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INSURER'S MISTAKEN JUDGMENT — A NEW TORT?

JOHN J. KIRCHER*

In days gone by when everything, including the law, was much less complex, an insurer's breach of its contract with an insured was treated much like any contract breach. If the insurer's breach was established, the insured's damages would be determined by what the contract obligated the insurer to do. The anxiety the insured may have sustained as a result of the delayed payment was not, after all, a matter to which the law of contracts addressed itself in the typical case of contract breach.¹

Now that times have changed and the law has changed with them, insurers are exhibiting growing concern over potential liability to insureds beyond their contractual undertakings. In certain cases insureds are seeking compensatory damages beyond contract benefits as well as punitive damages from their insurers for alleged contract breaches.

A good deal has been written about the liability of an insurer for its "wrongful" refusal to accept an offer by a third party to settle a claim against its insured within the policy limits of a liability insurance contract.² This article will be concerned only with the liability of an insurer leading to exposure beyond its policy benefits in the handling of claims of its own insured under so-called "first party" insurance coverages.³

An insured seeking to impose liability upon its insurer beyond contract benefits resulting from a first party insurance claim will typically employ one of two theories of liability: (1) intentional infliction of emotional distress, and (2) alleged

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1. RESTATEMENT OF CONTRACTS § 341 (1932).

2. The "Annotated Bibliography" in the Defense Research Institute monograph, Insurance Law — Excess Liability (Vol. 1973 No. 3, Sept. 1973), for example, lists a total of sixty-three law review articles on the subject.

3. First party insurance generally describes those types of insurance coverage under which the insured (or his beneficiaries) recovers benefits directly from his own insurer without the need to establish fault (*e.g.*, life, fire, accident and health, and income disability coverages).

breach of the duty of good faith and fair dealing arising from the contract of insurance. In some cases insureds have asserted both theories in the same action.

I. INTENTIONAL INFLICTION OF EMOTIONAL DISTRESS

At least since 1936 tort commentators have recognized that a person's interest in his own emotional tranquility is, of itself, deserving of protection under tort principles.⁴ The elements of the tort of intentional infliction of emotional distress are set forth in the *Restatement (Second) of Torts*:

One who by extreme and outrageous conduct intentionally or recklessly causes severe emotional distress to another is subject to liability for such emotional distress, and if bodily harm to the other results from it, for such bodily harm.⁵

The cases in which intentional infliction of emotional distress is alleged against a first party insurer involve conduct on the part of the insurer in the claims handling process. In actions in which insureds have been successful in asserting this theory, the insurers were found to have employed various forms of coercion, harassment and threats against the insured in order to minimize claim payment or completely escape their contractual responsibility.⁶ This course of conduct was followed even though the obligation to pay contract benefits was clear. An insurer's settlement tactics may be privileged and may not subject the insurer to liability for intentional infliction of emotional distress when the insurer does nothing more than insist upon its legal rights in a permissible way.⁷ However, when settlement tactics degenerate to extreme and outrageous bullying of the insured, liability for intentional infliction of emotional distress may attach if the requisite emotional response is sustained by the insured.⁸

Because of the space limitations on this article and because

4. See Magruder, *Mental and Emotional Distress in the Law of Torts*, 49 HARV. L. REV. 1033 (1936).

5. RESTATEMENT (SECOND) OF TORTS § 46(1) (1965).

6. *Wetherbee v. United Ins. Co. of America*, 265 Cal. App. 2d 1058, 71 Cal. Rptr. 764 (1968); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); *Eckenrode v. Life of Amer. Ins. Co.*, 470 F.2d 1 (7th Cir. 1972).

7. RESTATEMENT (SECOND) OF TORTS § 46, comment g and illustration 14 at 76 (1965).

8. *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 395, 89 Cal. Rptr. 78, 89 (1970).

the cases in which insureds have been successful in employing this theory present such clear examples to insurers of the type of conduct which should be avoided, the discussion of this theory of liability has been limited. In addition, it has been thoroughly discussed elsewhere.⁹ Suffice it to say that a first party insurer's decision to resist its insured's claim should be based upon its good faith assessment that the facts, applicable policy provisions and applicable law do not justify honoring the claim. It should not be made "to save some money for the company" after an assessment of the claim shows its validity.

II. DUTY OF GOOD FAITH AND FAIR DEALING

This writer has chosen to devote the bulk of this article to the second of the two theories employed by first party insureds against their insurers to impose liability beyond contractual undertakings. As this theory has developed, it presents far more complex and troublesome questions for insurers.

