implied covenant of good faith and fair dealing.²³ In order to protect the insured's peace of mind and security, "an insurer cannot reasonably and in good faith deny payments to its insured without *thoroughly* investigating the foundation for its denial."²⁴ An insurer must "fully inquire into possible bases that might *support* the insured's claim."²⁵ The investigation must be prompt, thorough, reasonable, and conducted in good faith. That is to say, *the insurer must consider facts favorable to the insured's position as well as those that favor the insurer*. This is one aspect of the insurer's duty to give equal consideration to both the insurer's and the insured's interests.²⁶

California has codified the duty to investigate in the Unfair Practices Statute ("UPA") which requires the insurer "to adopt and implement reasonable standards for the prompt investigation and processing of claims arising under insurance policies."²⁷ Even though no private right of action may exist under these statutes,²⁸ the application of the duty to investigate remains important. The UPA confirms the industry standards. Alternatively, other standards may be adopted by the company as fair standards for processing a claim. A violation of the

²³ See, e.g., *Wilson v. 21st Century Ins. Co.* (2007) 42 Cal.4th 713

²⁴ *Egan v. Mutual of Omaha Ins.Co.*, *supra*, n. 5, at 819 (emphasis added).

²⁵ *Id.* at 819 (emphasis added).

²⁶ *Id.* at 818.

²⁷ Cal. Ins. Code § 790.03(h)(3).

²⁸ See, e.g., *Moradi-Shalal v. Fireman's Fund Ins. Companies* (1988) 46 Cal.3d 287.

statutory, industry, or self-imposed standards provides support for a bad faith claim. They can serve as standards for determining the bad faith conduct of the insurer.²⁹

The Insurer’s “Good Faith Dispute” Defense

Recent cases have allowed an insurer to defend against charges of bad faith by raising the “good faith dispute” or “genuine issue” defense. That is, the insurer claims that because there is a genuine issue of fact or law regarding its liability for the claim, it is insulated from any potential bad faith liability. This is a misleading statement and may very well not be a sound argument. The “genuine issue” argument must be carefully analyzed.

The “genuine issue” doctrine arose as a defense to a claim of bad faith. It was created by the Ninth Circuit Court of Appeals, allowing district courts to conclude as a matter of law that an insurer’s denial of a claim is not unreasonable, so long as there is a “genuine issue as to the insurer’s liability.”³⁰ Up until the January 2001 decision in *Guebara v. Allstate Insurance Co.*,³¹ the Ninth Circuit had always interpreted the “genuine issue” to mean an uncertainty as to the applicable law. California courts adopting and applying the “genuine issue” doctrine applied it to coverage disputes arising from questions of law, i.e., disputes over policy interpretation or areas of unsettled and uncertain law.

However, more recently, in *Wilson v. 21st Century Ins. Co.*,³² the California Supreme Court reversed the trial court’s granting of summary judgment in a case in which

²⁹ See, e.g., *McLaughlin v. Natl. Union Fire Ins. Co.* (1994) 23 Cal.App.4th 1132. For example, the UPA may provide a “good faith” standard which an insurer will have to acknowledge. If it does not, it can be argued that it violated “the law.” Likewise, industry standards can establish “custom and practices” which also set standards for “good faith” claims practices. Further, internally established standards provide guidelines for company operatives which, if violated, also provide evidence of “bad faith” conduct.

³⁰ *Am. Cas. Co. v. Kreiger* (9th Cir. 1999) 181 F.3d 1113, 1123 (quoting *Lunsford v. Am. Guar. & Liab. Ins. Co.* (9th Cir. 1994) 18 F.3d 653, 656).

³¹ (9th Cir. 2001) 237 F.3d 987

³² (2007) 42 Cal.4th 713.

plaintiff/insured sought the \$100,000 policy limits in underinsured motorist benefits as a result of a motor vehicle accident with an automobile driven by a drunk driver.³³ 21st Century based its motion on the “genuine dispute” as to the value of the claim. The California Supreme Court rejected their position, observing that:

The genuine dispute rule does not relieve an insurer from its obligation to thoroughly and fairly investigate, process and evaluate the insured's claim. ... “The genuine issue rule in the context of bad faith claims allows a [trial] court to grant summary judgment when it is undisputed or indisputable that the basis for the insurer's denial of benefits was reasonable—for example, where even under the plaintiff's version of the facts there is a genuine issue as to the insurer's liability under California law. [Citation] ... On the other hand, an insurer is not entitled to judgment as a matter of law where, viewing the facts in the light most favorable to the plaintiff, a jury could conclude that the insurer acted unreasonably.” [Citation] Thus, an insurer is entitled to summary judgment based on a genuine dispute over coverage or the value of the insured's claim only where the summary judgment record demonstrates the absence of triable issues [Citation] as to whether the disputed position upon which the insurer denied the claim was reached reasonably and in good faith.³⁴

