

ORIGINS AND STANDARDS OF INSURANCE BAD FAITH TORT LIABILITY

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The Anatomy of a Bad Faith Case

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I. THE ORIGINS AND DEVELOPMENT OF THE TORT OF INSURANCE BAD FAITH.

The tort of insurance bad faith, based on tortious breach of the implied covenant of good faith and fair dealing, grew out of a judicial recognition that contract remedies were inadequate to address abuses by insurers of their insureds. The first published case holding an insurance company liable for bad faith appears to be Brassil v. Maryland Casualty Co. 210 N.Y. 235, 104 N.E. 622 (1914). The case involved an insurer who exerted control over litigation against its insured that resulted in a judgment against the insured in excess of the policy limits, whereupon the insurer refused to appeal and also refused to pay the judgment. In an apparent case of first impression in the United States, the New York Court of Appeals held as follows:

The mere statement of this unique situation indicates that the true measure of the rights of the plaintiff on the one hand and of the obligations of the defendant on the other is not to be found in the letter of the contract of insurance. That contract, by its very terms, was designed to exclude any such liability. But there is a contractual obligation of universal force which underlines all written agreements. It is the obligation of good faith in carrying out what is written. 210 N.Y. at 240-241, 104 N.E. at 624.

In addition, the court also held as follows:

In the light of these conditions it (is) idle to look to the letter of the insurance contract for the measure of the defendant's liability, and the fact that there are no precedents for such an action as this is a very impressive indication of the unusual and inequitable attitude of the defendant. Without attempting to further characterize the defendant's position, it is enough to say that it would be a reproach to the law if there were no remedy for so obvious a wrong as was inflicted upon this plaintiff. His rights, as we have said, go deeper than the mere surface of the contract written for him by the defendant. Its stipulations imposed obligations based upon those principles of fair dealing which enter into every contract. Even the defendant has invoked this implied obligation of good faith and fair dealing not expressed in the terms of its written contract, for by its answer it has set forth that it was incumbent upon the plaintiff to "deal fairly and in good faith...and that he should not voluntarily or knowingly do any acts which would impose or tend to impose on him or on this defendant a loss in the premises." If this was the plaintiff's duty, it was not less the correlative obligation of the

defendant to “deal fairly and in good faith” with him. 210 N.Y. at 242, 104 N.E. at 624.

Over time, abuses of insureds by insurance companies proved not to be as “unique” as the Brassil court apparently thought or hoped at the time. The subsequent development of the tort of insurance bad faith spread across the country as courts in virtually every state and in every federal jurisdiction confronted similar abuses. In addition to insurance company malfeasance, this development may also be explained, in part, by the fact that it was not until the 20th century that the United States completed transition from a primarily agrarian to a primarily industrial society. The population of the country became increasingly concentrated in urban areas, transportation and communication experienced society-wide availability, great expansion in the commerce and the middle classes occurred, and insurance and litigation became increasingly widespread. These phenomena are discussed, for instance, in William Manchester’s history of America in the first half of the 20th century, *The Glory and the Dream*.

The origins and rational basis for imposition of tort liability on insurance companies has been well recognized, not only by courts, but by commentators. John K. DiMugno, Editor and Chief of *California Insurance Law and Regulation Reporter* and the *Insurance Litigation Reporter*, and Paul E. B. Glad, Managing Partner of Sonnenschein, Nath & Rosenthal in San Francisco and Business Insurance Editor for *Underwriters Report*, observe in their book, *California Insurance Law Handbook*, as follows:

Recognizing the inadequacy of contract remedies, courts began to treat insurers’ unfair claims practices as a tort. Initially, the courts relied on traditional tort theories (citing cases between 1924 and 1931 from New Hampshire, Texas and South Carolina). Many (of) these traditional tort theories remain viable.... In the late 1950's, however, courts started to shift the theoretical justification for imposing tort liability on insurers away from traditional theories to the implied covenant of good faith and fair dealing present in all contracts. While a cause of

action for breach of the covenant in most contracts still lies solely in contract, courts have permitted tort remedies for breach of the covenant under contracts involving a “special relationship,” characterized by elements of public interest, adhesion, and fiduciary responsibility. The classic example of this type of contract is, of course, the insurance contract. (citing numerous California cases). DiMugno and Glad, *California Insurance Law Handbook*, Chapter 11, §11.1, page 225-226 Thomsen/West 2007.