A. *The California Approach*

As one familiar with insurance law might expect, the theory that a first party insurer may be liable to its insured for non-contract damages in the event it breaches its "duty of good faith and fair dealing" was first developed by the courts of California. Courts in that state have a history of treating insurance contracts as so much silly putty to be twisted and pulled into what they consider to be a proper form. While the courts of that state have ruled that insurers have a duty of good faith and fair dealing and that breach of that duty is a tort exposing the insurer to noncontract liability for consequential damages, they have not seen fit to fully articulate the precise nature of the duty so that conscientious insurers may seek to avoid liability.

The first case to consider a first party insurer's obligation of good faith and fair dealing was *Richardson v. Employers Liability Assurance, Corp.*¹⁰ The plaintiffs in that action were

9. DuBois & Bronson, *The Spectre of Punitive Damages in First Party Actions*, 40 INS. COUNSEL J. 290 (1973); DuBois, *The Spectre of Punitive Damages in First Party Actions II*, 42 INS. COUNSEL J. 242 (1975); Miller, *Recovery Beyond Property Policy Limits — A Plaintiff View*, 11 THE FORUM 523 (1976); Houser, *First-Party Claims for More Than Insurance Policy Limits — A Defendant's Viewpoint*, 11 THE FORUM 529 (1976).

10. 25 Cal. App. 3d 232, 102 Cal. Rptr. 547 (1972).

insured by the defendant under an auto insurance policy which provided coverage against injuries caused by uninsured motorists. They were injured in an auto accident which was precipitated by another motorist who ran a stop sign. Despite investigation by the insurer's local claims office which indicated that the stop sign violator was the sole cause of the accident and that he was uninsured, the insurer's home office took a "pay only as a last resort" attitude toward its insureds' claim for uninsured motorist benefits. The insureds, who had sustained over \$13,000 in medical and related expenses and had only \$20,000 in uninsured motorist coverage, were forced to submit their claim to arbitration. After the arbitration proceeding, at which the insurer presented no evidence to dispute the claim, the insureds were awarded the full amount of benefits due. Nevertheless, the defendant instructed its local claims personnel to attempt to settle for less than the policy limits. Finally, after judicial confirmation of the arbitration award, the insurer paid the benefits.

Despite the eventual payment, the insureds commenced an action against their insurer seeking compensatory and punitive damages. In analyzing the duty of the insurer to its insureds the court relied heavily on the case of *Crisci v. Security Insurance Co.*¹¹ That case, however, did not involve an insurer dealing with a claim of its own insured, but was concerned with the alleged bad faith of an insurer for its "unreasonable" refusal to settle the claim of a third party within the limits of its insured's liability insurance coverage. *Crisci* imposed the duty upon the insurer to act in good faith and to deal fairly with such claims to protect the interest of the insured. It defined "bad faith" as acts by the insurer amounting to dishonesty, fraud, concealment, or an unwarranted or unreasonable refusal to settle the claim.

The court in *Richardson* expanded upon the rationale in *Crisci* to hold that the duty of good faith and fair dealing is an implied covenant in every contract of insurance. It further held that breach of that duty is a tort which exposes the offending insurer to noncontract, consequential damages sustained by the insured. It held that the insurer's refusal to pay uninsured motorist benefits to the plaintiffs until compelled to do so was

11. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

unwarranted and unreasonable. The insurer, therefore, had breached its duty of good faith.

If the "rule" of *Richardson* could be confined to factual settings similar to that case, insurers would have a clear course to follow. They would be well advised to avoid assuming a recalcitrant attitude toward claims by insureds involving obvious coverage under a policy. However, the rule has been employed in other factual settings. Its application there raises serious questions as to the precise nature of the duty owed. Questions are also raised as to what, if anything, an insurer may do to avoid excess exposure in a case involving questionable liability to its insured under a policy of first party insurance.

*Gruenberg v. Aetna Insurance Co.*¹² presents an excellent illustration of the scope of the problems. The insured in *Gruenberg* had his nightclub covered by three separate fire insurance policies. Following a fire the insured was charged with both arson and defrauding an insurer. He alleged that an adjuster employed by the defendants told a fire department official that the insured carried excessive insurance on the property. While the criminal charges were pending, an attorney representing the insurers made a demand upon the insured to appear and be examined concerning the fire loss. Provisions in the fire policies gave the insurers this right of examination.¹³ The insured's attorney advised the attorney for the insurers that he had instructed his client to make no statement concerning the fire while criminal charges were pending. The insurers' attorney responded by advising that if the insured did not appear as demanded, the insurers would treat this as a breach of the contracts of insurance and deny coverage for the loss. The insured did not, in fact, appear when demanded. However, after the criminal charges against him were dropped for lack of probable cause, his attorney advised the insurers' attorney that his client was ready to appear and be examined. This was met with the reaffirmation by the insurers that the insured had breached the contract when he failed to appear when demanded, and coverage was denied.