To overcome the “genuine issue” doctrine, it is critically important to disabuse trial courts of any misconceptions about the extent of the doctrine in the first instance. In fact, the “genuine issue” rule is not a “rule” at all. It is a principle which has a limited and defined application. It is to be applied on a “case-by-case basis” and can only be applied if the underlying facts creating the so-called “genuine issue” are undisputed. Thus, if any of the underlying facts are in dispute, as a matter of law, the “genuine issue” defense cannot be applied. Even then, the principle only “may” apply.

Insurance companies have increasingly relied on what they perceive as an emerging “defense” to their denials or wrongful handling of claims from their insureds: the “good faith

³³ Plaintiff's UIM limits were \$100,000. She collected the \$15,000 limits from the drunk driver's carrier, leaving her with a claim for a balance of \$85,000 against her own UIM coverage.

³⁴ *Id.* at 754-755. The Court found that 21st Century had not met this burden because it had not thoroughly and fairly investigated, processed and evaluated the insured's claim. See *Id.* at 756.

dispute.”³⁵ Initially, this doctrine arose in the context of a genuine coverage dispute, in which the Ninth Circuit advanced the proposition that a “genuine dispute” as to coverage suggests that an insurer acted reasonably. However, the doctrine is greatly overstated by insurance companies, as confirmed by *Wilson*. Indeed, prior to *Wilson*, there was a notion in at least one case that the principle was being relied on too heavily, and being misapplied.³⁶ At least one case has held that even reasonable conduct can expose a carrier to bad faith in certain circumstances.³⁷

The cases concede that this doctrine cannot be applied if:

- The insurer is guilty of misrepresentation in handling the claim;
- The insurer’s employees lie during deposition or discovery or to the insured;
- The insurer dishonestly selected its experts;
- The insurer’s experts are unreasonable; or
- The insurer fails to conduct a reasonable investigation.³⁸

³⁵ See *Chateau Chamberay Homeowners Assn. v. Associated Internat. Ins. Co.* 90 Cal. App. 4th 335, in which the insured homeowners association suffered damage to condominium structures as the 1994 Northridge Earthquake. The carrier investigated and made some advance payments in the six figures. The insured submitted its estimate of repairs for several million dollars, including some items not covered. Suit was filed, after which the parties agreed to arbitration, where a substantial portion was rejected by the arbitrator. The insurer moved for summary judgment on the bad faith claim, with supporting declarations spelling out in detail the property adjustment process. There was no counter by the insured. The motion was granted and affirmed on the basis that there was a “genuine dispute.” However, the court cautioned: “. . . [This] does not mean . . . that the genuine dispute doctrine may properly be applied in every case involving a purely factual dispute between an insurer and an insured. This is an issue which should be decided on a case-by-case basis.” *Id.* at 348.

³⁶ Before *Wilson*, there was a hint that its ruling was imminent. See *Guebara v. Allstate Ins. Co.*, *supra*, n. 43, at 99 (Fletcher, J. dissenting): “Indeed, the California Supreme Court has not even considered whether the ‘genuine issue as to coverage’ rule is an accurate statement of California law. The rule is of uncertain provenance. We announced the ‘genuine issue rule’ in *Safeco Ins. Co. v. Guyton*, 692 F. 2d 551, 557 (9th Cir.1982), without citing any California authority for the proposition that a genuine dispute may be used as a proxy for reasonableness.” It must be noted that the California Supreme Court explicitly held in *Garvey v. State Farm Fire & Cas. Co.*, *supra*, n.6, at 410, that the Ninth Circuit in *Safeco Ins. Co. of America v. Guyton* “misappl[ied]” California law on the coverage question before it. Since *Guyton* misapplied California law, it provides no credible support for a “genuine dispute rule.”

³⁷ *Johansen v. Cal. State Auto. Assn. Inter-Ins. Bureau*, 15 Cal. 3d 9 (1975) (good faith, though erroneous, belief in no coverage does not protect insurer from excess liability claim).

