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A Model First-Party Insurance Excess-Liability Act

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I. INTRODUCTION

Insureds buy financial protection and peace of mind against fortuitous losses. They pay the requisite premiums and put their faith and trust in their insurers to pay policy benefits promptly and fairly when the insured event occurs. Good faith and fair dealing is their expectation. It is the very essence of the insurer-insured relationship. In some instances, however, insurance companies refuse to pay the promised benefits when the underwritten harm occurs. When an insurer decides to delay or to deny paying benefits, the policyholder can suffer injury not only to his economic well-being but to his emotional and physical health as well. Moreover, the holder of a policy with low monetary limits may see his whole claim virtually wiped out by expenses if the insurance company compels him to resort to court action.

One who buys an insurance policy purchases both financial and peace-of-mind security, two interests worthy of legal protection. Yet, if the insurer's refusal to pay is viewed as a simple breach of contract, traditional contract theory allows the insured to recover only the promised policy benefits plus interest rather than all damages caused by the company's breach. Contract damages are said to be compensatory, but, as Professor Gilmore observes, the "whole structure of the 19th century damage law seems to have been dedicated to the proposition that the buyer should get no more than a

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token recovery."[1] In modern contract law, however, it is possible to discern a retreat from classical contract damage law which protected "infant-industry" sellers from large damage recoveries[2] toward a theory which allows buyers to recover all damages proximately caused by the seller's breach.

In recent times courts have been giving greater protection to the reasonable expectations of contracting parties by recognizing duties keyed to those expectations. Each contracting party, for example, is held to a duty in contract performance defined in terms of an objective standard of good faith conduct. Whereas traditional formulations of contract law characteristically eschewed propositions couched in "good faith,"[3] the good faith standard has been centrally placed in modern contract law by the *Uniform Commercial Code*[4] and by the *Restatement (Second) of Contracts*.[5] Courts are encouraged to explore and assess the reasons behind a promisor's decision not to perform a contractual obligation. The reasons may be sound and in good faith or may be faulty and in bad faith. As the reasons for breach are examined, the concept of fault, once purely a servant of tort, is being woven into traditional contract doctrine. When an insurance company, for example, places its own economic interests above that of its insured, it has not complied with the good-faith standard and may be required to pay, in addition to the policy benefits, all damages proximately caused.[6] These extra-contract damages may be compensatory (such as damages for emotional distress, attorney's fees, loss of earnings, a percentage of the amount claimed, and other consequentials) as well as punitive.

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[1] Gilmore, *Products Liability: A Commentary*, 38 U. CHI. L. REV. 103, 112 (1970). A classical example of this position is the opinion of Justice Holmes in Globe Ref. Co. v. Landra Cotton Oil Co., 190 U.S. 540 (1903).

[2] For an explanation of the protectionist policy of classical contract damage theory, *see* Danzig, *Hadley v. Baxendale: A Study in the Industrialization of the Law*, 4 J. OF LEG. STUDIES 249 (1975).

[3] Holmes, *A Contextual Study of Commercial Good Faith: Good-Faith Disclosure in Contract Formation*, 39 U. PITT. L. REV. 381 (1978).

[4] The Uniform Commercial Code defines "good faith" in two sections. The general definition is found in Section 1-201(19): " 'Good faith' means honesty in fact in the conduct or transaction concerned." The Article Two definition, pertaining to the sale of goods, is found in Section 2-103(b): " 'Good faith' in the case of merchants means honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade."

[5] RESTATEMENT (SECOND) OF CONTRACTS § 231 (Tent. Draft No. 5, 1970).

[6] For an early example in the area of third-party excess liability, *see* Communale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 328 P. 2d 198 (1958).

This expanded form of contract liability is well-recognized in third-party insurance excess-liability cases. However, less analysis has been given to the evolving case law and legislation concerning first-party excess-liability insurance contracts.[7]

The purpose of this article is to study the various statutes concerning first-party, excess liability in an effort to compose a model act. The primary issues affecting this problem are two-fold: First, what type of extra-contract damages should be available (e.g., attorney fees, litigation expenses, consequential losses, emotional distress, punitive damages); and, second, should these extra-contract damages be based on an equitable standard of good-faith conduct (fault) or on strict liability principles (no fault)? These are crucial questions as the division between contract and tort becomes ever more blurred in modern law.

Finally, a subsidiary purpose of the article is to elicit further understanding of the concept of commercial good faith. Because good faith is an amorphous concept, manifested in endlessly variable settings and forms, it does not identify a manageable body of law for analytic inquiry. Insurance law, however, does provide a locus for particularized study of good faith. Since insurance law has a more mature conception of good faith than does classical contract law, it is especially useful for present purposes.[8]

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[7] A definition of first-party insurance might be helpful. It generally describes that type of insurance coverage under which the insured or his beneficiary recovers policy benefits directly from the insurer without establishing fault. The insurer's duty to pay runs directly to the insured. Life, disability, fire and other property insurance, health and accident, and title insurance are examples of first-party insurance. It can be contrasted with third-party (liability) insurance under which the insurer has a duty to defend and to make settlement for its insured. The award of damages for excess liability is novel in first-party insurance cases. It is, however, well accepted in third-party insurance cases where the insurer "wrongfully" (*i.e.*, in bad faith or negligently) mishandles the settlement obligation under the liability policy. The annotated bibliography in 3 DEFENSE RESEARCH INSTITUTE, INSURANCE LAW — AVOIDING EXCESS LIABILITY (1973), for instance, catalogues a total of 63 law review articles on third-party excess liability. *See generally* R. KEETON, BASIC TEXT ON INSURANCE LAW 510-13 (1974).

[8] Although insurance law is affected by special considerations inapplicable to general contract law, it has supplied basic ideas for that body of law. To the extent that modern contracts reflect adhesion rather than bargaining and also constitute status relationships, insurance is an important body of law for understanding the future of contract law.

II. Statutory Damages For Insurer's Refusal To Pay First-Party Claims

With four exceptions[9] every state legislature has enacted at least one of four varieties of statutes which authorize extra-contract damages for an unpaid first party insurance claim. The allowed damages may be in the form of an interest charge computed on the claim, a reasonable attorney's fee, an additional percentage added to the claim, punitive damages, or any combination of these. The motivating factor behind such legislation is to discourage the contesting of valid claims and to assure prompt, fair, good faith claim settlements by insurance companies with their policyholders. The statutes fall into two broad categories: (1) piece-meal first-party penalty acts, and (2) comprehensive first-party excess-liability legislation.[10]

A. *Piece-Meal First-Party Penalty Acts*

These assorted acts fall into three classifications: (1) Unauthorized Insurer's Process Penalty; (2) No-Fault Penalty; and (3) Unfair Claims Settlement Practices Penalty.

1. Unauthorized Insurer's Process Penalty. Thirty-nine states have enacted legislation concerning insurance companies not authorized (i.e., licensed) to do business in the state.[11] The ostensible

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[9] Montana, Ohio, South Carolina and Washington. Although South Carolina does not have any specific first-party penalty legislation, its state reports are replete with cases allowing recovery of punitive damages if there is proof of fraudulent intent accompanied by a fraudulent act when the insurer fails or delays paying a first-party claim. *See, e.g.*, Felder v. Great Amer. Ins. Co., 260 F. Supp. 575 (D.C.S.C. 1966); Dawkins v. National Liberty Life Ins. Co., 252 F. Supp. 800 (D.C.S.C. 1966); West v. Service Life & Health Ins. Co., 220 S.C. 198, 66 S.E.2d 816 (1951). Additionally, recent cases have awarded attorneys' fees to successful first-party insureds where insurer's failure to defend is without reasonable cause. *See, e.g.*, Boggs v. Aetna Cas. & Sur. Co., 272 S.C. 460, 252 S.E.2d 565 (1979).

[10] Because the first acts are piece-meal with little case construction or elaboration, they do not provide very fertile ground for the aims of this article. Nonetheless, for a genuine foundation to construct a model act, these eclectic acts must be given passing consideration and description.

[11] Alaska Stat. § 21.33.035 (Cum. Supp. 1975) [formerly § 21.33.070 (1968)]; Ariz. Rev. Stat. Ann. § 20-406 (1956); Cal. Ins. Code § 1619 (West 1972); Colo. Rev. Stat. Ann. § 10-3-1005 (1973); Conn. Gen. Stat. Ann. § 38-268 (Cum. Supp. 1975); Del. Code Ann. tit. 18, § 2110 (1974); Fla. Stat. Ann. § 626.911 (West 1972); Ga. Code Ann. § 56-611 (1971); Haw. Rev. Stat. § 431-342(j) (1968); Idaho Code § 41-1209 (1961); Ill. Ann. Stat. ch. 73, § 735(6) (Smith-Hurd 1965); Ind. Code Ann. § 27-4-4-5 (Burns 1975); Iowa Code Ann. § 507A.7(4) (West Cum. Supp. 1975) [formerly § 507A.5 (West 1949)]; Ky. Rev. Stat. Ann. § 304.11-040(15) (Baldwin 1969); Me. Rev. Stat. Ann. tit. 24-24A, § 2108 (1974); Mass. Gen. Laws

purpose of such legislation is to discourage the public from purchasing insurance policies from nonadmitted insurers; however, in addition to subjecting unlicensed insurers to the state court's jurisdiction, this type of legislation generally imposes a fault-based penalty to assure seasonable settlement of claims.[12] A penalty of a reasonable attorney's fee is levied if the failure to pay a claim for policy benefits is "vexatious and without reasonable cause" or in "bad faith." The non-admitted insurer thus must bear the insured's cost of counsel in enforcing a valid claim. Some states go further and add an additional penalty based on a percentage of the claim.[13] Moreover, Wisconsin authorizes punitive damages if the unauthorized insurance company knew the insurance contract violated state law.[14] This fault-based penalty found in the various acts shores up the good faith standard of conduct required of non-admitted insurers in the settlement process.

Because of the lack of case law in this area, due apparently to a failure to enforce these statutes, it is difficult to determine the meaning of the good faith (fault) standard in this context.

2. *No-Fault Penalty.* All jurisdictions which have passed some form of no-fault automobile insurance plan have incorporated into the no-fault legislation a provision allowing extra-benefit damages when a no-fault benefit is not paid within the prescribed statutory period.[15] Typically, these statutes provide for the payment of no-

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ANN. ch. 175B, § 4 (West 1972); MINN. STAT. ANN. § 60A.22 Subd. 4 (West 1968); MISS. CODE ANN. § 83-21-51 (1972); MO. ANN. STAT. § 375.296 (Vernon 1968) [formerly § 375.168 (Vernon 1951)]; NEB. REV. STAT. § 44-137-07 (1943); N.H. REV. STAT. ANN. § 406-B:7 (1968); N.J. REV. STAT. § 17B:33-8 (Cum. Supp. 1975); N.M. STAT. ANN. § 38-1-10 (1978); N.Y. INS. LAW § 59-a4 (McKinney 1966); N.C. GEN. STAT. § 58-153.1(d) (1975); N.D. CENT. CODE § 26-09-15 (1970); OKLA. STAT. tit. 36, § 1105 (Cum. Supp. 1975) amending tit. 36, § 1105 (1958); OR. REV. STAT. § 746.350 (1974) [formerly § 736.258 (1973)]; PA. STAT. ANN. tit. 40, § 1005.4 (Purdon 1971); R.I. GEN. LAWS ANN. § 27-16-13 (1968); S.D. COMPILED LAWS ANN. 58-12-3 (1967); TENN. CODE ANN. § 56-1105(B) (1968); TEX. INS. CODE tit. 1.14-1 § 7 (Vernon Pamphlet Supp. 1975-76); UTAH CODE ANN. § 31-35-5 (1974); VT. STAT. ANN. tit. 8, § 3390 (1970); VA. CODE ANN. § 38.1-70 (1970); W. VA. CODE ANN. § 33-4-13(d) (1975); WIS. STAT. ANN. § 618.48 (West Spec. Pamphlet 1975); WYO. STAT. ANN. § 26.1-239 (Cum. Supp. 1975).