The insured then brought suit against the insurers. He al-

12. 9 Cal. 2d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

13. Lines 113-122 of the standard policy, enacted by legislation in most states, so provide. See, e.g., WIS. STAT. § 203.01 (1973).

leged that the conduct of the insurers caused him severe emotional distress, loss of earnings and other consequential damages. The insurers' general demurrer was sustained and the appeal followed.

In *Gruenberg* the California Supreme Court, as did the intermediate appellate court in *Richardson*, relied heavily on *Crisci*. It also extended the duty of good faith and fair dealing.

The duty to so act is imminent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.¹⁴

The insurers attempted to justify their conduct on the ground that the insured had breached the contract before they denied coverage. The dissent in this case noted that the insurers had very good reason to take the action complained of by the insured. It found that the policy provisions authorizing the insurers to demand examination of the insured concerning the loss were drafted and enacted by the state's legislature; that they were construed by the state's supreme court to require compliance by the insured as a condition precedent to recovery under the policy; and that they were further construed by the same court to require the insured's appearance and examination concerning the loss even though criminal charges stemming from the same loss were pending against the insured.¹⁵ The majority, however, stated:

we do not say that the parties cannot define, by the terms of the contract, their respective obligations and duties. We say merely that no matter how those duties are stated, the non-performance by one party of its contractual duties cannot excuse breach of the duty of good faith and fair dealing by the other party while the contract between them is in effect and not rescinded.¹⁶

If California insurers were expecting some clear guidance from *Gruenberg*, it certainly was not received. There it was held that an insurer, which denies coverage based upon advice

14. 9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486 (1973).

15. *Id.* at 590, 510 P.2d at 1049, 108 Cal. Rptr. at 497.

16. *Id.* at 578, 510 P.2d at 1040, 108 Cal. Rptr. at 488.

of counsel, a legislatively-enacted policy provision and clear interpretation of that provision by the state's highest court could be held to have breached its duty of good faith and fair dealing to its insured. In fact, the dissent in *Gruenberg* gave a rather perplexing interpretation of what the majority had done:

It is respectfully suggested that the majority have advised an insurer that if it expects to avoid a *Crisci* . . . lawsuit, there is only one safe course: Pay all claims and investigate afterwards, assuming, of course, payment doesn't waive that right.¹⁷

The California Supreme Court received another chance to shed some light on this "new tort" of breach of the duty of good faith and fair dealing when it considered the case of *Silberg v. California Life Insurance Co.*¹⁸ However, it seemed to do nothing more than reinforce the view of the dissent in *Gruenberg* as to the practical effect of that decision.

The plaintiff in *Silberg* carried a policy issued by the defendant which covered up to \$5,000 in medical and hospital expenses. The policy provided that it would not cover "any loss caused by or resulting from . . . injury or sickness for which compensation is payable under any Workmen's Compensation . . . Law." After the plaintiff sustained an injury and made a claim for policy benefits, the defendant denied benefits because the plaintiff had also filed a workmen's compensation claim. The defendant advised him that no decision could be made on his claim until the compensation claim was determined. The workmen's compensation carrier also denied the plaintiff's claim. However, a compromise of the compensation claim was finally reached and the plaintiff was paid for a portion of the loss sustained. The defendant then advised its insured that the settlement of the compensation claim made its policy exclusion applicable and that his claim for medical and hospital benefits was denied.

The plaintiff commenced an action against his insurer on the contract and also sought damages for alleged physical and mental distress. He alleged that his insurer was guilty of fraud, bad faith, and malicious and oppressive conduct. He sought both compensatory and punitive damages. The trial court,

17. *Id.* at 592, 510 P.2d at 1049, 108 Cal. Rptr. at 497.

18. 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

without a jury, found that the policy language was ambiguous and that the plaintiff was entitled to the contract's benefits. A jury considered the other claims of the plaintiff and awarded him \$75,000 in compensatory damages and \$500,000 in punitive damages. The trial court granted the insurer's motion for a new trial finding insufficiency of the evidence to support the verdict and excessive damages.

On appeal by the plaintiff, the California Supreme Court considered the question of the ambiguity of the policy and agreed with the trial court. It considered the exclusion in light of the policy's insuring agreement which obligated the defendant "to pay for loss, except losses covered by any Workmen's Compensation . . . Law." It reasoned that the insuring agreement, read with the exclusion, could lead to the interpretation that the policy would provide coverage for any portion of a loss not paid by workmen's compensation.