³⁸ *Chateau Chamberay*, *supra*, n. 48, at 349.

These are important concepts to understand when negotiating an insurance bad faith case in which the “genuine issue” doctrine is being relied on by the carrier. Unless it is abundantly clear that it applies, it is important to strenuously argue against its imposition. Certainly *Wilson* helps in taking that approach.

CAN YOU CONVERT THE CONTRACT CLAIM TO A TORT CLAIM?

It is obvious from the above that either using traditional tort principles³⁹ or those requisites for the tort of insurance bad faith, it is critical to the recovery of extra-contractual damages to convert the contract claim to a tort. This requires going outside the four corners of the contract and examining carefully the *conduct* of the insurer in *administering and managing* the claim.⁴⁰

Requirement of Financial Loss

Past cases have discussed the question of whether the claim for insurance bad faith is a personal injury or economic claim (i.e., property claim). Decisions have generally described it as the latter.⁴¹ As a result, financial injury must occur before there can be an award for emotional distress.⁴² Such a requirement is said to reduce the danger of frivolous or fictitious claims.⁴³

³⁹ See, e.g., *Fletcher v. Western Nat'l. Life Ins. Co.* (1970) 10 Cal.App.3d 376.

⁴⁰ See, e.g., *Life Ins. Co. of Georgia v. Johnson* (1997) 701 So.2d 524; *Sparks v. Republic Natl. Ins. Co.* *supra*, n.5; *Linthicum v. Nationwide Ins. Co.*, *supra*, n. 23; *Gruenberg v. Aetna Ins. Co.*, *supra*, n. 5; *Best Place, Inc. v. Penn America Ins. Co.* (1996) 82 Hawaii 120; *White v. Unigard Mut. Ins.*, *supra*, n. 5.

⁴¹ *Waters v. United Services Auto. Assn.*, *supra*, n. 5, at 1078-1079.

⁴² *Id.* at 1079, see also, *Continental Ins. Co. v. Superior Court (Bangert)* (1995) 37 Cal.App.4th 69, 86.

⁴³ See, e.g., *Clayton v. United Services Auto. Ass'n* (1997) 54 Cal.App.4th 1158, 1161; Croskey et al., *Cal. Practice Guide: Insurance Litigation* (The Rutter Group 2007) ¶ 13: 82, p. 13-20.

Recovery of Damages for Emotional Distress

As a general proposition, the requirement of financial injury provides verification of an accompanying claim for emotional distress. As one California Court of Appeal stated:

The principal reason for limiting recovery of damages for mental distress is that to permit recovery of such damages would open the door to fictitious claims, to recovery for mere bad manners, and to litigation in the field of trivialities.... Obviously, *where, as here, the claim is actionable and has resulted in substantial damages apart from those due to mental distress, the danger of fictitious claims is reduced*, and we are not here concerned with mere bad manners or trivialities but tortious conduct resulting in substantial invasions of clearly protected interests.⁴⁴

In order to recover for emotional distress in a case involving insurance bad-faith, it is not necessary that it be *severe*.⁴⁵

Similarly, in order to recover for emotional distress, it is not necessary to prove that the emotional distress is proximately caused by a financial loss, only that both emotional distress and financial distress were caused. As one court noted:

[P]laintiff in a bad faith case must prove some economic loss as a means of validating the seriousness of his or her emotional distress. Once economic loss is shown, however, the plaintiff is entitled to recover for all emotional distress proximately caused by the insurer's bad faith without proving any causal link between the emotional distress and the financial loss.⁴⁶

Recovery of Attorneys' Fees

In a bad faith action, the insured may recover attorneys' fees that incurred in the insured's action to recover benefits under the insurance policy. However, fees that are the result of the insured's efforts to collect extra-contractual damages (i.e., emotional distress damages) are not recoverable. Attorneys' fees are only recoverable under the tort-based cause of action, not the contract-based cause of action. The rationale for allowing recovery of attorneys' fees for the

⁴⁴ *Waters* at 1072 (quoting *Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 433-434).

⁴⁵ *Waters, supra*.