[12] The unauthorized insurers penalty is so named because it is found within the "Unauthorized Insurer's Act" or "Foreign Insurer's" section of state insurance codes and, more specifically, under the heading "Attorney's Fees," "Vexatious Refusal to Pay Claim," or "Service of Process."

[13] *See, e.g.*, GA. CODE ANN. § 56-611 (1971) (25% of claim as penalty plus reasonable attorney fee).

[14] WIS. STAT. ANN. § 618.48 (West Spec. Pamphlet 1975).

[15] ARK. STAT. ANN. § 66-4021 (Cum. Supp. 1975); COLO. REV. STAT.ANN. § 10-4-708 (1973);

fault benefits within 30 days after proper filing of reasonable proof of loss. Any benefits that are not paid within 30 days are considered overdue and accrue a statutory interest at a rate that varies from 10% per annum[16] to 18% per annum.[17] In addition, if the no-fault carrier fails to pay the benefit within 30 days and the insured obtains an attorney to secure the benefit, a reasonable attorney's fee will be assessed against the delinquent insurer.[18] The idea apparently is that strict liability for litigation expenses allows the insured to have the full benefit due him without a reduction for costs of enforcing a bona fide claim. The attorney's fee is assessed regardless of the reasons, good or bad, the company may have had for failing or refusing to pay the benefit. Although non-compliance with the statute arguably raises a presumption of bad faith, the imposition of liability for attorney's fees is not based on fault. Some states, however, go further and add an additional (fault) penalty based on noncompliance with the standard of good faith conduct.[19] The Georgia legislation, for example, provides a penalty of not more than 25% of the amount due if the failure to pay within 30 days was not in good faith.[20] Additionally, if 60 days have elapsed after the filing of proper proof of loss and *unless* the insurer has failed to pay in good faith, punitive damages may be awarded in Georgia.[21] Such extracontract damages illustrate a curious incorporation of fault-based notions into no-fault legislation to

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CONN. GEN. STAT. ANN. §§ 38-333, 334 (West Cum. Supp. 1975); FLA. STAT. ANN. § 627.736(4)(b) (West 1972); GA. CODE ANN. § 56-3406(b) (Cum. Supp. 1975); HAW. REV. STAT. § 294-4, 1975 HAW. SESS. LAWS, Act 113, amending 294-4, 1974 HAW. SESS. LAWS, Act 168, and HAW. REV. STAT. § 294-30, 1974 HAW. SESS. LAWS, Act 168; KAN. STAT. ANN. §§ 40-3110, 3111 (1973); MD. ANN. CODE art. 48A, § 544 (Cum. Supp. 1975); MASS. GEN. LAWS ANN. ch. 90 § 34M (West Cum. Supp. 1975); NEV. REV. STAT. §§ 698-410 to 420 (1973); N.J. REV. STAT. §§ 39:6A.1 to .20 (1973); N.Y. INS. LAW § 675 (McKinney Cum. Supp. 1975); N.D. CENT. CODE § 24-41-09 (Cum. Supp. 1975); PA. STAT. ANN. tit. 40 §§ 1009.106(a)(2), .107 (Purdon Cum. Supp. 1975); UTAH CODE ANN. § 31-41-8 (1974).

[16] FLA. STAT. ANN. § 627.736(4)(b) (West 1972).

[17] KAN. STAT. ANN. § 40-3110 (1973).

[18] The following states permit the additional assessment of a reasonable attorney's fee: Arkansas, Colorado, Connecticut, Florida (by case law, not statute), Georgia, Hawaii, Kansas, Massachusetts, Nevada, New Jersey, New York, Oklahoma, Oregon, Pennsylvania, and Utah.

[19] Colorado, for example, provides that if the denial of benefits is wilful, the claimant should be awarded three times the benefit amount, plus 18% interest and a reasonable attorney's fee. COLO. REV. STAT. ANN. § 10-4-708 (1973).

[20] GA. CODE ANN. § 56-3406b(b) (Cum. Supp. 1975).

[21] *Id.* at 56-3406b(c).

assure fairness in contract performance.

Given the greenness of most no-fault acts, the judiciary has had little opportunity to construe the good faith penalty. A recent exception, however, is the decision by the Georgia Court of Appeals in *Bituminous Casualty v. Mowery*,[22] which illustrates much of the misunderstanding surrounding the principle of good faith by the bench and the bar.

To aid in understanding the issue and holding in *Mowery*, let us assume the following facts. State A has a general first-party act which imposes a penalty upon proof by the insured that the carrier refused payment in bad faith.[23] State case law construing that act holds that the insurer as a matter of law is justified in litigating a case of first impression and, therefore, no bad faith penalty attaches in that situation.[24] State A also has a no-fault penalty which applies unless the insurer can prove that its failure to pay was in good faith.[25] The insured duly submits a claim for no-fault medical benefits, even though the medical expenses were already paid by workmen's compensation. Although the no-fault act clearly provides that medical benefits are not to be reduced by worker's compensation payments (a collateral source provision),[26] the no-fault carrier refuses to pay because the insured has already recovered under worker's compensation and, according to the insurer, should not profit under the new, vague no-fault act. The collateral source provision has never been litigated. Finally, the carrier argues that it has met its burden of showing good faith by proving the absence of bad faith since it is litigating a "first impression" issue.

Assuming the preceding, the court now responds:

> Although this is a persuasive argument, we are not convinced the solution is found in defendant's syllogism; i.e.: This is a 'first impression' issue. Litigating a first impression issue is not, as a matter of law, 'bad faith.' Ergo, if it is not 'bad faith,' it must be 'good faith.'[27]

Professor Summers, the author of the seminal piece on the good

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[22] 145 Ga. App. 45, 244 S.E.2d 573 (1978).
[23] GA. CODE ANN. § 56-1206 (1971).
[24] State Farm Mut. Auto Ins. Co. v. Bass, 231 Ga. 269, 201 S.E.2d 444 (1973).
[25] GA. CODE ANN. § 56-3406b(c) (Cum. Supp. 1975).
[26] *Id.* at § 56-3409b(a).
[27] 145 Ga. App. at 51, 244 S.E.2d at 577.

faith principle,[28] would apparently disagree with the court in *Mowery*. Under his theory good faith is a mere excluder principle used by courts to eliminate various forms of bad faith. Although one can define bad faith, good faith, he opines, is undefinable. The task then is to define the specific form of "bad faith" and then infer an opposite meaning for good faith.[29] The court in *Mowery*, on the other hand, apparently perceives the requirement of good faith as involving three parts: good faith, bad faith, and a third black hole of faith in between. The faith in the gap is either no faith (absence of good and bad faith), or perhaps simply the leap of faith. Such semantic quibbling, it is suggested, serves no useful function.

Refusing to get mired in a Serbonian Bog of semantical inquiry, the court in *Mowery* provides guidance for understanding the fault notion of good faith. It refocuses our attention on good faith rather than on logic or semantics. It recognizes that an insurer may deliberately flout the good faith requirement and avoid penalty liability when it decides that it is cheaper to litigate the first-impression issue. The court holds that

> it is not a showing of 'good faith' per se for an insurer to show the issue is one of 'first impression.' But, there must be 'reasonable and probable cause' for the insurer [sic] litigating the 'first impression' issue . . . . Was there 'reasonable and probable cause' for the action [the insurer] took? If so, whether the defense was one of 'first impression' or a defense asserted many times before, the defendant's good faith in litigating the question would be a bar to imposition of the statutory

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[28] Summers, *Good Faith in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV. 195 (1968).

[29] Apparently Summers would contend that the idea of good faith is a fictional expedient without any conceptual or extractable meaning and therefore must be defined in the negative.

> [T]he typical judge who uses this phrase [good faith] is primarily concerned with ruling out specific conduct, and only secondarily, or not at all, with formulating the positive content of the standard. Good faith, then, takes on specific and variant meanings by way of contrast with the specific and variant forms of bad faith which judges decide to prohibit ... as an excluder should not waste effort formulating his own reductionist definitions. Instead, he should characterize with care the particular forms of bad faith he chooses to rule out.

Id. at 202-07.

penalty.[30]

The court gives assured guidance in ascribing meaning to good faith. The notion of good faith is transumed from an abstract into a concrete concept that derives its meaning from the context of its use. To act in good faith necessitates objective reasonableness to support one's action or inaction. An inchoate definition of good faith conduct in the first-party penalty context emerges from *Mowery*: good faith refusal to pay first-party benefits means that the insurer has reasonable grounds or probable cause in law or in fact to reject the claim.

3. Unfair Claims Settlement Practices Penalty. Twenty-two states have enacted an Unfair Claims Settlement Practices Act.[31] This act, appearing within the "Trade Practices" or "Unfair Competition" section of state insurance codes, typically provides a catalogue of offenses which if "knowingly committed" or "performed with such frequency as to indicate a general business practice" are considered to be unfair practices. The cataloging occurs under four headings: marketing, rates and underwriting standards, cancellation, and claim settlements. Applying to both first-party and third-party insurance, one obvious purpose of this legislation is to prevent unfair claims settlement practices by requiring insurance companies to comply with the good faith standard in claims settlement. The prescribed penalties are vested in the insurance commissioner and include administrative relief (cease and desist orders) and civil relief (for example, a court may award the insurance commissioner $5,000 for each violation up to $50,000 in any six-

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[30] 145 Ga. App. at 53, 244 S.E.2d at 578.

[31] ALA. CODE tit. 28A, § 249(1) (Cum. Supp. 1973); ARK. STAT. ANN. § 66-3005(9) (Cum. Supp. 1975); CAL. INS. CODE § 790.03(h) (West Sum. 1975) [amending § 38-61 (1969)]; DEL. CODE ANN. tit. 18, § 2304(16) (1974); HAW. REV. STAT. § 431-647 (Supp. 1974); ILL. ANN. STAT. ch. 73, § 1031(4) (Smith-Hurd Cum. Supp. 1975); IOWA CODE ANN. § 507B.4(9) (West Cum. Supp. 1975) [amending § 507.B.4 (West 1949)]; KAN. STAT. ANN. § 40-2404(9) (1973); MASS. GEN. LAWS ANN. ch. 176D § 3(9) (West Cum. Supp. 1975); NEB. REV. STAT. § 44-1525(9) (1943); N.H. REV. STAT. ANN. § 417.4XV (Cum. Supp. 1974); N.J. REV. STAT. ANN. § 17:29B-4 (Ch. 100, Cum. Supp. 1975) [amending § 17:29B-4 (1970)]; N.J. REV. STAT. 17B:30-31.1 (Ch. 101 Cum. Supp. 1975); N.M. STAT. ANN. §§ 59-11-12, 59-11-13; N.Y. INS. LAW § 40-d (McKinney Cum. Supp. 1975) [amending 40 (McKinney 1966)]; N.C. GEN. STAT. § 58-54.4(11) (Cum. Supp. 1975) [amending § 58-54-4 (1949)]; N.D. CENT. CODE § 26-30-04.9 (Cum. Supp. 1975) [amending § 26-30-04 (1970)]; OR. REC. STAT. § 746.230 (1974); PA. STAT. ANN. tit. 40 § 1171.5(10) (Purdon Cum. Supp. 1975); S.D. COMPILED LAWS ANN. § 58-33-46.1 (Cum. Supp. 1974); TEX. INS. CODE art. 21.21-2 (Vernon Pamphlet Supp. 1975-76); W. VA. CODE ANN. § 33-11-4(9) (1975).

month period).[32]

The general effect of such legislation on private lawsuits is yet to be determined, but it may be the sleeping giant in the area of excess-liability in insurance law. When the act has been found to be violated by an insurance commissioner, it provides a puissant springboard for extra-contractual recoveries against insurance companies, adjusters and agents.[33]

B. Comprehensive First-Party Excess-Liability Acts

Seventeen states have enacted statutes providing for payment of attorney's fees and, in certain instances, a percentage of the claim to an insured when the insured successfully prosecutes a lawsuit claiming first-party policy benefits against a licensed insurance company.[34] Although the statutes vary considerably regarding the nature of the penalty, the kinds of policies and coverages to which they apply, the kind of insurer involved, and the like, it is possible to place them into two broad classifications. One class of penalty statutes imposes extra-contract damages without regard to the insurer's good faith in failing to pay the claim within a specified time after demand. The penalty provided by this form of legislation is

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[32] *See, e.g.*, PA. STAT. ANN. tit. 40 § 1171.5(10) (Purdon Cum. Supp. (1975)). With the exception of Massachusetts, MASS. GEN. LAWS ANN. ch. 176D § 7 (Cum. Supp. 1975), no awards to policyholders are explicitly granted. In Massachusetts, however, if the Insurance Commissioner determines that an insurer has used unfair settlement practices, a policyholder may be awarded punitive damages not to exceed 25% of his claim on a policy issued by that company.