Turning to the question of the insurer's liability for breach of its duty of good faith and fair dealing, the court noted first the insurer's awareness of the dispute as to whether workmen's compensation benefits were payable. It said that the defendant could have paid its benefits and then asserted a lien in the workmen's compensation proceeding to recover the payments it had made. The court then held that the action of the insurer in asserting its right to wait until the workmen's compensation proceeding was concluded violated, as a matter of law, the duty of good faith and fair dealing owed to its insured.

B. Damages Flowing From the Breach

Consideration should be given to the type of damages for which the insurer may be held liable when found to have breached its duty of good faith and fair dealing. As has been noted, the California courts have held that although the duty arises by implication from the contract of insurance, its breach is a tort.

A reading of the cases noted above would indicate that the California courts will take a rather liberal view of what the damages stemming from this ill-defined tort will be. They would appear to cover any "consequential damage" sustained by the insured proximately caused by the insurer's breach of its "duty." Clearly included would be damages for the emotional distress sustained by the insured as a result of worry as to whether his claim will be paid and also resulting from worry

over debts that the insurance benefits might have paid.¹⁹ Damages for any financial setbacks, such as loss of property, which the insured is able to trace to his lack of money because of nonpayment of the policy's benefits would also appear to be included.²⁰

Are punitive damages recoverable from an insurer who breaches its duty of good faith and fair dealing to the insured? The court in *Richardson* reasoned that punitive damages are recoverable. The court recognized the general rule that punitive damages are not generally recoverable for contract breach.²¹ In fact, a California statute provides for the recovery of such damages only in actions "for breach of an obligation not arising from contract."²² The court reasoned that the fact that the insurer's conduct constituting a tort also involves a breach of a covenant implied by law in the insurance policy does not prevent recovery of punitive damages.²³ It is interesting to note the semantic exercise engaged in by the court to avoid the California Code's prohibition against awarding punitive damages. The court first tells us that the duty ("obligation") of good faith and fair dealing is implied in ("arises from") every insurance contract. Yet, the court says, since the breach of the duty ("obligation") amounts to a tort, recovery of punitive damages is allowed since the insured's action is "for breach of an obligation not arising from contract" within the meaning of its code provision. Be that as it may, the California Supreme Court in *Silberg* provided at least some form of limitation when it announced that mere breach of the insurer's duty is not enough to subject it to liability for punitive damages in that state. The insurer must also be found guilty of fraud, oppression or malice and must have acted with the intent to vex, injure or annoy, or with conscious disregard for the plaintiff's rights.²⁴

19. "Since in the instant case we are concerned with mental distress resulting from a substantial invasion of property interests of the insured and not with the independent tort of intentional infliction of emotional distress, we deem Section 46 [RESTATEMENT (SECOND) OF TORTS] to be inapplicable." *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 580, 510 P.2d 1032, 1041, 108 Cal. Rptr. 480, 489 (1973).

20. *Id.*

21. RESTATEMENT OF CONTRACTS § 342 (1932).

22. CAL. CIV. CODE § 3294 (West 1970).

23. 25 Cal. App. 3d 232, 245, 102 Cal. Rptr. 547, 556 (1972).

24. 11 Cal. 3d at 462, 521 P.2d at 110, 113 Cal. Rptr. at 718 (1974).

C. *The Non-California View*

At least for now the "new tort" of breach of a duty of good faith and fair dealing appears to be limited in application to California. In *Drake v. Milwaukee Mutual Insurance Co.*,²⁵ for example, the insured claimed that the insurer was guilty of "tortious breach of contract" for failing to honor her uninsured motorist coverage claim. In assessing the situation the court held that the insurer's denial was, at most, due to a then arguable interpretation of Wisconsin law as to whether the potential tort liability of someone other than the uninsured motorist to the insured would block an uninsured motorist coverage recovery. The court held that if there is a genuine dispute over the status of the law when the denial of coverage is made, it cannot be said that the denial of coverage was made in bad faith.