⁴⁶ *Clayton v. United Services Automobile Association, supra*, n. 60, at 1161.

tortuous refusal to pay benefits is found in *Brandt v. Superior Court of San Diego*:⁴⁷

“[A]ttorney’s fees...are recoverable as damages resulting from a tort in the same way that medical fees would be part of the damages in a personal injury action.”⁴⁸ These include attorneys’ fees for defending a bad faith award on appeal.⁴⁹

THE SEVEN POINT TEST FOR EVALUATING A “BAD FAITH” CASE

Here is a quick checklist for looking at the potential for bad faith and punitive damages in an insurance tort case:

1. What is the **personal plight** of the insured/claimant plaintiff? In short, how sad is the story? Will the story justify “ringing the bell” in the minds of the jury?
2. What is the **amount of the contract claim**? Is the amount sufficient to justify a substantial compensatory award? Is the fact that plaintiff has been deprived of these sums sufficient justification for a significant emotional distress award?
3. What is the **amount of compensatory damages** that is likely to be awarded for economic loss, emotional distress and attorneys’ fees? The greater the amount of compensatory damages, the larger the potential for punitive damages. This is particularly true in a “cap” state such as Indiana in which three times the compensatory award may pose a much greater exposure to punitive damages than the monetary cap of only \$50,000.⁵⁰
4. **How long has the plaintiff been a policyholder** (in a suit by an insured)? A jury will expect the insurer to “give slack” to an insured who has been a policyholder for a substantial period of time. Reluctance by the insurer to give the benefit of the doubt to long-standing

⁴⁷ (1985) 37 Cal.3d 813, 817; see also *Cassim v. Allstate Ins. Co.* (2004) 33 Cal.4th 780; *Essex Ins. Co. v. Five Star Dye House, Inc.* (2006) 38 Cal.4th 1252.

⁴⁸ *Id.* at 817.

⁴⁹ *Baron v. Fire Ins. Exch.*, *supra*, n. 9, (2007) 154 Cal.App.4th 1198; see also, *McGregor v. Paul Revere Life Ins. Co.* (9th Cir. 2004) 369 F.3d 1099, 1101.

insureds who have continued to fuel the company coffers with premium payments may create a jury climate for a punitive claim.

5. What is the **length of time from claim to compensation**? The longer the period from the time of the initial injury to trial (or payment of what was rightly owed), the higher the punitive potential. A lengthy period of denial only bolsters the perception that insurance company claims personnel are taught to hold on to the insurer's money for as long as possible in order to maximize profits.

6. What is the likely **credibility of the company witnesses**? The story of the claims handling is influenced by the believability of the insurance company's witnesses, who may be subject to impeachment and/or may be shown to have taken an adversarial posture against the insured, which is inconsistent with the principles of good faith claims handling.⁵¹

7. What is the **overall perception of the insurance company**? That is, what picture will the jury have of the insurer? Promises of "Good Hands," "Good Neighbor" and "Piece of the Rock" give the jury the impression that the insurer can be trusted, but these advertising slogans may be perceived as just marketing tools for attracting customers, with no intention of meeting these standards of customer concern, care or treatment. Also, if the insurer is perceived as being very wealthy (even if the jury will not hear evidence of financial wealth until a later aspect of the trial),⁵² this perception can affect the jury's determination.

⁵⁰ Ind. Code § 34-4-34-4.

⁵¹ As noted throughout this Chapter, general principles require that the insurer give equal consideration to the interests of the insured as it does to its own. That is, an insurer is not permitted, in making claims decisions, to put its own interests ahead of the insured. See *Egan v. Mutual of Omaha*, *supra*, n. 5. Moreover, the insurer has a duty to conduct a "thorough investigation" of the claim, not one designed to find ways to deny the claim. *Id.*

⁵² For example, in California the trial is required to be bifurcated on request of the court or counsel so that the jury does not hear any evidence of financial wealth unless and until it has determined that the defendant has acted in the requisite manner which permits such an award. Cal. Civ. Code § 3295(d). This conduct is defined as "oppression, fraud, or malice" which are specifically defined in California's statutes. Cal. Civ. Code § 3294(c).

STRATEGY FOR NEGOTIATIONS

The environment for seeking redress for insurance company wrongs is not always “plaintiff friendly.” While juries may be sympathetic, the barriers posed by evidentiary rules, punitive “caps,” and the views of judges and appellate courts to class actions or large punitive “windfalls” must be evaluated before committing your law firm to these suits. They require careful planning and consideration before filing.

Tort reform and the courts’ approaches to punitive damages claims have made some carriers feel more secure that bad faith and punitive damages are not a threat as they were in the 1970’s and 1980’s when insurance bad faith cases matured.⁵³

Now, there are still cases where punitive damages are warranted, but the commitment of time, money and the client’s emotional and physical resources is large. For example, Ray Bourhis, a well known insurance bad faith lawyer in San Francisco, has written a telling story of one of his more recent insurance bad faith cases.⁵⁴ Anyone doing insurance bad faith work is well advised to read this book.