William Shernoff, Sanford Gage and Harvey Levine, in their treatise on insurance bad faith law, devote a detailed and extensive first chapter to the “evolution and development of the tort of bad faith.” They observe as follows:

An understanding of the development of the tort of bad faith requires an appreciation of the importance of insurance in modern society. As of 1979, the insurance industry collected annually nearly \$150 billion dollars in insurance premiums--an amount that represented approximately one-eighth of the total disposable income of all Americans. Because of the industry’s vast size and the unequal bargaining position between the insurer and its insured, special rules that recognize the peculiar nature of the insurance contract have been developed.

The tort of bad faith has grown out of an appreciation of the fact that an insurance contract is not an ordinary agreement and that principles of contract law are totally inadequate in protecting the consumer from the wrongful denial of insurance claims or the failure of an insurer to provide other benefits conferred by the policy, such as the defense of third party lawsuits under a liability insurance policy. In an effort to deter dilatory, unconscionable, or unfair claims practices, most jurisdictions have relied on the vitality of contemporary tort law in imposing a duty on insurance companies to deal fairly and in good faith with policyholders in various situations, including both first party and third party actions. These courts have used the resilience and flexibility of American tort law to accomplish desirable social goals. In particular, they have allowed the policyholder to obtain the benefits of his insurance agreement without the limitations imposed by the more rigid principles of contract law, while providing an impetus for deterring future wrongs by the insurance industry. (footnotes omitted)¹ Shernoff, Gage and

¹ Footnotes 3 and 4 to the Shernoff text identify published case citations in 46 states recognizing first party insurance bad faith tort liability and in 37 states recognizing third party bad faith tort liability, and these listings are not exhaustive.

Levine, *Insurance Bad Faith Litigation*, Chapter 1, Evolution and Development of the Tort of Bad Faith, §1.01, pages 1-1 to 1-7 (Matthew Bender 1997).

II. THE ORIGINS AND DEVELOPMENT OF THE TORT OF INSURANCE BAD FAITH IN CALIFORNIA.

There is more than a little bit of irony to be found in the origins of bad faith tort law in California. The first case in California to rule that tortious insurance bad faith applied was a ruling issued by the United States District Court, the Northern District of California at the express request of an insurance company which argued that it should be not held liable in tort for ordinary negligence, but rather for a comparatively higher standard of bad faith. In *Christian v. Preferred Acc. Ins. Co.* 89 F.Supp. 888 (N.D. Cal. 1950), the plaintiff had sued the insurance company in an excess judgment setting for negligence and for bad faith. The court held that the proper theory for tort liability should be bad faith, and not ordinary negligence, thereby adopting the position argued by the defendant insurance company. The court indicated as follows:

Defendants on the other hand contend that the criteria is whether or not there was a showing of bad faith on the part of the insurance company in the failing to compromise before a cause of action would arise making an insurance company liable for an excess over the policy limit for which the insured is liable to the injured party recovering the judgment. *Royal Transit v. Central Surety and Ins. Corp.* 7 Cir. 168 F.2d 345, is an example of the cases relied upon by the defendants to support their contention. 89 F.Supp.at 889.

The Christian court observed that the decisional law in the various jurisdictions that had addressed the issue at that time were not uniform. Some jurisdictions were holding insurance companies liable in tort under a negligence theory and some jurisdictions were holding insurance companies liable in tort under bad faith. Still other jurisdictions, the court noted, used the terminology interchangeably; the court referred to holdings from the Fourth Circuit, and the States of Washington, New York and Kentucky. In support of the defendant insurer's position

that the proper standard should be tortious bad faith, the district court noted that in addition to the 7th circuit the bad faith remedy had been held to be the proper one previously in the 6th Circuit and the 10th Circuit.

