

Summer 1992

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### Recommended Citation

Christina M. L. Lass, *The Injured Third Party in California: Extending Bad Faith for Full Compensation*, 26 Val. U. L. Rev. 843 (1992).

Available at: <https://scholar.valpo.edu/vulr/vol26/iss3/9>

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# **THE INJURED THIRD PARTY IN CALIFORNIA: EXTENDING BAD FAITH FOR FULL COMPENSATION**

## **INTRODUCTION**

The insurer's bargaining position is naturally superior to the insured's bargaining position. The insurer controls the terms of the policy and the payment of claims. Consequently, the insured is at the insurer's mercy and is unprotected from the insurer's unfair practices.

The insured must accept the insurer's refusal to pay a claim. For example, an injured insured submits a claim to the insurer. Although the claim is within the terms of the policy, the insurer may refuse to pay the claim. The courts have tried to strengthen the position of the insured by allowing the insured to sue the insurer for bad faith.<sup>1</sup> However, the bad faith suit has merely shifted the imbalance between the insured and the insurer. In some circumstances, the insured may submit incomplete or false information, or delay in submitting information to the insurer. In response, the courts have allowed the insurer to raise the conduct of the insured as a defense to liability under the policy. This defense is called comparative bad faith.

Third parties are particularly disadvantaged by the insured's bad faith suit. Many conflicts concerning the payment of insurance claims involve a third party, who is not a party to the insurance contract. For instance, a third party who is injured by the insured in an automobile collision is without sufficient recourse when the insurer refuses to honor a claim for the injuries submitted by the third party.

In California, third parties are precluded from directly suing the insurer because the third party is not a party to the insurance policy, and privity is not present between the insurer and the third party. Without the requisite element of privity, the third party may not directly sue the insurer based on the theory of the implied covenant of good faith and fair dealing. This Note argues that in California, a third party should have a cause of action for bad faith against the insurer for nonpayment of the third party's claim. This Note proposes a statutory basis for a third party cause of action.

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1. Bad faith refers to the breach of the covenant of good faith and fair dealing implied in the insurance policy. See *infra* notes 5-10 and accompanying text.

In establishing a third party's right to maintain a cause of action against the insurer for bad faith, an imbalance is created between the insurer and the third party. The statute proposed by this Note includes a provision that limits the liability of the insurer when sued for bad faith by a third party. This limitation will establish a balance in third party suits similar to that which exists in first party suits between the insured and the insurer.

Part I of this Note will discuss the tort of bad faith and its relation to both contract and tort law. Bad faith will be analyzed in the context of insurance, and its development in California will be illustrated.<sup>2</sup> Part II will establish that the relationship between the insurer and the third party makes the need for a private third party cause of action compelling.<sup>3</sup> This Note will then propose a statutory cause of action to allow third parties to recover against the insurers, while also placing a limitation on the third party's recovery.<sup>4</sup>

## I. BACKGROUND

### A. *Bad Faith Defined*

Bad faith is the breach of the implied covenant of good faith and fair dealing found in every contract.<sup>5</sup> The duty of good faith and fair dealing is a duty that is imposed on the parties to a contract to deal with each other fairly, honestly, and in good faith.<sup>6</sup> Good faith requires that neither party will injure the other party's right to receive the benefits of the contract.<sup>7</sup> The duty of good faith and fair dealing operates as a matter of law,<sup>8</sup> and is independent of all other contractual obligations.<sup>9</sup> In an insurance contract, for instance, the duty

2. See *infra* notes 5-87 and accompanying text.

3. See *infra* notes 88-169 and accompanying text.

4. See *infra* notes 170-78 and accompanying text.

5. *Matthew E. Karanian, Note, California Casualty General Insurance Co. v. Superior Court: Bad Faith For All*, 18 PAC. L.J. 307, 314 (1986).