[33] *See, e.g.*, Royal Globe Ins. Co. v. Keoppel, Cal. 3d, 592 P.2d 329, Cal. Rptr. (1979). This case recognizes for the first time a claim for relief in a third-party claimant based on the insurer's failure to exercise good faith and fair dealing to effectuate a prompt and fair settlement of the claim. Although the court acknowledged that the insurer's common-law duty of good faith in third-party insurance ran solely on the insured, it held that the legislation created new civil causes of action in third-party claimants. For a criticism of this case, see Catapano-Friedman, *Civil Liability Under the California Unfair Practices Act in the Aftermath of* Royal Globe, 21 F.T.D. 61 (1980).

[34] ARK. STAT. ANN. § 66-3238 (1966) [amending § 66-3238 (1947), and § 66-3239 (1947)]; DEL. CODE ANN. tit. 18, § 4102 (1974); FLA. STAT. ANN. 627.428 (1972) [formerly FLA. STAT. ANN. § 625.08 (1957) and § 627.0127 (1969)]; GA. CODE ANN. § 56-1206 (1971); IDAHO CODE § 41-1839 (Cum. Supp. 1973); ILL. ANN. STAT. ch. 73, § 767 (Smith-Hurd Cum. Supp. 1975); KAN. STAT. ANN. § 40-256 (1973); LA. REV. STAT. §§ 22:656, 22:657 (West 1959); ME. REV. STAT. tits. 24-24A, § 2436 (1974); MO. ANN. STAT. §§ 375, 420 (Vernon Supp. 1975); NEB. REV. STAT. § 44-359 (1943); OKLA. STAT. tit. 36, § 1219 (Cum. Supp. 1975); S.C. CODE §§ 38-9-320, -9-330 (1976); S.D. COMPILED LAWS ANN. § 58-12-3 (1967); TENN. CODE ANN. § 56-1105(a) (1968); TEX. INS. CODE arts. 3.62, 3.62-1, and 10.13 (1961); WYO. STAT. ANN. § 26-1-328-1 (Cum. Supp. 1975).

compensatory in nature and fault on the part of the insurer is irrelevant. Under the second class of legislation, the penalty applies only when the carrier has acted in bad faith in delaying or refusing to pay the insured. The *sine qua non* for penalty liability in this second classification is fault on the insurer's part. These two varieties of statutes will now be examined to ascertain not only the purposes for eliminating or requiring fault as a prerequisite to the statutory penalty but also to describe what meaning and standard is applied to the good faith requirement.

1. Strict Liability Statutes. Eight states[35] statutorily authorize a court to award attorney's fees to an insured who has been put to the expense and burden of bringing a lawsuit to enforce a first-party claim and has done so successfully. Although the statute may be penal in nature insofar as the insurer is concerned, it is compensatory with respect to the insured. The policy behind this legislation is to deter nonpayment of claims after just demand[36] and to create a cause of action in the policyholder to assure that there will be no diminution of the actual recovery. As a Florida court explains: "The purpose of the statute is to discourage the contesting of insurance policies . . . and to reimburse successful plaintiffs for their outlays for attorney's fees . . . . "[37]

As a condition precedent to recovering the attorney's fee, a plaintiff has to prove: (1) a specific demand; (2) facts giving rise to the claim; and (3) a statement or other objective conduct by the insurer indicating that it would not pay. Some states add a fourth requirement that the insured must at trial recover the *full* amount of the original demand.[38] Since one purpose of the statute is to discourage contesting of claims, the insurer's good faith in delaying or refusing to pay is immaterial. A considerable body of case law, following an *expressio unius est exclusio alterius* philosophy of

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[35] Arkansas, Delaware, Florida, Idaho, Maine, Nebraska, Oklahoma, and Texas. *See* note 34 *supra.*

[36] The policy is explained by a Delaware court thusly:

> Nothing in the statute indicates a legislative intent to confine such award [attorney's fees] to instances where an insurer has taken an unreasonable position . . . . The legislature has seen fit to allow the insured attorney's fees without regard to the good faith of the insurer's position in a particular instance. This form of deterrence to nonpayment of claims for loss of insured's property has been upheld as valid legislation.

Galiotti v. Travelers Indem. Co., 333 A.2d 176, 180 (Del. Super. 1975).

[37] Salter v. National Indem. Co., 160 So. 2d 147, 148 (Fla. App. 1964).

[38] *See, e.g.*, Alexander v. Pilot Fire & Cas. Co., 331 F. Supp. 561 (D.C. Ark. 1971).

statutory construction, supports the following proposition:

> The fact that the insurer's refusal to pay the amount owed by it under the terms of the policy was in good faith and on reasonable grounds does not relieve the insurer from payment of attorney's fees . . . . [39]

Even though it is arguably a question of good faith whether an insurer should be liable for a penalty, statutes imposing attorney's fees for the mere failure to pay a claim for a specified period of time after demand without reference to the insurer's bad faith are held not to be in conflict with the federal Constitution.[40]

In addition to attorney's fees, Texas and Arkansas impose a penalty of 12% of the claim as damages notwithstanding the insurance company's good faith in its assertion of a defense or its refusal to pay based on an honest and reasonable difference of opinion concerning the law involved. A long line of authority in both states has consistently held that the insurer's good faith does not take the case out of the statute.[41] These additional damages are likewise compensatory in nature, that is as compensation for the cost of collecting the debt.

Reading the cases construing the strict liability penalty acts, one is at first struck by the ease with which the penalty is imposed. The ideal of good faith and fair dealing is seemingly ignored as the policies of deterrence and compensation are served. On the other hand, it may be argued that the ideal of good faith is in fact directly supported by its implicit recognition in the theory of strict liability. There is a statutory presumption of "bad faith" on the part of the insurer who is unsuccessful in the lawsuit. The trial is not bogged down with inquiries into the meaning and standard of the elusive concept of good faith. As one judge in Texas warned:

> No question of the good faith of the defense to the policy can be interposed to prevent collection of the penalties . . . . If the question of good faith as to a defense was allowed to intrude itself into the trial of cases against insurance companies, it would be a difficult matter to ever obtain a judgment for

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[39] Cincinnati Ins. Co. v. Palmer, 297 So. 2d 96, 98 (Fla. App. 1974).

[40] Life & Cas. Ins. Co. v. McCray, 291 U.S. 566 (1934).

[41] *See* cases cited in Life & Cas. Ins. Co. of Tenn. v. Wiggins, 224 Ark. 377, 273 S.W.2d 405 (1954); New York Life Ins. Co. v. Veith, 192 S.W. 605 (Tex. Civ. App. 1917).

penalties.[42]

Arguably clandestine use of doctrines such as strict liability to foster the ideal of good faith is antithetical to our system of jurisprudence. Covert manipulation to achieve allegedly just results provides little solace to insurance companies who attempt to deal fairly with their financial resources on behalf of all their insureds. Imposing a penalty for an honest mistake in judgment, for example, seems to thwart rather than to promote the ideals of good faith and fair dealing. On the other hand, the Texas court may be right. State-of-mind issues such as motivation are terribly complex and may be unresolvable. The next section may shed some light on this unsettling issue.

2. *Fault-Based Penalty Statutes.* Nine states[43] have statutes which by their terms impose either a reasonable attorney's fee only[44] or a percentage of the recovery (from 12% to double the recovery)[45] plus a reasonable attorney's fee[46] when the insurer's de-

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[42] *Id.*

[43] Georgia, Illinois, Kansas, Louisiana, Missouri, South Carolina, South Dakota, Tennessee, and Wyoming. GA. CODE ANN. § 56-1206 (1971) (if within 60 days after demand, refusal is in bad faith, court may award up to 25% of insurer's liability plus all reasonable attorney's fees); ILL. ANN. STAT. ch. 73, § 767 (Smith-Hurd Cum. Supp. 1975) [amending ch. 73, § 767 (Smith-Hurd 1965)] (if refusal, after demand prior to trial, is vexatious and without reasonable cause, plaintiff can recover attorney's fees based on statutory limits); LA. REV. STAT. § 2:657 (West 1960) (applies only to health and accident policies; if benefit unpaid after 30 days and insurer fails to comply with reasonable businessman standard, then penalty is double the benefits plus attorney's fees), and LA. REV. STAT. § 22:658 (West 1960) (applies to all policies except life, health and accident; if failure to pay, 60 days after demand, is arbitrary, capricious, or without probable cause then 12% of claim [25% in automobile policies against theft] and reasonable attorney's fees); KAN. STAT. ANN. § 40-256 (1973) (after judgment court can award reasonable attorney's fees if insurer's refusal was without just cause or excuse); MO. STAT. ANN. § 375.420 (Vernon Supp. 1975) (if refusal to pay prior to trial was without reasonable cause or excuse then penalty not to exceed 25% of first $1,500 of loss and 10% of remainder plus attorney's fees; section entitled *Vexatious Refusal to Pay Claim*); S.C. CODE § 38-9-320 (1976) (if refusal after 90 days is without reasonable cause or in bad faith then insurer liable for all reasonable attorneys' fees up to one-third of claim but no more than $2,500); S.D. COMPILED LAWS ANN. § 58-12-3 (Cum. Supp. 1976) (if insured wins at trial and insurer's refusal is vexatious or without reasonable cause, then penalty is reasonable sum as attorney's fees); TENN. CODE ANN. § 56-1105(A) (1968) (if refusal 60 days after demand is not in good faith then penalty of up to 25% of the liability can be awarded); WYO. STAT. ANN. § 26.1-328.1 (Cum. Supp. 1975) [amending § 26.1-328.1 (1973)] (if refusal is unreasonable and without cause then court may assess 10% interest per year and reasonable attorney's fees).

[44] Illinois, Kansas, South Carolina, South Dakota and Wyoming.

[45] *See* note 43 *supra*. Additionally, South Carolina has a statute which imposes a penalty of 10 times the claim and makes it a misdemeanor for a first-party insurer to settle or agree

lay or refusal to pay a claim is in bad faith. These statutes explicitly recognize a duty on the insurer to act fairly, promptly, and in good faith in settling first-party claims submitted to it for payment. When the company's refusal to pay is not objectively reasonable under the circumstances, the penalty attaches. Described as "penal"[47] or "highly penal,"[48] the fault-based penalty is exemplary in character. For present purposes, an examination of these statutes may augment an understanding of the meaning and standard for the concept of good faith.

a. Contextual Meaning of "Good Faith". The key to understanding the meaning of good faith in this context lies in the way in which courts treat the various statutory language used to describe the insurer's misconduct in contract performance. Only Georgia and Tennessee expressly predicate penalty liability on the company's refusal being not in good faith. The other jurisdictions use seemingly diverse words, referent to facts extrinsic to the insurer's state-of-mind, which permit inferences regarding its actual state-of-mind in refusing to pay. The statutory language includes "vexatious and without reasonable cause,"[49] "arbitrary, capricious, and without probable cause,"[50] "without just cause or excuse."[51] Notwithstanding the dissimilarity in statutory language, case law from the several states demonstrates that the ultimate issue is the good or bad faith of the insurer. In the typical case, the court and jury look to all of the surrounding facts to ascertain whether the carrier had reasonable cause for refusing to pay, and, if it did, the court or jury does not exact a penalty. Otherwise, the penalty applies.

In Louisiana, for example, no penalty attaches unless the failure to pay is "arbitrary, capricious, or without probable cause." Nonetheless, Louisiana courts phrase the issue in terms of good faith, that is, whether the defense to the policy can be honestly main-

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to settle in merchandise or services rather than money. *See* S.C. CODE § 38-9-330 (1976).