Another uninsured motorist case, *Baxter v. Royal Indemnity Co.*,²⁶ had facts almost identical to *Richardson*. In what appeared to be a clear case of liability, the insurer forced the insureds to resort to arbitration before uninsured motorist benefits were finally paid. The insureds sought damages over and above the benefits provided by the policy claiming that the insurer's action was motivated by bad faith, self-interest, malice and spite. The Florida court specifically disapproved of the rule in *Richardson*. It held that, unlike the position of the insurer as a fiduciary of the insured as respects a liability insurance policy when a claim is made against the insured, the insurer and insured in an uninsured motorist claim situation are contractual adversaries. Noting that the policy provided for arbitration should the insurer and insured disagree as to the claim, the court stated:

It is difficult to rationalize how either party could be charged with the commission of a tort merely because it elected to exercise a lawful option open to it under the contract. If a party to a contract exercises an option given to it by the clear and lawful terms thereof, it would appear immaterial whether such election was motivated by good faith, bad faith, self-interest, spite, or indifference.²⁷

25. 70 Wis. 2d 977, 236 N.W.2d 204 (1975).

26. 285 So. 2d 652 (Fla. 1973), *writ of cert. discharged* 317 So. 2d 725 (Fla. 1975).

27. 285 So. 2d 652, 656 (Fla. App. 1973).

III. THE CALIFORNIA FALLOUT

It would be relatively easy to dismiss cases such as *Silberg*, *Richardson* and *Gruenberg* as nothing more than three additional examples of attempts by California appellate courts to redistribute the nation's wealth by employing their concepts of good social policy rather than sound, well-articulated, legal reasoning. That approach, however, would provide little solace to insurers who wish to deal fairly with their insureds without also throwing open the corporate coffers to all comers and thereby possibly exposing their officers and directors to liability to stockholders and policyholders for mismanagement.

Unfortunately, little solace can be drawn from the California cases discussed in this article — except, perhaps, that liability for what it now calls “bad faith” does not, ipso facto, also expose an insurer to liability for punitive damages. What these cases say is that “bad faith” may amount to nothing more than an honest mistake in judgment. Mistakes in judgment may amount to nothing more than a sincere belief that a policy provision is clear and thus prevents recovery by the insured. Of course, under the new view of “bad faith” the mistake in judgment may also amount to something as reckless as denying coverage because of reliance upon prior interpretations of the policy provisions by the jurisdiction's highest court. What the California courts are telling insurers operating in that state is that they will be absolutely liable for their insureds' consequential damages if an honest mistake in judgment results in the failure to pay a claim which, upon hindsight, should have been paid.

The dissent in *Gruenberg* may have been correct in interpreting the majority's opinion to mean that the only way for insurers to avoid the liability stemming from the “new tort” is for them to adopt a “pay now and investigate later” approach. One would hope the dissent is wrong, but it is hard to read the opinions any other way. However, as also noted by the *Gruenberg* dissent, an insurer which adopts that approach may be held to have waived the right to recover back what it had paid. There is authority for the position that an insurer which makes a payment under a policy, after a possible defense has been called to its attention and after foregoing further investigation of that defense, does not make the payment under a “mistake in fact” and is not entitled to recover back the pay-

ment.²⁸ Also, it is an accepted rule of restitution that even where payment is made under a mistake in fact, the payment may not be recovered back if there has been such a change in the position of the payee that it would be unjust to require him to make a full refund.²⁹

The California courts have created this "new tort" in an obvious attempt to afford more protection to insureds. However, it has not really been established that there is a need of this additional protection. Each day disputes arise between parties to contracts as to their respective rights and obligations. Each day these disputes are resolved in our courts or, if the contracts so provide, by arbitration. Why should an insured be afforded remedies for contract breach which are not afforded to parties under other forms of contracts? The tort of intentional infliction of emotional distress is available to protect the insured should the insurer's claims handling procedures be truly oppressive and outrageous. State insurance departments are intended to serve the public and handle complaints from insureds as to insurer practices on a regular basis. Likewise, state legislatures are capable of prohibiting what are considered to be unfair claims handling practices and of imposing penalties for violations.³⁰

It is suggested that other courts should carefully consider the ramifications involved before adopting California's new tort of "insurer's mistaken judgment." It is also suggested that the California court should reconsider what it has done. It should at least clarify, at the earliest possible opportunity, the precise nature of this tort. If it feels no obligation to insurers in the state who wish to deal fairly with their insureds and avoid this excess liability, it should consider the insurance-buying public that will ultimately pay for the cost of the new tort of "insurer's mistaken judgment."

28. See, e.g., *Meeme Mut. H.P.F. Ins. Co. v. Lorfeld*, 194 Wis. 322, 216 N.W. 507 (1927).

29. RESTATEMENT OF RESTITUTION § 69(1) (1936).

30. The National Association of Insurance Commissioners has developed a "Model Unfair Claims Practices Settlement Act." See, e.g., Houser, *supra* note 9 at 534.