The Christian court also noted that under standard procedural law applicable to diversity cases, California state court decisions would be controlling, but that there was no California. However, there was no California appellate court decision at the time there had been a prior San Francisco Superior Court ruling to that effect. The Christian court further noted the standard procedural rule that in the absence of any expression of a common law rule by the Supreme Court of California, the final authority on state law, it was “the duty of the federal court to follow the decisions of intermediate state courts unless convinced that the supreme court would rule otherwise.” 89 F.Supp. at 890.²

The next published case in California upholding the right to sue in tort for insurance bad faith was Brown v. Guarantee Ins. Co. (1957) 155 Cal.App.2d 679, which also involved an excess judgment situation. The Brown case cited with approval language from a Mississippi case, as follows:

In resolving problems such as the one before us, any one of several approaches to the issues may present itself. The solution may be sought in the terms of the policy itself, and the court may attempt to resort to contract law. Or the insurer may be viewed as a fiduciary, possibly as an agent, and thereupon the court will employ the principles of law which govern an agent's relationship to his principal. In such situations the law generally demands good faith. Or the courts may turn to tort law and hold that the insurer in dealing with the defense, including the matter of settlements, must exercise due care. 155 Cal.App.2d at 683.

As the Christian court did before it, the Brown court also noted that this subject matter, in

² See also Federal Rules of Evidence, Rule 501.

addition to having resulted in holdings in a number of prior jurisdictions, had also been the subject of *American Law Reports (ALR)* articles. The Brown court, noting that no other California appellate court had yet passed on the question before it, and further noting that the Christian case “has held such action exists in California and is based upon bad faith rather than negligence,” the court rationally adopted the position that tort liability was based on bad faith, as had been urged by the insurance company defendant in Christian. 153 Cal.App.2d at 683-684.

In so holding, the Brown court also drew approvingly from like prior cases from Wisconsin, Tennessee, New York, Kentucky, and from federal courts.

The next California case on the subject was Ivy v. Pacific Automobile Ins. Co. (1958) 156 Cal.App.2d 652, which acknowledged that the insurance company’s attorney owed allegiance to two clients and had a “high duty of care to both clients,” the insurer and the insured. 156 Cal.App.2d at 659. The Ivy court noted that there was a conflict among jurisdictions “as to whether liability in such cases is predicated on negligence or upon bad faith.” Ibid. The court noted that “California has recently aligned itself with the jurisdictions that apply the bad faith test,” citing Brown v. Guarantee Ins. Co. supra, referring to it as a “well reasoned opinion.” Ibid.

Following Ivy, the California Supreme Court issued its opinion in Comunale v. Traders & General Ins. Co., (1958) 50 Cal.2d 654, 328 P.2d 198. The Comunale court noted that one question presented to it on appeal from the judgment in the case was, as follows: “Did Sloan have a cause of action against Traders for the amount of the judgment in excess of the policy limits?” 50 Cal.2d at 657. Citing with approval both Brown v. Guarantee Ins. Co., supra, and Ivy v. Pacific Automobile Ins. Co. supra, the court held that an insurer that did not protect its insured while exercising control of the litigation was “guilty of bad faith in refusing a

settlement.” Ibid.

The tort of insurance bad faith was being adopted by courts all over the country, not just in California, and the courts were simultaneously establishing the tort’s elements and parameters. The Crisci court referred to the determination of whether an insurer had given consideration to the interests of its insured as involving the application of a test of whether a “prudent insurer” would have acted in such a way. 66 Cal.2d at 429. Likewise, the Crisci court indicated that “liability is imposed not for a bad faith breach of the contract, but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.” 66 Cal.2d at 430. In this context, the Crisci court noted that “fundamental in our jurisprudence is the principle that for every wrong there is a remedy and that an injured party should be compensated for all damage proximately caused by the wrongdoer.”

In support of its holding, the court in Crisci noted a unique characteristic of insurance contracts that supported imposition of tort liability on insurers, as follows:

Among the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental loss, and 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. 66 Cal.2d at 430.

The court provided this rational underpinning to its holding that the award of emotional distress damages did not result from an insurer’s breach of contract, but rather in the circumstance where the breach of contract also involved the violation of a tort duty, such that the breach also constituted a tort. Ibid.