[46] Tennessee provides only a penalty of up to 25% of the insurer's liability. *See* note 43 *supra*.

[47] McFarland v. Franklin Life Ins. Co., 416 S.W.2d 378 (Tex. Civ. App. 1967); Peoples Bank and Trust Co. v. United States Fid. and Guar. Co., 156 Tenn. 517, 3 S.W.2d 163 (1928).

[48] *See, e.g.*, Haase v. Business Men's Assur. Co., 275 S.W.2d 381 (Mo. App. 1955).

[49] Illinois and South Dakota.

[50] Louisiana.

[51] Wyoming.

tained. Suppose an insurer refuses to pay based on a disputable coverage defense such as whether medical procedures could be performed within the time required by the policy;[52] the insured "breached" a policy warranty;[53] an accidental injury caused a heart attack;[54] a loss was total or repairable;[55] or the policy was effectively cancelled by mailed notices of cancellation.[56] The Louisiana courts have held that if there is reasonable ground or probable cause for the defense (based on the standard discussed below) then the penalty is inapplicable. The various statutory words are translated into reasonableness. As one Louisiana court explains,

> the words 'arbitrary' and 'capricious' within this section are practically synonymous and mean without reasonable cause and do not imply an opprobrious connotation; arbitrary action is based on one's will and usually implies an abuse of one's authority.[57]

Thus, if objectively reasonable grounds support the claimed defense, the carrier is deemed to have acted in good faith in asserting the defense. The Louisiana courts typically conclude that a bona fide belief exculpates the company from penalty liability.[58] The courts look first, however, to the defense and its reasonableness and then infer the state of the insurer's mind. The same process is followed in a jurisdiction which requires "vexatious" refusal for penalty liability.[59] Vexatious is synonymous with unjustified,[60] which similarly signifies lack of reasonable or probable cause or excuse. If the failure to pay is unjustified or unfounded, the insurer acts in "bad faith".

In this context, acting in good faith means having reasonable or probable cause in law or in fact which excuses performance of a contractual duty. The concept bad faith (or acting not in good faith) means any frivolous and unfounded refusal in law or in fact

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[52] Valladares v. Monarch Ins. Co., 282 So. 2d 569, La. App. 1973.
[53] Travelers Indem. Co. v. Gult Weighing Corp., 352 F. Supp. 335 (E.D. La. 1972).
[54] Tullier v. Ocean Acc. & Guar. Corp., 243 La. 921, 148 So. 2d 601 (1963).
[55] Ranzino v. Allstate Ins. Co., 210 So. 2d 907 (La. App. 1968).
[56] Skipper v. Federal Ins. Co., 238 La. 779, 116 So. 2d 520 (1960).
[57] Stead v. Pearl Assur. Co., 167 So. 2d 527, 531 (La. App. 1964).
[58] *See* notes 52-57 *supra*.
[59] *See, e.g.*, Brooks v. Great Amer. Ins. Co., 131 Ill. App. 2d 781, 267 N.E.2d 132 (1971).
[60] Volz v. Travelers Ins. Co., 161 S.W.2d 985 (Mo. App. 1942).

by an insurer to comply with the policyholder's demand to pay as agreed.[61] Bad faith does not imply an opprobrious connotation nor is it the equivalent of actual fraud.[62] Rather the term is descriptive merely of some device or excuse, which has no reasonable basis in law or in fact, resorted to by an insurance company to delay or deny an insured the policy benefits. If the above meaning of good faith were assimilated into the larger context of the general law of contracts, the duty to act in "good faith and fair dealing" would be equivalent to an imposed duty to act with due care and diligence in the performance of agreed duties.

One can glean further support for the proposition that a standard of good faith and fair dealing implicitly contains a contractual duty of care in contract performance from other situations where the penalty is assessed. After proof of loss and demand for payment have been reasonably made, for example, the carrier not only has a reasonable time (or the time specified in the statute) to investigate the claim but it also may have an affirmative duty to do so. Failure to investigate (that is, failure to act with due care and diligence) may cause the company to take an untenable position regarding the claim and thereby subject itself to penalty liability. Although an insurer may believe that it has a valid policy defense, that belief is not in good faith if the true facts, which are discoverable upon a proper and diligent investigation, show that it had no defense.[63] There is no duty to pay a claim where a bona fide question of liability exists; however, the carrier has an obligation to conduct an expeditious, good faith investigation prior to denying and refusing payment.[64] "Where insurer's investigation and adjustment of plaintiff's claim was incomplete, insufficient and not conducted in good faith," a South Dakota court explains, "the refusal

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[61] Although cases supporting this idea can be found in all the nine states, the Georgia cases are particularly instructive. The leading case is Interstate Life & Acc. Ins. Co. v. Williamson, 220 Ga. 323, 138 S.E.2d 668 (1964). The Georgia cases are collected in ENCYCLOPEDIA OF GEORGIA LAW §§ 198-201 (1969).

[62] Cases from most of the nine states are compiled in J. APPLEMAN & J. APPLEMAN, INSURANCE LAW AND PRACTICE § 1612 n.12 (1967) (hereinafter cited as APPLEMAN ON INSURANCE), and G. COUCH, COUCH ON INSURANCE 2d § 58:58 n.15 (R. Anderson ed., 1966) (hereinafter cited as COUCH ON INSURANCE).

[63] *See* cases cited in COUCH ON INSURANCE § 58:201 n.11.

[64] Matthews v. Travelers Ins. Co., 212 Kan. 292, 510 P.2d 1315 (1973); Brown v. Continental Cas. Co., 209 Kan. 632, 498 P.2d 26 (1972); Berry v. Aetna Cas. & Sur. Co., 259 So. 2d 430 (La. App. 1972); West v. Lincoln Income Life Ins. Co., 239 So.2d 379 (La. App. 1970).

to pay was vexatious or without reasonable cause."[65] Therefore, when an insurer chooses to resist liability based on a supposed defense, which a reasonable investigation would have proved to be without merit, it acts in bad faith and the statutory penalties apply.[66]

In relation to the company's conduct, the requirement of good faith is a shield as well as a sword. If the carrier succeeds in its defense of the insured's lawsuit, obviously no penalty can attach. But even if the insurer loses in its defense, the penalty, in these eight states, does not automatically attach. Fault on the insurer's part is a necessary prerequisite. A jury is not permitted to find fault (bad faith) simply because in its opinion the claim ought to have been paid.[67] The mere fact that an adverse judgment has been rendered is not, without proof of fault, sufficient to show that the insurer has not acted in good faith. Rather, the test is whether the insurer had, upon due diligence in evaluating and investigating the claim, reasonable cause for believing that a jury would uphold its policy defense. Thus, a showing of a good faith belief in refusing to pay a claim insulates an insurer from liability for statutory penalties.

An excellent summary of the meaning of good faith in this penalty context is provided by a Missouri court:

> As to this point, the law is well settled that while affirmative proof is not required to show the fact of vexatious refusal, yet the statutory penalty should not be inflicted in any given case unless the facts and circumstances attending the company's denial of liability were such as to fairly warrant the inference that its refusal to pay was willful and without reasonable cause as the facts would have impressed themselves upon a reasonable person before the trial. In other words, the mere fact that the determination of the case on its merits happens to result adversely to the company is not in and of itself a sufficient justification for the infliction of the statutory penalty, but the test is rather that of whether it would appear that the company had made its defense in good faith, or instead had had good reason to know that the proof to the con-

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[65] Eldridge v. Northwest G.F. Mut. Ins. Co., 88 S.D. 426, 221 N.W.2d 16 (1974).
[66] Matthews v. Coastal States Ins. Co., 291 So.2d 475 (La. App. 1974).
[67] *See, e.g.*, Ga. Life Ins. Co. v. McCranie, 12 Ga. App. 855, 78 S.E. 1115 (1913).

> trary of its contentions would be so strong and convincing that it could not reasonably expect a verdict by the jury in its favor.[68]

This court introduces the idea that the standard for measuring the insurer's conduct is an objective one; however, the application of this standard may differ among the eight states with fault-based penalty legislation.

b. Standard For Evaluating Insurer's "Good Faith". Since fault is a prerequisite to penalty liability, the reasons for an insurer's refusal to pay must be evaluated. The actual mental processes of any individual carrier, however, cannot be verified by hindsight. Modern contract law has abandoned any theory of subjective motivation or intention as wholly impracticable since no one can actually know the inner workings of another's mind. It looks instead to outward manifestations and circumstances as the basis of contractual liability and not as mere evidence of subjective intent or motivation.[69] The test in this insurance context, as in most contractual disputes, is the traditional, reasonable person test. In determining whether the company has acted properly, or conversely, in bad faith, the standard by which its conduct is evaluated is that of a reasonable and prudent person.[70]

This objective, reasonable person test requires a consideration of all circumstances which have probative value. For an insured to recover the statutory penalties, he must introduce evidence which shows that the company's refusal was in bad faith (vexatious, wilful, without reasonable cause, and the like) based on the circumstances as they would appear to a reasonable and prudent person. A Kansas court, emphasizing the duty to investigate, phrases the test in this manner:

> The question is, how did the matter appear . . . [to the company] as judged by a reasonable and prudent man seeking to determine the facts of the controversy which it was his duty in good faith to investigate.[71]

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[68] Chavaries v. National Life & Acc. Ins. Co., 110 S.W.2d 790, 793 (Mo. App. 1937).

[69] For a discussion of the subjective versus objective controversy in general contract law, *see* J. MURRAY, MURRAY ON CONTRACTS (1974).

[70] Cases supporting the test are collected in APPLEMAN ON INSURANCE 365, and COUCH ON INSURANCE 42-43.

[71] Brown v. Continental Cas. Co., 209 Kan. 609, 498 P.2d 26, 36 (1972).

An insurer need not act as judge and jury but only reasonably and upon reasonable grounds. Nevertheless, this objective societal standard, most familiar to those studied in the law, may be inappropriate in this context. Although the law uses an ordinary person standard in contract interpretation and construction,[72] the very nature and complexity of insurance contracts may necessitate a more particularized standard in contract performance. The ordinary-person standard tolerates ignorance of insurance contracts, policies and practices, prejudice against insurance companies,[73] misinformation, and the like. Perhaps a more equitable way of evaluating an insurer's conduct in this commercial context is to adopt the following two-step inquiry.

First, the standard ought to be referent to the insurance industry in general. Rather than basing the standard on the customs and mores of society, it should be predicated on the customs and practices of the insurance industry, that is, a prudent-insurer standard. Each insurer would be held to a standard of customary good faith conduct established by general industry practices in contract performance. Although no courts have articulated a prudent-insurer standard in the penalty context,[74] the Louisiana legislature takes a step in that direction by providing that all claims have to be paid within thirty days "unless just and reasonable grounds, such as would put a reasonable and prudent *business man* on his guard, exist."[75]

A prudent insurer-standard would require a court first to hear evidence of general insurance customs and practices regarding the claim in litigation and then to ascertain if the individual insurer in refusing to pay has complied with industry practices. If not, the penalty attaches. On the other hand, if the company has met the

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[72] For a discussion of the average man on the street "utterly unacquainted with the niceties" of contract language as "master interpreter", *see* W.F. YOUNG, CASES AND MATERIALS ON INSURANCE 78-81 (1971).

[73] For an empirical study of the prejudicial effect of insurance on jury verdicts, see Broeder, *The Pro and Con of Injecting Plaintiff Insurance Companies in Jury Trial Cases: An Isolated Jury Project Case Study*, 6 NATURAL RESOURCES J. 269 (1966). Cases concerning discussion, during jury deliberation, of possible insurance coverage as prejudicial misconduct are collected in Annot., 47 A.L.R.3d 1299 (1973).

[74] Although there is a conflict among the authorities, the prudent-insurer standard (objective), in contrast to the this-insurer (subjective) standard, is used to decide the issue of materiality in insurance litigation. *See generally* KEETON ON INSURANCE 388-93.