Insurance bad faith cases offer an early opportunity for resolution for several reasons.

⁵³ See, e.g., *Egan, supra*, n. 5. When the jury returned its verdict in November 1974 of \$5 Million in punitive damages, Wall Street was shocked, and the insurance industry was reeling. For the next 15 years or so, a battle was waged in the courts over these cases. See Guy O. Kornblum, “Large Punitive Damages Verdicts Are Plaguing Corporate America,” *Business Law Brief*, London, Editor A. H. Hermann (November 1987); Guy O. Kornblum, “California Leads the Way in Bad Faith, But No One Wants to Follow – Recent Trends in California First Party Bad Faith Law,” with G. Olsen, 14:1 *Western State University Law Review* 37 (Fall 1986); Guy O. Kornblum, “Punitive Damages: What, Why, When and How Much! An Introduction to the Modern Notions of Punitive Damages in General Tort, Commercial and Insurance Actions,” 2:1 *On the Risk*, 11 *Journal of Academy of Life Underwriting* (Oct.-Dec. 1985); Guy O. Kornblum, “Recent Developments in ‘Bad Faith’ Litigation Against Insurers,” with G. Olsen, 14:1 *Journal of International Association of Insurance Counsel* (1985). Cases such as *Linthicum v. Nationwide Ins. Co.*, *supra*, n. 23, started to draw a line between bad faith alone and what was required for punitive damages. Later, the California Supreme Court adopted many reforms to punitive claims which were reflected in amendments to its statutes. See amendments to Cal. Civ. Code § 3294 at Stats.1980, c. 1242, p. 4217, § 1; Stats.1982, c. 174, § 1; Stats.1983, c. 408, § 1; [Stats.1987, c. 1498, § 5](#); [Stats.1988, c. 160, § 17](#); [Stats.1992, c. 178 \(S.B.1496\), § 5](#). Changes included adding the requirement of “clear and convincing proof” and further defining “malice” and “oppression” as including “despicable conduct.”

⁵⁴ Ray Bourhis, *Insult to Injury: Insurance, Fraud, and the Big Business of Bad Faith*, Berret-Koehler Publishers, Inc. (2004).

First of all, they are expensive to prepare and try. Capturing the case early, evaluating the damages, and looking at the down the line costs should motivate both sides to review the case to see if mediation at an early stage is prudent. Second, insurance bad faith cases present a unique opportunity for an early evaluation. If there are coverage issues, they can be evaluated by reviewing the policy provisions and the applicable law. Because there is already a “paper trail” called a “claims file,” there is an excellent source of information for preparing a chronology of claims handling and learning what was done and why. Once the pertinent files are obtained, you should have considerable information about the claims handling, and the reasoning, or lack of such, behind it.

The pertinent insurance company files can be obtained and reviewed early in the case. This may include underwriting and claims files as well as industry and company manuals as a means for evaluating how the claim was handled – that is, what was done and why. The client and client representatives, such as brokers should be interviewed and files obtained for review. On the defense side, the company personnel should be interviewed to determine the basis for underwriting and claims decisions.

In some cases the parties might agree on limited early discovery with a view towards mediating once they have completed this preliminary discovery or informal exchange of information.

A well thought out Litigation Management⁵⁵ Plan by both sides should lead the parties to assess when a “plateau”⁵⁶ is reached, i.e., when the parties are ready to negotiate.

The point is that with some early effort, the parties to an insurance bad faith case should be able to explore a resolution of the case before they begin the process of protracted litigation.

⁵⁵ See Chapter 3, p. 1.

⁵⁶ See Chapter 1, p. 22.

From all perspectives, this is just common sense since so much is already available by the time suit is filed.

One strategy I have used successfully in insurance bad faith cases is to file suit, then send the claims handler or key insurance operative a copy of the file endorsed complaint, with a brief overview of the allegations and an invitation to mediate. Sometimes I suggest some mediators, or I invite them to provide a list of acceptable mediators. In other cases, I have offered to go to whomever they chose if they pay the costs of mediation (with the mediator not knowing that only one side is paying). Any of these open the door to discussion, and in almost all cases I at least get a reply that there is interest, and we go from there to see if an agreement to mediate can be reached. On very few occasions is my invitation ignored.

GOOD MEDIATING

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