In Gruenberg v. Aetna Ins. Co. (1973) 9 Cal.3d 566, the California Supreme Court dealt with a first party insurer-insured relationship. It reviewed the prior cases discussed above, and

noted that “...in Comunale and Crisci, we made it clear that ‘(liability) is imposed (on the insurer) not for bad faith breach of the contract, but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.’” 9 Cal.3d at 573. Breach of that duty, the court observed, gave rise to a cause of action in tort for breach of the implied covenant of good faith and fair dealing. 9 Cal.3d at 574. Further confirming that the prior holdings were tort holdings, the court commented as follows:

It is manifest that a common legal principle underlies all of the foregoing decisions; namely, that in every insurance contract there is an implied covenant of good faith and fair dealing. The duty to so act is immanent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort. 9 Cal.3d at 577.

In Silberg v. California Life Ins. Co. (1974) 11 Cal.3d 452, the California Supreme Court stated that “the principle was firmly established in Comunale...and Crisci...” that the duty imposed on insurers sounds in tort. 11 Cal.3d at 460-461.

In Frommoethelydo v. Fire Ins. Exchange (1986) 42 Cal.3d at 208, the California Supreme Court observed that “an insurer holds itself out as a fiduciary,” and that “with the public trust must go private responsibility consonant with the trust, including qualities of decency and humanity inherent in the responsibilities of a fiduciary.” 42 Cal.3d at 215.

The California Supreme Court, in Sarchett v. Blue Shield of California (1987) 43 Cal.3d 1, held that health care service plans, which are technically not insurance companies, are also liable in tort for breach of the implied covenant of good faith and fair dealing. In that case, the court observed that “Blue Shield notes that it is a health care service plan rather than an insurance company. Because the distinction is immaterial for purposes of our decision, we

discuss the issues in terms of insurance.” 43 Cal.3d 1, 3 fn.1.³

In Foley v. Interactive Data Corp. (1988) 47 Cal.3d 654,254 Cal.Rptr. 211, the California Supreme Court, in holding that tortious bad faith was not applicable in the employment contract context, extensively reviewed the distinction between employment and commercial contracts on the one hand and insurance contracts on the other. See discussion at 47 Cal.3d 682-695. In so doing, the Supreme Court approved of the historical and rational grounds for the tort of insurance bad faith. The court observed that “the distinction between tort and contract is well grounded in common law, and divergent objectives underlie the remedies created in the two areas.” 47 Cal.3d at 683. The court noted that “tort law is primarily designed to vindicate ‘social policy.’” Ibid.

The Foley court also noted that “initially, the concept of a duty of good faith developed in contract law as ‘a kind of safety valve to which judges may turn to fill gaps and to qualify or limit rights and duties otherwise arising under rules of law and specific contract language.’” 47 Cal.3d at 684. The court noted that the exception to that general rule that developed in the

³The term “health care service plan” is a creature of California’s Knox-Keene Act, which authorized organization of such entities under the California Health & Safety Code. In California, such plans are regulated by the Department of Managed Care, not the Insurance Commissioner. Other states refer to such plans by various names, but they are all a form of managed care organization (“MCO”), also referred to as health maintenance organizations (“HMO”). Unlike indemnity-type health insurance that covers expenses incurred for treatment as a result of accident or sickness, MCO plans provide for specified medical services to be secured and provided during the specified term of coverage.

context of insurance contracts was for a variety of policy reasons that provided a basis for an action in tort. Ibid. The court commented that “California has a well-developed judicial history addressing this exception,” and cited in that regard Comunale, Egan v. Mutual of Omaha Ins. Co. (1979) 24 Cal.3d 809, cert. den. 445 U.S. 912 (1980), Crisci and Gruenberg.

The Foley court quoted extensively and approvingly from Egan as follows:

The insured in a contract like the one before us does not seek to obtain a commercial advantage by purchasing the policy--rather, he seeks protection against calamity. Thus, as one commentary has noted, “the insurer’s obligations are...rooted in their status as purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public’s interests seriously, where necessary placing it before their interests in maximizing gains and limiting disbursements.... As a supplier of a public service rather than a manufactured product, the obligations of insurers go beyond meeting reasonable expectations of coverage. The obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary...”the relationship of insurer and insured is inherently unbalanced: the adhesive nature of insurance contracts places the insurer in a superior bargaining position. This emphasis on the “special relationship” of insurer and insured has been echoed in arguments and analyses in subsequent scholarly commentary and cases....” 47 Cal.3d at 684-685.