[75] LA. REV. STAT. § 22:657 (West 1960) (emphasis supplied).

prudent-insurer standard, the second step would require a court to scrutinize the fairness of the general industry practice concerning the claim made. If the practice is repugnant to basic societal expectations of good faith and fair dealing then penalty liability is appropriate. Basic interests of both commerce and society are served by this two-step examination of the insurer's conduct. Expectations of insurers generally, derived from their marketing, underwriting, cancellation and claims settlement practices, are recognized and validated by step one. Yet such customary practices may later be invalidated if necessary to protect fundamental expectations of society in fair dealing.

The state of an insurer's knowledge regarding a claim is not static but increases with the passage of time. First, the proof of loss is filed; then the insurer investigates; the pleadings are filed; and, finally, the factual basis of the claim is made at trial. Given this shifting state of knowledge, a question arises as to the appropriate point in time at which the reasonableness of the insurer's conduct should be judged. In analyzing at what point in time the objective standard of good faith conduct should apply, four situations are readily conceivable: (1) at the time of refusal, the insurer has reasonable cause to deny the claim and nothing thereafter negates that cause; (2) at the time of refusal, insurer has reasonable cause for nonpayment but a subsequent change in circumstances, prior to the filing of the complaint, indicates that the ground for refusal is unjustified; (3) same as (2) except that the fact(s) negating the policy defense for nonpayment arise for the first time in the pleadings or at trial; (4) at the time of refusal, the insurer has no reasonable cause to deny the claim but subsequent fact(s), arising before or at the trial, show a legitimate defense to the claim. The simplest situation is the first and there no penalty attaches since good faith is shown at all times. The other three situations pose substantial problems in fixing the appropriate time at which to apply the good faith standard.

The time fixing problem, however, has not been adequately addressed by the courts in any of the nine states having fault-based penalty statutes. Case law from these states demonstrates that the courts are either not cognizant of the issue or are unsure about what time is pertinent to judge the insurer's conduct.[76] A Kansas

[76] An example of this confusion occurs in Missouri, where at least two separate rules are

court, for example, pronounced this inconsistent rule as controlling:

> [W]hether there was any bona fide and reasonable ground for contesting the claim depends upon circumstances existing *when payment is withheld or liability is declined* . . . . The question is, how did the matter appear *before the trial* as judged by a reasonable and prudent man seeking to determine the facts of the controversy which it was his duty in good faith to investigate.[77]

Notwithstanding the apparent confusion, it is possible to discern in the cases three different times at which the courts apply the good-faith standard: (1) "time of refusal," (2) "before trial," and (3) "at trial." The precise meaning and policy of these conflicting time-rules are difficult to describe because some courts recognize all three rules as authoritative. The Georgia cases are illustrative.

In *Calvert Fire Insurance Company v. Mack*,[78] the Georgia Court of Appeals stated that "before trial" is the proper time to apply the standard:

> The question of bad faith is to be judged upon the facts as they appeared *prior to the time of the trial* as they bore upon the insurer's reason, or absence of reason, for refusing to pay the claim upon demand.[79]

At other times the Georgia courts follow the "time of refusal" rule:

> Whether there is any reasonable grounds for contesting the claim is a matter which depends upon the circumstances ex-

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recognized. In Patterson v. American Ins. Co., 174 Mo. App. 37, 44, 160 S.W. 59, 62 (1913), one rule is stated: The penalty should not be inflicted unless the evidence and circumstances show that such refusal was willful and without reasonable cause as the facts appeared to a reasonable and prudent man before trial. In Paetz v. London Guar. & Acc. Co., 228 Mo. App. 564, 570, 71 S.W.2d 826, 832 (1934), the court announces this rule: Whether a refusal or failure to pay is vexatious or not, must be determined by the situation as presented to the (insurance company) at the time it was called on to pay. *Id.* Other cases cite both rules without acknowledging or discussing the possible differences. *See, e.g.*, Adams v. State Farm Ins. Co., 265 S.W.2d 738, 741 (Mo. App. 1954); Goodman v. National Liberty Ins. Co., 228 Mo. App. 327, 65 S.W.2d 1061, 1063 (1933).

[77] Koch v. Prudential Ins. Co., 205 Kan. 561, 567 (1970), 470 P.2d 756, 760 (emphasis supplied).

[78] 88 Ga. App. 617, 76 S.E.2d 829 (1953).

[79] *Id.* (emphasis supplied).

> isting *when liability is declined or not admitted*, not by the event of the ultimate determination.[80]

Yet there is strong case authority in Georgia holding that the insurer's good or bad faith in refusing to pay can only be determined from the evidence that is relevant and admissible at trial for a determination of the case on its merits. In *Interstate Life & Accident Insurance Company v. Williamson*,[81] the Supreme Court of Georgia, for example, answered the following certified question in the affirmative:

> Where at the expiration of sixty days after demand by an insured for the amount claimed to be due under an insurance policy the insurance company knows of no good reason for refusing to pay the claim, does a defense later discovered and made, on the trial of the case, going far enough to show probable cause for making such defense vindicate the insurer's refusal to pay the claim so as to preclude the insured from recovering attorney's fees and penalty provided in [the Georgia statute]?[82]

Therefore, it appears that all three time rules have been judicially blessed in Georgia. An apparent reconciliation is possible if the purpose of the penalty statutes is given primary consideration.

Case law from the nine states overwhelmingly supports the idea that the outcome of the trial should have no bearing on the issue of the carrier's good faith in contract performance. As previously suggested, the fact that the jury decides that the claim should have been paid should not be dispositive of the issue of penalty liability. The converse should also be true. Just because a company is successful in its defense at trial, that fact should not give rise to a conclusive presumption that the insurer acted in good faith when it denied payment before trial. The pleadings and the trial should have no influence either way on the issue of penalty liability. Unless the law seeks to foster gambling and gamesmanship, the "at

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[80] Dorsey v. State Farm Ins. Co., 238 F. Supp. 391, 398 (N.D. Ga. 1965) (emphasis supplied). *See also* Fireman's Fund Ins. Co. v. McConnell, 198 F.2d 401, 403 (5th Cir. 1952); Gov't Employees Ins. Co. v. Hardin, 108 Ga. App. 230, 132 S.E.2d 513 (1963); Reserve Life Ins. Co. v. Ayers, 101 Ga. App. 887, 115 S.E.2d 477 (1960).

[81] 200 Ga. 323, 138 S.E.2d 668 (1964).

[82] *Id.* at 325, 138 S.E.2d at 669 (emphasis supplied).

trial" rule as stated by the Georgia Supreme Court in *Williamson* is indefensible. If an insurer acts initially in bad faith in refusing to pay, it should not later be exculpated when it stumbles upon a successful defense at trial. The "at trial" rule, if followed, encourages bad faith conduct in contract performance which directly conflicts with the relevant public policy as announced by the state legislature in its penalty legislation. The policy of fault-based penalty statutes is to encourage fair, prompt, good faith settlement of first-party claims *when* demand for payment is made. Pursuant to the idea of purposive interpretation of statutory language, a court should support the legislative policy by eliminating, as "circumstances" for the reasonable person to consider, everything that happens after the pleadings are filed.

If a court eschews the "at trial" rule as violative of the public policy stated by the legislature, it is not necessary that it then must choose between the "time of refusal" and "before trial" rules. These two rules complement each other and are not inevitably inconsistent. If a court were simply to follow the "before trial" rule then it would not have a true guide regarding the time to apply the standard. The "before trial" rule is a negative one in that it eliminates the pleadings and the trial as circumstances for the reasonable person to consider. Yet it does not positively point the court and jury to any specific time to apply the standard. Contrawise, the "time of refusal" rule specifically points to the circumstances as they existed at the time the insurer withheld or refused payment. Yet, as the hypothetical situations previously mentioned indicate, changed circumstances after a good faith refusal may negate the reasonableness of the company's initial decision. Neither rule is the ideal solution to the problem. Again a potential reconciliation lies in the policy of the penalty legislation. Arguably, one purpose of the penalty statute is to impose upon the insurer a continuing duty to act reasonably regarding the claim. Logically, the reasonable person test applies at the point at which the reasonable person acts, that is, at the time that the insurer withheld or refused payment. The standard should apply at that time and the insurer's decision must be in good faith. Thereafter, and "before trial," the insurer must continue to act fairly and in good faith regarding the demand for payment. If subsequent to the making of a good faith refusal, the company learns facts that would have made the refusal in bad faith if that knowledge had been possessed

at the time of refusal, then the carrier will have the penalty taxed if it continues to refuse to pay. The proper rule would be one which judges the insurer by the reasonable person construct on the basis of circumstances actually ascertained by the insurer down to the time of trial.

This proposed test applies to the circumstances existing at the time of refusal and requires that the initial decision not to pay be in good faith. Additionally, the test embraces any changed circumstances, after refusal and before trial, that may negate the reasonableness of the original decision. Facts adduced from the pleadings and at trial should not be considered by the reasonable person either for or against the insurance company in evaluating its conduct in refusing to pay the claim. The penalty statute thus has continuing effect until the time of trial. This reconciliation eliminates the "at trial" rule and defines the "surrounding circumstances" which the reasonable person test includes in terms of both "at the time of refusal" and "before trial." This approach focuses the issue of good faith more precisely, thereby promoting, in a more concerted fashion, the ideal of good faith and fair dealing in contract performance.

III. Summary of the Issues and the Model Act

A. *Major Issues To Be Resolved*

Before enacting a comprehensive first-party insurance excess-liability act, a legislature would have to address several fundamental issues, such as: (1) Should the statute be based on strict liability or fault liability? (2) If fault-based, what meaning, standard and method of application of good faith should be adopted? (3) Should damages be a penalty in the form of a fixed percentage or should damages be compensatory? (4) Should the problem of excess-liability be left to the common-law system of case-law development or is the matter ripe for legislation?

1. Strict Liability Or Fault Liability? The preceding examination of the various first-party excess-liability statutes reveals at least three underlying policies: (1) to discourage the contesting of valid claims; (2) to assure prompt, fair, good faith payment of claims; and, (3) to encourage insurers to be cost efficient by rejecting invalid claims. The weakness in the present legislation is that no statute is able to promote all three policies. The first two policies of deterrence and compensation are advanced effectively

by strict liability legislation, but strict liability directly vitiates the third policy of economic efficiency. Surely in our inflation ridden society some consideration must be given to the increased costs of insurance when insurers have to "pay out more," pressured by the brooding omnipresence of strict liability. It is economically unwise to penalize an insurer (and its policyholders) for an honest mistake in judgment in rejecting a claim. Since this third policy appears to be fostered solely by the good faith requirement, a legislature must ostensibly choose between statutory strict liability and statutory good faith penalties. A good case can be made for either version.

Strict liability penalties attach regardless of any reasonable grounds or probable cause which may justify nonpayment. Arguably, strict liability legislation subjects companies to paying larger amounts either in settlements or in payment of judgments. By eliminating the protection to all parties that an inquiry into good faith affords, strict liability legislation may encourage claimants to litigate rather than to accept settlements. The increased amounts and other costs that insurers must pay are passed on to insureds by way of a corresponding increase in the premium rates. The net result is that fewer and fewer people will continue to insure; that in turn will adversely affect the societal goal of allocating the costs of accidents in an equitable manner.

Nevertheless, several solid rationales for imposing strict liability can be identified. First, rather than increasing costs and premiums, strict liability could result in a savings. Only under strict liability is the insurer operating subject to a clear, predictable rule — excess liability attaches if the insured wins the lawsuit based on the unpaid claim. The good faith standard can be expected to generate more extensive litigation of disputed facts and law than will strict liability. The latter eliminates or reduces costly litigation stemming from the dispute over good faith versus bad faith conduct. Second, the reasons that shore up strict liability in the tort area generally lend further support for imposing the same liability on insurers. Unlike a good faith standard, strict liability provides a sufficient incentive to compel insurers to make their products merchantable (safe) and reasonably fit for their intended purposes.[83]

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[83] The reasons underlying Section 402A of the Restatement (Second) of Torts likewise apply to the product of insurance. For a discussion of the incentive to create a non-defective product, *see* W. PROSSER, THE LAW OF TORTS § 97, at 650 (4th ed. 1971).

Many insurance contracts are defective in that ambiguities often make them difficult to read and to comprehend.[84] They are difficult to apply with any precision in many recurrent situations. Another objective of a strict payment sanction is to force insurers to clarify policy language.

Strict liability is imposed on product manufacturers because they impliedly represent (warrant) that the product is reasonably fit for its intended use.[85] Courts in recent insurance cases have applied the implied warranty of fitness to the insurance product.[86] The reasonable expectation of most insureds is that there is a sum of money fixed by the policy limits which will be paid to them fairly and promptly when any covered accident occurs. Strict liability is the most straightforward method of fulfilling that reasonable expectation. Additionally, strict liability socializes the costs of accidents by imposing liability on manufacturers who are in a good position to distribute those costs.[87] That rationale certainly applies to insurers, the quintessential risk spreaders. Nonetheless, some may argue that applying strict liability to a professional service such as insurance is a dangerous precedent. Even courts that warmly embrace strict liability balk when professional services are involved.[88] The response to that argument is that one can adequately distinguish insurance services from those of the lawyer, doctor, preacher or teacher. Not only does an insurer have the protection of risk distribution on a widespread basis, but it also

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[84] For a discussion of procedural and substantive inconspicuousness (unconscionability) and the duty to read and comprehend an insurance contract, see Holmes, *Interpreting an Insurance Policy: Unconscionability and the Evidentiary Condition*, 12 GA. L. REV. 783 (1978).

[85] W. PROSSER, *supra* note 82, § 97, at 651. *See also* RESTATEMENT (SECOND) OF TORTS § 402A, comment c (1965).

[86] For an excellent judicial discussion and application of the implied warranty of fitness to an insurance contract, see C & J Fertilizer v. Allied Mut. Ins. Co., 227 N.W.2d 169, 177-79 (Iowa 1975). The basic idea is that an insured should be able to rely on the insurer to issue a policy payable to the proper person in a form to carry out its purpose. Insurance contracts are being dealt with more as a commodity than as a contract. Glickman v. New York Life Ins. Co., 16 Cal.2d 626, 107 P.2d 252 (1940). Even Samuel Williston, a designer of what is now called the classical theory of contract, notes the developing view of insurance as a special form of chattel. S. WILLISTON, WILLISTON ON CONTRACTS § 900 (3d ed. 1957). *See generally*, Comment, *The Application to Insurance Contracts of the Implied Warranty in Sales Law*, 34 YALE L. J. 203 (1925).

[87] *See* 2 F. HARPER & F. JAMES, THE LAW OF TORTS § 28.19, at 1576 (1956).

[88] *See, e.g.*, Carmichael v. Reitz, 17 Cal. App. 3d 958, 95 Cal. Rptr. 381 (1971); Magrine v. Spector, 53 N.J. 259, 250 A.2d 129 (1969).

chooses to assume the risk of liability. Unlike many cases of professional misjudgment or malpractice, the carrier has had ample time to fulfill its insured's reasonable expectations but has voluntarily, consciously and wilfully decided not to pay. Notwithstanding the preceding rationales for legislating strict liability, the final rationale may be the most persuasive. Imposing strict liability for failing to pay a meritorious claim would allow a greater degree of prediction and certainty for both the company and its policyholders. When a covered loss occurs, insureds will be protected against serious, substantial economic and emotional injury that can arise when the insurer has guessed wrong.[89]

In contrast to strict liability penalties, the fault-based penalty, by evaluating the reasonableness of the insurer's conduct, may seem fairer to all interested parties—individual insured, the carrier, and other policyholders. The requirement of good faith can have a wholesome effect upon companies that unreasonably withhold payment while at the same time allowing carriers to contest first-party claims when legitimate grounds for doing so exist. The good faith standard seems to strike a fair compromise. It alone supports to some extent all three policies of deterrence, compensation and economy. The strongest attack that can be made against a statutory good faith penalty involves prediction and meaning. The good faith standard, it is said, is ineffable and undefinable, lacks sufficient resolving power, and thereby fails to provide meaningful predictability in this important commercial context. Whatever its ostensible effect on the claims settlement, the opaque good faith standard is easily thwarted by courts, such as the Georgia Supreme Court in *Williamson*,[90] who "legislate" the requirement of good faith out of the statute. Construction of the fault-based penalty statute by Georgia courts illustrates the potential futility of trying to legislate good faith.

On occasions the Georgia courts have engrafted conditions onto the Georgia penalty act by judicial interpretation and construction, which may have emasculated the good faith element. Whereas, for example, it was formerly held that penalty liability applied if the

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[89] The case law development of extra-contract recoveries is discussed in Holmes, *Is There Life After Gilmore's Death of Contract? Inductions From a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330 (1980).

[90] *See* note 81 *supra*.

carrier's refusal was either frivolous *or* unfounded,[91] the Georgia Supreme Court now holds that there is no penalty liability unless the refusal to pay is *both* "frivolous *and* unfounded."[92] Another example is the requirement that the plaintiff-insured recover every penny claimed in the complaint[93] as a condition precedent to recovering any penalties; the Georgia courts have held to the contrary on this issue.[94] Notwithstanding that an insurance contract is the example *par excellence* of an adhesion contract and that all ambiguities must be construed most strongly against the insurer, no penalty attaches, according to the Georgia courts,[95] if the interpretation of the policy presents a close question. Fulminating against these judicially created restrictions, Judge Evans of the Georgia Court of Appeals strongly argues for a return to the basic policy of good faith settlements as mandated by the Georgia legislature in its first-party penalty act:

> This law has been on the books for one hundred years . . . . But little by little our appellate courts have chiseled and whittled away until this statute, by judicial interpretation and construction is made almost meaningless. It is a rare case indeed, when penalty and attorney's fees are awarded for bad faith, that such case runs the gauntlet of the Court of Appeals and the Supreme Court and comes out unscathed . . . . Could it be that our General Assembly *really intended* that this statute be so restricted, hampered, and placed in a strait-jacket? Did the General Assembly mean to give lip service only to the question of bad faith with no real relief to be afforded? . . . If it is intended to do away with the bad faith law entirely, a simple repeal of the statute would accomplish that end; but if it is intended that the law shall be effective, some

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[91] Cimarron Ins. Co. v. Pace, 212 Ga. 427, 431, 93 S.E.2d 593, 596 (1956); American National Ins. Co. v. Holbert, 50 Ga. App. 527, 528, 179 S.E. 219 (1935); Metropolitan Life Ins. Co. v. Lovett, 50 Ga. App. 763, 768, 179 S.E. 253, 256 (1935).

[92] Dependable Ins. Co. v. Gibbs, 218 Ga. 305, 316, 127 S.E.2d 454, 461 (1962).

[93] Great American Indem. Co. v. Kennedy, 94 Ga. App. 567, 570, 95 S.E.2d 742, 745 (1956); Fireman's Ins. Co. v. Larsen, 52 Ga. App. 140, 182 S.E. 677 (1935).

[94] Canal Ins. Co. v. Winge Bros., 97 Ga. App. 782, 786, 104 S.E.2d 525, 529 (1958); New York Life Ins. Co. v. Williamson, 53 Ga. App. 28, 184 S.E. 755 (1936); Metropolitan Ins. Co. v. Lovett, 50 Ga. App. 763, 768, 179 S.E. 253, 256 (1935); Central Mfgs. Ins. Co. v. Graham, 24 Ga. App. 199, 99 S.E. 434 (1919).

[95] *See, e.g.*, United States Fid. & Acc. Co. v. Woodard, 118 Ga. App. 591, 164 S.E.2d 878 (1968).

> amendment is indicated to overcome the various far-fetched constructions and interpretations that have been placed thereon by our appellate court of Georgia.[96]

It may be that the Texas judge was accurate in his observation that it would be a difficult matter to secure a judgment for penalties if the issue of good faith is injected into the lawsuit. But when a rule becomes weighty with exceptions, obfuscated with inconsistent results, new persons with new ideas attempt some purer scheme. Perhaps that time has come if Judge Evans is right.

Because of the disadvantages and advantages of each type of legislation, it is suggested that the best position would be a compromise between the two rather than an either-or choice. The three societal values of deterrence, compensation and economy (as well as other rationales discussed) can be better served if strict liability and good faith notions are synergistically used in one unified statute. This reconciliation can be accomplished by a more considered study of these three values. First, regarding compensation, an insured is interested in the net rather than the gross economic recovery from his insurer. When the carrier decides not to pay a worthy claim, the insured must unjustly bear the expense of attorney's fees and other litigation costs in collecting from the company. A policyholder with low monetary policy limits may see his entire claim virtually wiped out by litigation expenses that were proximately caused by the insurer's unilateral decision not to pay. Based on restitutionary principles, an insured who wins the lawsuit for first-party benefits should be made whole. If the insured has to bear the litigation expenses to prove his claim, then his reasonable expectations in purchasing the policy will be denied. On balance, it seems only right that the insurer should be strictly liable for the expenses of successful litigation by its insured so that an insured with a well-founded claim will be fully compensated for the loss. Even though the insurer may have been acting reasonably, it voluntarily chose to contest and did so unsuccessfully. It should now compensate its insured for the costs of that contest.

On the other hand, the public wants insurance companies to be vigorous in policing claims, thereby holding down premiums. On

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[96] State Farm Mut. Auto. Ins. Co. v. Harper, 125 Ga. App. 696, 702-04, 188 S.E. 2d 813, 818-19 (1972). (emphasis in original). (Evans, J., concurring specially).

the basis of economy, insurers should be encouraged to contest doubtful claims and should not be penalized for their prudent conduct. In contrast to the compensatory award of litigation costs including attorney's fees, a carrier with reasonable grounds or probable cause to contest a claim deserves no penalty. Its conduct merits no punitive liability. Nevertheless, a carrier ought to be deterred from making an unfounded contest; penalty liability serves that cautionary function. The balance between economy in premium structure and deterrence from unfounded refusals to pay is struck by requiring that the insurer either act in good faith or face additional liability. The requirement of good faith encourages insurers to deny claims upon reasonable grounds and to pay meritorious claims. The policies of economy and deterrence are fittingly served.

In summary, it is inevitable in any society that individual interest shall come into conflict. It is the law in a civilized society that acts as arbiter. The legal process demonstrates an ongoing search to strike a balance between conflicting interests. By combining the policies of good faith dealing with strict liability in a first-party excess-liability act, the balance is struck. Societal values of economy, compensation and deterrence are fittingly fostered. Strict liability for attorney's fees and reasonable litigation expenses assures policyholders that they will be fully compensated for worthy claims. Good faith and fair dealing based on an equal consideration test exonerates a carrier's honest mistake in judgment and causes insurers to contest claims of doubtful merits.

2. Meaning, Standard and Application of "Good Faith"? Lawyers and legislators can be confused by the use of the vague term good faith. They may want a surer standard with more meaningful predictability for evaluating an insurer's conduct. This article has attempted to provide a meaning as well as predictive guidance for applying the good faith standard. It is urged that a legislature adopt the following meaning, standard and application of good faith. In this insurance context good faith means that a prudent insurance company, after diligent, careful investigation and evaluation of the first-party claim, would have reasonable grounds or probable cause in law or in fact to refuse to pay. The reasonable grounds or probable cause must exist at the time the company rejects the claim and continue thereafter up to the time of trial. Thus, the good faith standard calls into question the reasonableness of the insurer's trial. Additionally, insurance companies are

held to a higher standard than that of the tort standard of due care. The good faith standard mandates that an insurer do nothing to injure the insured's right to receive policy benefits. The insurer must weigh the competing interests and give the insured's interest at least as much consideration as its own. The equal-consideration test[97] requires the court and jury to make a two-step inquiry. The first inquiry is objective: Was there a reasonable basis in law or fact for denying benefits? The second is subjective: Did the insurer deny benefits while it knew or should have known that there was no reasonable basis for doing so? This knowledge can be implied as a matter of law.[98] It should be noted that intent to harm is not a requisite of bad faith conduct.[99] Proof of fraud, malice, oppression or outrageous conduct is not required. It is only necessary that the carrier knowingly took an unreasonable position in denying policy benefits to its insured.