III. THE UNREASONABLENESS STANDARD IN INSURANCE BAD FAITH CONTENT.

Some commentators suggest that California cases have not explained the unreasonableness standard or given it substantive content. This is not correct. First, California case law on insurance bad faith is extensive and the standards are well settled, as evidenced by the fact that there are standardized jury instructions. Second, there are an abundance of secondary authorities which readily explain the content of standards applicable in the tort of insurance bad faith, citing extensive case law. For example, see Levy & Sacks, *California Torts*, Vol. 6, Chapter 82, Section 82.50 (Matthew Bender 1997); Shernoff, Gage & Levine, *Insurance Bad Faith Litigation*, Chapter 2, Nature of the Duty of Good Faith and Fair Dealing

(Matthew Bender 1997); DiMugno & Glad, *California Insurance Law Handbook* (Shepard's 1995); and many others.

Courts and juries, especially in the last 30 years in California, have rarely had demonstrable difficulty in deciding and applying standards of liability in insurance bad faith cases, nor have insurers been treated arbitrarily. Facts may vary widely from case to case in application of bad faith law but, as just one example, a federal court judge was able to hold that on the one hand the insurer had a duty to defend in an underlying action, but on the other hand, that the insurer's refusal to defend in that underlying case did not constitute breach of the implied covenant of good faith and fair dealing. See Staefa Control System, Inc. v. St. Paul Fire & Marine Ins. Co. 847 F.Supp.1460 (N.D. Cal. 1994), modified on other limited grounds 875 F.Supp. 659 (N.D. Cal. 1994).

Typically, jury instructions are based on cases which demonstrate that insurers cannot be held liable in bad faith for merely breaching the contract or for merely being mistaken or negligent, such as the following:

On the tort liability issue, even accepting the failure to defend as having been a breach of contract, an insurer's responsibility to act fairly and in good faith in handling an insured's claim "is not the requirement mandated by the terms of the policy itself--to defend, settle, or pay. It is the obligation under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. The elements of the tort cannot be defined by the terms of the policy; for there to be a breach of the implied covenant, the failure to bestow benefits must have been under circumstances or for reasons which the law defines as tortious. The mere denial of benefits does not demonstrate bad faith. California Shoppers, Inc. v. Royal Globe Ins. Co. (1985) 175 Cal.App.3d 1, 14.

As for mistake itself, bad faith implies unfair dealing rather than mistaken judgment. Id. at 55.

Bad faith implies unfair dealing rather than mistaken judgment or poor prognostication. Good or bad faith is a question of fact in each case. Critz v.

Farmers Ins. Group (1964) 230 Cal.App.2d 788, 796, disapproved on other grounds in Crisci v. Security Ins. Co. (1967) 66 Cal.2d 425.

The precise nature and extent of the duty imposed by the implied covenant of good faith and fair dealing will depend on the contractual purposes. Negligent behavior alone does not constitute a violation of the covenant of good faith and fair dealing. National Life & Accident Ins. Co. v. Edwards (1981) 119 Cal.App.3d 326.

Use of the phrase “conscious and deliberate act or failure to act” has never been used in California insurance bad faith cases to describe the factual or legal elements of the insurance bad faith cause of action, which essentially derives from *Gruenberg v. Aetna Ins. Co.* and is grounded in “unreasonableness.” The word “deliberate” connotes an intent to harm, which is not only confusing and misleading in the context of insurance bad faith, but misstates the appropriate standard. The appropriate standard of unreasonableness, like the majority of jurisdictions, includes consciousness of action or omission, not the intent to harm.

Likewise, “no reasonable basis” language has also not been used in California insurance bad faith cases. Jurisdictions that use the term “no reasonable basis” in conjunction with bad faith causes of action are those minority jurisdictions in which the bad faith cause of action is viewed as an intentional tort. See e.g., *Anderson v. Continental Ins. Co.*, 86 Wisc. 2d 675, 692, 271 N.W. 2d 368 (1978). California is not such a jurisdiction.