3. Penalty or Compensation? Assuming that attorney's fees and litigation expenses will be authorized, a legislature would next have to determine what additional damages ought to be recover-

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[97] The prevailing view is that carriers must give the insured's interests at least equal weight in deciding whether or not to pay under the policy. KEETON ON INSURANCE 511 (1971). The equal-consideration test stems from the landmark case of Comunale v. Traders & General Ins. Co., 50 Cal. 2d 654, 320 P.2d 198 (1958). In *Comunale*, the California Supreme Court held that a covenant of good faith and fair dealing was implicit in every contract including all varieties of insurance contracts. The court further held that all parties under this duty cannot do anything which would injure the other party's right to receive contractual benefits, and that the insurer must accord the insured's interests at least as much consideration as its own. Any insurer who violates this good faith duty by not reasonably settling does so at its own risk. Insureds are thereby compensated for all resulting detriment including judgments in excess of policy limits.

[98] In two instances the California Supreme Court has held that an insurer's failure to pay first-party benefits is a breach of the covenant of good faith as a matter of law: (1) when an insurer fails to undertake a proper investigation of the insured's claim, Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 598 P.2d 452 (1979); (2) when an insurer drafts an ambiguous policy provision and then interprets it against the insured in justifying its refusal to pay, Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103 (1974).

[99] Courts draw distinctions based on the nature of the insurance company's conduct which can proceed from fairly but incorrectly withholding payment to unreasonably serving its own interests in refusing to pay to withholding payment with intent to do the insured harm. As one court explained:

> [P]roof of a violation of the duty of good faith and fair dealing does not establish that the defendant acted with the requisite intent to injure the plaintiff. Thus it does not follow that, because State Farm took an unreasonable position on the validity of a defense to coverage under Beck's policy, State Farm acted with intent to harm Beck.

Beck v. State Farm Mut. Auto. Ins. Co., 54 Cal. App. 3d 347, 351, 126 Cal. Rptr. 602, 607 (1976).

able. One approach is to tax a penalty which consists of a sum not exceeding a certain percentage of the claim if the insurer cannot prove that its failure or refusal to pay was in good faith. Another approach is to award all economic or pecuniary losses which were proximately caused by the bad faith breach of contract. Although most statutes considered in this article take the penalty approach, it would seem preferable to follow a compensatory scheme. If the issue were left to common law development, the policy of compensation would be followed. In fact, courts of at least twenty-one states allow plaintiffs to recover all economic losses in excess of the policy amount plus interest from first-party insurers who act in bad faith by failing to pay well-founded claims.[100]

It is urged that the following method be used for damage awards: attorney's fees and litigation expenses be awarded on the principle of strict liability, economic or pecuniary losses be given on the principle of fault (bad faith conduct) and punitive and mental distress damages be granted based on the penalty policy. As stated, intent to harm is not a prerequisite for proving bad faith conduct. However, if the facts show fraud, malice, or oppression by an insurer then punitive and, in a proper case, mental distress damages ought to be authorized.

Some insurers have used fraudulent or oppressive conduct to force insureds into unfair settlements. Disability and health insurers, for example, have engaged in malicious and outrageous conduct to avoid legitimate claims,[101] have intentionally left insureds and their families destitute,[102] have fraudulently attempted to induce insureds into waiving their policy rights,[103] and have harrassed insureds by requiring burdensome, unnecessary medical examinations[104] and by slandering the insured.[105] Fire insurers have

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[100] These cases are collected at Holmes, *Is There Life After Gilmore's Death of Contract?—Inductions from a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330, 353 n.96 (1980).

[101] *See, e.g.*, Felder v. Great Am. Ins. Co., 260 F. Supp. 575 (D.C.S.C. 1966); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); State ex rel. Larson v. District Ct. of 8th Jud. Dist., 149 Mont. 131, 423 P.2d 598 (1967).

[102] *See, e.g.*, Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

[103] *See* cases cited in 10 S.C.L.Q. 444, 468 (1958). *See also* World Ins. Co. v. Wright, 308 So. 2d 612 (Fla. App. 1975).

[104] *See, e.g.*, Haas v. Pacific Mut. Life Ins. Co., 70 Ohio App. 332, 334, 41 N.E.2d 263, 265 (1941).

initiated unfounded prosecutions for arson and fraud,[106] forced insureds into expensive and time-consuming examinations solely to delay payments,[107] and propelled insureds into bankruptcy by delaying desperately needed policy benefits.[108] A life insurance company, for instance, used an invented defense to force a poor widow to settle for less than what was due.[109] One commentator warns that "unless prevented by courts, it is to the interest of a disability insurer to engage in protracted and unwarranted litigation creating undue stress which may well precipitate the insured's death."[110] In short, insurers do use fraudulent, oppressive and abusive tactics to coerce insureds into unfair settlements. In such cases, punitive damages as well as mental distress damages have been recovered. Thus, any statutory scheme should accord sensitivity in judgment to deter such conduct by providing for these additional damages. When the breach of the covenant of good faith is accompanied by intentional aggravated misconduct by the insurer, a court should be authorized to award punitive and, if reasonably proven, mental distress damages.

4. To Legislate or Adjudicate? Perhaps the first issue to be addressed legislatively is whether the issue of excess liability arising from first-party insurance ought to be left to the courts for its evolution. The choice between a legislative or a judicial route to a societal problem, however, is largely historical and academic.[111] Ideally, it might be preferable to leave legal rules and principles to be worked out over time by the traditional process of judicial inclusion and exclusion. But there are too many objections to the adjudicatory method of discovering law. First, the older justifications supporting the common law tradition, such as states rights

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[105] *See, e.g.*, Miller v. Mutual of Omaha Ins. Co., 235 So. 2d 33 (Fla. App. 1971).

[106] *See, e.g.*, Mustachio v. Ohio Farmers Ins. Co., 44 Cal. App. 3d 358, 118 Cal. Rptr. 581 (1975); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 571, 510 P.2d 1032, 1035, 108 Cal. Rptr. 480, 483 (1973).

[107] *See, e.g.*, Merrin Jewelry Co. v. St. Paul Fire & Marine Ins. Co., 301 F. Supp. 479, 484 (S.D.N.Y. 1969); Independent Grocery Co. v. Sun Life Ins. Co., 146 Minn. 214, 178 N.W. 582 (1920).

[108] *See, e.g.*, Reichert v. General Ins. Co. of Am., 68 Cal. 2d 822, 827, 442 P.2d 377, 379, 69 Cal. Rptr. 321, 323 (1968) (*en banc*).

[109] Eckenrode v. Life of Amer. Ins. Co., 470 F.2d 1 (7th Cir. 1972).

[110] J.A. APPLEMAN & J. APPLEMAN, 16 INSURANCE LAW & PRACTICE § 8881, at 626 (1967).

[111] III R. POUND, JURISPRUDENCE 675 ff. (1959). *See also* Stoljar, *Codification and the Common Law, in* PROBLEMS OF CODIFICATION 1 (S. Stoljar ed. 1977).

and distrust of the legislature, are not so appealing today. Second, the common-law technique can generate confusion and uncertainty since the growth of a body of law is piecemeal and haphazard. Some jurisdictions will adjudicate aspects of excess liability; others will not. Different solutions are often pronounced and no one knows which solution may be followed in another jurisdiction. Trivial questions can receive elaborate discussion while fundamental ones lie in a provoking state of uncertainty. No court has authority to reduce any subject to a complete, orderly and systematic statement. Third, the common law system has the potential for fashioning anomalous rules which survive. The analytical method is slow in getting rid of these obsolete rules. Irrationality in law results. Finally and most importantly, time and judicial labor and money are wasted while the public waits for the courts to say what the law is. We live in an age of instant everything, including instant answers. The pressures of a complex world demand efficiency in the application of law. The case law cannot rise to meet new situations as it could do in the past. It was the demand for one set of legal rules that was behind the growth of the common law.[112] Likewise, the demand today for one law and efficiency in its application is leading to a codification of the common law in the United States.[113] Although attempts to reshape the law by judicial inclusion and exclusion may work over time, there is no substitute for well-drawn, comprehensive legislation.

Nonetheless, there is one notable drawback to the statutory method. Statutes present an interpretive function, and no holy grail of statutory drafting, interpretation and construction exists. In any legislation, unintended and virtually inevitable ambiguities will arise from bad draftsmanship or from the prevalence of ambiguity and equivocation in language generally or from the legislature's failure to foresee and provide for all potential problems. The solution is to acknowledge candidly that perfection in draftsman-

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[112] Prior to the Norman Conquest there was no unitary body of English law and local customary law differed significantly. One of the demands in the Magna Carta was for one measure of corn and one measure of ale for all England. MAGNA CARTA ch. 35.

[113] Our society requires uniformly operating rules of conduct to ensure social harmony. The need for certainty, predictability and uniformity in the laws among the states is reflected in federal legislation and in uniform state laws. *See, e.g.*, Dunham, *A History of the National Conference of Commissioners on Uniform State Laws*, 30 LAW & CONTEMP. PROB. 231 (1965).

ship and in judicial construction of statutes is unattainable. But, as Justice Frankfurter fittingly opined: "Fit legislation and fair adjudication are attainable."[114] Fit legislation requires the legislature to assist the court in its search for legislative intent or purpose. In many instances, the problems of ambiguity in language or in hiatus can be overcome by a careful statement of purposes and policies for any legislation. The one remaining question then is: Has there been sufficient thinking about first-party excess-liability so that the major problems and potential solutions are known? Given the amount of existing legislation and recent case law creating a common law cause of action,[115] it seems reasonable and appropriate now to legislate rather than to adjudicate. In that spirit, the following model act is proffered to effect the policies of certainty, consistency, uniformity, order and predictability in first-party insurance excess-liability law. It is a new wine and a new wineskin.

AN ANNOTATED PROPOSAL FOR LEGISLATION
MODEL FIRST-PARTY INSURANCE EXCESS-LIABILITY ACT[116]

(1) Short Title

This Act shall be known and may be cited as the "First-Party Insurance Excess-Liability Act."

(2) Purposes; Rules of Construction

(a) This Act shall be liberally construed and applied to promote its underlying purposes and policies.

(b) The underlying purposes and policies of this Act are

(i) To protect the reasonable expectation of policyholders that their insurers will pay policy benefits promptly and fairly when an insured event occurs;

(ii) To discourage insurers from contesting valid first-party claims;

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[114] Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 546 (1947).

[115] *See* note 100 *supra*.

[116] This model act is based in part on the seventeen first-party excess-liability statutes already enacted. However, most of the provisions were drafted to resolve problems that have arisen under those statutes. Many of those problems have been identified by Jeffrey S. Muir in his analysis of the Georgia Insurance Penalty Act. *See* Note, *Wrongful Refusal to Pay Insurance Claims in Georgia*, 13 GA. L. REV. 935 (1979) [hereinafter cited as *Wrongful Refusal*].

(iii) To encourage insurers to be cost efficient by rejecting invalid claims; and,
(iv) To cause insurers to contest claims of doubtful merit by exonerating an insurer's good-faith mistake in judgment in failing or refusing to pay a claim.

(3) Definitions

As used in this Chapter:
(a) "Insurance contract" means any policy, plan, surety, guaranty, indemnity, certificate or contract issued by an insurer, except liability insurance policies including all liability coverage in multiple-line insurance policies,[117] and any action under the Worker's Compensation Act in this State.[118]
(b) "Insurer" means any company, association, firm, plan, exchange or corporation that issues any insurance contract as defined herein including but not limited to marine and inland marine, fire, casualty, life, personal accident and health, annuity, cargo, fidelity, surety, medical, hospital and surgical benefit, fraternal benefit society, farmers' mutual aid association, Lloyd's organization, local mutual aid association, nonprofit hospital service plan, medical service corporation, any reciprocal or interinsurance exchange, reinsurer, and any other organization of any kind or nature whatsoever that issues first-party insurance contracts. [Alternative Provision: "Insurer" means any company, firm, plan, exchange or corporation as

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[117] Since a liability insurer has a duty to pay on behalf of its insured, liability insurance policies would be covered by this Act if that duty were breached. *See Wrongful Refusal, supra* note 116, at 939-41. Nonetheless, it is my opinion that third-party excess-liability case law is well-developed among the states and gives rise to policies and problems inapplicable to first-party cases. Courts which have considered the issue hold that a distinction between first and third-party cases is warranted. *See, e.g.*, Neal v. Farmers Ins. Exchange, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978); Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 392 A.2d 576, 580-81 (1978). Therefore, separate legislation ought to be enacted for third-party excess liability. *See, e.g.*, Schwartz, *Statutory Strict Liability for an Insurer's Failure to Settle: A Balanced Plan for an Unresolved Problem*, 1975 DUKE L.J. 901.

[118] Obviously many varieties of insurance contracts could be exempt from the act for various reasons. Some states omit worker's compensation policies due to existing legislation which apparently is deemed adequate. *See, e.g.*, IDAHO CODE § 41-1839(3) (1977); NEB. REV. STAT. § 44-359 (1974). If worker's compensation policies are included in this Act then the word "court" should throughout be "court and board." Some states omit fraternal benefits societies for similar reasons. *See, e.g.*, Brown v. Travelers Protective Ass'n, 45 Ga. App. 410, 411, 165 S.E. 143, 144 (1932). Each legislature would be required to examine its peculiar statutes to ascertain which insurance contracts ought to be omitted from this legislation.

defined by the laws of this State at _____, except liability insurers and worker's compensation carriers.]

(c) "Insured" means any claimant entitled to bring an action on the insurance contract including but not limited to the named insured, an additional or omnibus insured, beneficiary, representative of a claimant or his estate, an assignee, and any person or entity having a beneficial interest in the insurance contract.

(d) "Good faith" requires an insurer to act reasonably and honestly by weighing the competing interests and giving the insured's interest in his claim at least as much consideration as its own. An insurer has acted in good faith if:

(i) After diligent, careful investigation and evaluation of the insured's claim, it had reasonable grounds or probable cause in law or in fact to cause a prudent insurance company to act as the insurer did. If evidence of insurance-industry custom or usage of trade is introduced, each custom or usage must be equitable as a matter of law. No presumption of reasonable or probable cause shall be based on a showing that the insured's claim involves a legal or factual issue of first impression.[119] In such a case, an insurer must show that reasonable and probable cause existed to justify a prudent insurer's insistence on litigating the first impression issue; and,

(ii) At the time of its initial refusal to pay or when the benefits became overdue and continuously thereafter until action was instituted, the insurer had actual knowledge of the reasonable grounds or probable cause in law or in fact that justified its initial as well as continuing refusal or failure to pay the overdue benefits.[120]

(4) When Policy Benefits Are Overdue

(a) A claim for payment of benefits under an insurance con-

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[119] Many courts hold that any defense by the insurer that raises an issue of first impression is presumptively reasonable and therefore in good faith. *See Wrongful Refusal, supra* note 116, at 964-65. Since any inventive insurer can conjure up a first impression issue in most cases, the good faith inquiry is easily short-circuited. This provision is designed to require the insurer to prove that its defense is not improbable or frivolous but is in fact asserted in good faith.

[120] *See* text at notes 76-82 *supra. See also Wrongful Refusal, supra* note 116, at 953-57.

tract against loss delivered or issued for delivery within this State is payable within sixty (60) days after either written notice and proof of claim as required by the contract or written demand with reasonable proof of the fact and the amount of loss sustained is communicated to the insurer, whichever first occurs.[121] "Payment of benefits" means any primary and matured benefit, and excludes all collateral benefits, including but not limited to loan and surrender values, and any present claim for unmatured benefits. A claim which is neither disputed nor paid within the 60-day period is overdue. For purposes of calculating when and the extent to which any benefits are overdue, any communication shall be treated as made on the date the communication was placed in the United States Mail to the last known address in a properly addressed, postpaid envelope, or, if not so posted, on the date of delivery.

(b) If during the 60-day period, the insurer, in writing, notifies the insured that reasonable additional information is required, the claim shall not be overdue until thirty (30) days after the reasonable additional information is communicated to the insurer.[122]

(c) An insurer may dispute a claim by furnishing to the insured or his representative a written statement that the claim is disputed with a statement of the grounds upon which it is disputed. If the insurer therein denies liability or refuses to pay, then all statutory conditions, including the 60-day period, precedent to an action under this Act are excused, and any claim created by this Act is thereupon overdue.[123]

(5) Damages Recoverable For Overdue Benefits

In any action brought by the insured for overdue benefits or

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[121] Some statutes require that the insured make a demand for payment rather than file a proof of loss or death to activate the statutory rights. If a policy contains a provision that liability will not accrue until 90 days after proof of loss is received, then the statutory demand cannot be made until that time has elapsed. If the statute provides a waiting period of 60 days, for instance, then the insurer has two investigative periods totalling 150 days before the statutory penalties would be legally applicable.

[122] This provision is an adaptation of ME. REV. STAT. ANN. tit. 24-A, § 2436 (West Supp. 1978-79).

[123] In most states a refusal to pay already waives the proof-of-loss condition in the contract. This provision simply codifies what most cases hold already regarding waiver of statutory conditions precedent. *See Wrongful Refusal, supra* note 116, at 950-51.

in any action brought by the insurer against the insured, such as declaratory judgment, injunctive or interpleader or action to cancel, lapse, change or alter the contract,[124] involving the overdue benefits, the insured may recover the following:

(a) the overdue benefits plus interest. When an insurer fails to pay a claim or any part thereof when due, the amount of the overdue claim or part thereof shall bear interest at the rate of 1½% per month computed from the date when the policy benefits became due and payable;[125]

(b) a reasonable attorney's fee and all reasonable and necessary expenses of litigation. A reasonable attorney's fee for advising and representing an insured on an overdue claim or action for an overdue claim shall be paid by the insurer if overdue benefits are recovered in an action against the insurer or if overdue benefits are paid after receipt of notice of the attorney's representation. In the event of an appeal in which the insured prevails, the appellate court shall adjudge or decree against the insurer and in favor of the insured a reasonable sum as fees or compensation for the insured's attorney prosecuting the suit and for all reasonable and necessary litigation expenses on appeal.[126] A court in fixing such fees and expenses shall consider all benefits to the insured incident to the prosecution of the suit, accrued and to accrue on account of the insurance contract.[127] When so awarded, fees and litiga-

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[124] Most statutes use the phrase "against the insurer" so that courts thereunder refuse to apply the statute in cases brought "against the insured." *See Wrongful Refusal, supra* note 116, at 941-44. It should be noted that Arkansas has a separate statute entitled: *Allowance of Attorney Fees in Suits to Terminate, Modify or Reinstate Policy.* ARK. STAT. ANN. § 66-3239 (1966).

[125] The phrase "when the policy benefits became due and payable," is based on North Am. Life & Cas. Co. v. Wolter, 593 F.2d 609 (5th Cir. 1979).

[126] Most statutes do not explicitly provide for attorney's fees for appeals, which is a legislative oversight. There are other ways of handling the inclusion of attorney's fees for appeals than the one in the model act. Texas, in addition to permitting a remand for the assessment of fees, has a remittitur procedure that enables the trial court to enter appeal costs in the judgment which can be ministerially removed when it is apparent that no appeal will be taken. *See, e.g.*, International Life Ins. Co. v. Russell, 473 S.W.2d 653 (Tex. Civ. App. 1971). Some jurisdictions authorize appellate courts to add attorney's fees on appeal. *See, e.g.*, Lumberman's Mut. Ins. Co. v. Blackburn, 477 P.2d 62 (Okla. 1970); Old Republic Ins. Co. v. Alexander, 245 Ark. 1029, 436 S.W.2d 829 (1969).

[127] A legislature may want to consider adopting a separate hearing on attorney's fees similar to the following from South Dakota:

The determination of entitlement to an allowance of attorney fees as costs and the

tion expenses shall be included in the judgment or decree rendered in the case. Where there are several contracts insuring the same insured against the same loss whether issued by the same or by different insurers, the court may fix the amount of the allowance so that the total fees and expenses on account of one loss shall not be increased by reason of the fact that the insured brings separate suits on such contracts;[128]

(c) a penalty in a sum not to exceed twenty-five percent (25%) of the overdue benefits unless the insurer does prove to the court or jury trying the case that its failure or refusal to pay was in good faith. [Alternative Provision: a sum for all harm, expense, loss and injury incurred by the insured as a proximate result of the insurer's refusal or failure to pay unless the insurer can prove to the court or jury trying the case that its failure or refusal to pay was in good faith;[129]] and,

(d) mental distress damages, if reasonably proven, and punitive damages in all cases where the insured can prove to the court or jury trying the case that the insurer failed or refused to pay with an intent to harm the insured. To recover these additional damages, the insured must show fraud, malice, oppression, abusive settlement tactics or other intentional, aggravated misconduct by the insurer.[130]

(6) When an Insurer May Be Exempt From the Act

If, in any action, it is alleged that before the commencement

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amount thereof under § 58-12-3 shall be made by the court or the department of labor at a separate hearing of record subsequent to the entry of a judgment or award in favor of the person making claim against the insurance company, and, if an allowance is made, the amount thereof shall be inserted in or added to the judgment or award. Such a hearing shall be afforded upon the request of the claimant made within ten days after entry of the judgment or award.

S.D. COMPILED LAWS ANN. § 58-12-3.1 (1978).

[128] This provision is an adaptation of ILL. ANN. STAT. ch. 73, § 767(2) (Smith-Hurd Com. Supp. 1979).

[129] The alternative recognizes that the insured ought to recover only its actual losses which may be more or less than the 25% penalty. This provision codifies the developing first-party insurance excess-liability case law in the jurisdiction. For a discussion of these cases, see Holmes, *Is There Life After Gilmore's Death of Contract?—Inductions From a Study of Commercial Good Faith in First-Party Insurance Contracts*, 65 CORNELL L. REV. 330 (1980). Perhaps some monetary limit ought to be placed on the amount recoverable under this alternative.

[130] *See* text at note 100 *supra*.

thereof, tender of the full amount of benefits due was made by the insurer to the insured, and, if the allegation is found to be true or if it is determined that no amount is due, then the insurer will be held to have prima facie acted in good faith, and, unless rebutted, no recovery under subsection (4) of this Act shall be allowed.[131] [Alternative Provision: In any action, if it is alleged that a tender was made by the insurer before the commencement of the action in which a judgment or award is rendered and the amount recovered is not in excess of such tender, then the insurer will be held to have prima facie acted in good faith and, unless rebutted, no recovery under subsection (4) of this Act shall be allowed.[132]] The fact that any judgment, decree or award for the insured is less than the amount of the insured's demand shall not prohibit or limit the insured's rights under this Act provided that the judgment, award or decree for the insured is more than the amount deposited in court [Alternative: tendered], and provided that the insured's demand bears a reasonable relationship in monetary terms to the judgment, award or decree.[133]

(7) Competing Claims and Deposits in Court Registry

An insurer may establish good faith by showing its observance, inconsistent with prompt payment of benefits, of legal process. If, however, the process issues on behalf of a person claiming benefits in competition with a person who thereafter claims under this Act, and issues out of a court of this State, good faith requires that the insurer promptly deposit any amount admitted to be due into the registry of that court. The courts of this State are authorized to receive such deposits and to dispose of them as justice requires.[134]

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[131] This provision is a variation of IDAHO CODE § 41-1839(2) (1977).

[132] This alternative provision is a variation of S.D. COMPILED LAWS § 58-12-3 (1978).

[133] This provision is responsive to those cases that hold the penalty act is inapplicable when the insured fails to recover every penny that it originally demanded. *See Wrongful Refusal, supra* note 116 at 962-63.

[134] This provision is a variation from Arkansas. ARK. STAT. ANN. § 66-3238 (1966).

(8) Act Does Not Bar Any Other Remedy

> The remedy or remedies of this Act do not bar, prohibit, limit or displace any other remedy provided by law or equity. This Act shall be administered, however, so as not to duplicate compensation for interest, litigation expense, or any other harm, and not to cumulate penalties.[135]

[135] Maine and South Dakota allow only attorney's fees by statute and therefore state explicitly that the statute does not preempt any common law action for damages in the event of a wrongful refusal to pay first-party benefits. ME. REV. STAT. ANN. tit. 24-A, § 2436 (West Supp. 1979-80). The provision in the model act was drafted to reflect that policy.

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