6. 1 JOHN C. MCCARTHY, RECOVERY OF DAMAGES FOR BAD FAITH § 1.7 (5th ed. 1990) (citing *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958); *Merlo v. Standard Life & Accident Ins. Co.*, 130 Cal. Rptr. 416 (Ct. App. 1976); *Jarchow v. Transamerica Title Ins. Co.*, 122 Cal. Rptr. 470 (Ct. App. 1975); *Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co.*, 375 A.2d 428 (Conn. Super. Ct. 1977); *Allstate Ins. Co. v. Reserve Ins. Co.*, 373 A.2d 339 (N.H. 1977)).

7. 1 MCCARTHY, *supra* note 6, § 1.7.

8. *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1037 (Cal. 1973) (the implied covenant is "the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities"). See RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. a (1981).

9. *Gruenberg*, 510 P.2d at 1040. For example, an insurer must honor the duty of good faith and fair dealing in addition to not breaching the terms of the contract itself.

is absolute.<sup>10</sup> If the insurer breaches the duty of good faith and fair dealing, and the insured breaches the terms of the policy, the insurer will not be excused from liability for a breach of the implied covenant of good faith and fair dealing.<sup>11</sup>

Bad faith does not refer to any particular type of conduct.<sup>12</sup> In California, bad faith refers strictly to the breach of the implied covenant of good faith and fair dealing and the resulting liability and does not depend on the absence or presence of certain conduct.<sup>13</sup> In an insurance context, bad faith refers to the denial of an insurance claim without a reasonable basis.<sup>14</sup>

The breach of the covenant of good faith and fair dealing is not restricted to contract law, but also draws on tort law.<sup>15</sup> Contract remedies are more

10. *Id.*

11. *Id.*

12. In California, bad faith does not require that the insurer acted in a malicious or immoral manner. *Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 986 n.5 (Cal. 1978). *See also Mello v. Occidental Life Ins. Co. of Cal.*, 187 Cal. Rptr. 168 (Ct. App. 1983) ("the lack of *good faith* will be established when the insurer shall 'erroneously' or 'improperly' fail to abide by the [insurance] policy's promises

. . . actual . . . misconduct is not required").

13. 1 MCCARTHY, *supra* note 6, § 1.9. Some jurisdictions, like California, do not require the absence or presence of conduct by the insurer. *Id.* Other jurisdictions, such as Alabama, Arkansas, Florida, North Carolina, and Ohio require the insurer to have acted with a dishonest purpose. *Id.* Other jurisdictions require conduct that is short of ill will or just a lack of reasonable basis for the insurer to deny the claim. *Id.*

14. *McCormick v. Sentinel Life Ins. Co.*, 200 Cal. Rptr. 732, 739 (Ct. App. 1984) (an insurer may breach the covenant of good faith if "the insurer unreasonably withholds policy benefits due under a policy"). *See also Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1038 (Cal. 1973) ("when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort"). In California, an insured must prove that the insurer's "erroneous decision not to pay a claim was made unreasonably and without proper cause." Guy O. Kornblum, *Defending an Insurance Bad Faith Action*, 20 THE BRIEF 47, 48 (1991). *See also id.* at 52 n.11 (citing *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 686 P.2d 1158 (Cal. 1984)). Other conduct that has indicated bad faith includes: "failure to investigate a claim thoroughly, failure to evaluate a claim objectively, unjustified delay in payment of a claim, abusive or coercive practices to compel compromise of a claim, improper refusal to defend an insured, and improper handling of defense of insured, resulting in loss of goodwill." Kornblum, *supra*, at 49 (extensive list of types of conduct that have indicated bad faith).

15. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW § 25G, at 120 (1987). A primary motivation for recognizing tort duties in insurance was because contract remedies were inadequate. *Id.* *See also Gruenberg*, 510 P.2d at 1036 (holding that the breach of the duty of good faith and fair dealing sounds in both contract and tort). The court's award of damages in *Gruenberg* for emotional distress solidified the principle that tort damages, including punitive damages, would be awarded for bad faith. JERRY, *supra*, § 25G, at 120.

A claim for bad faith usually involves a three tiered analysis: contractual liability, extra-contractual liability, and punitive damages. GUY O. KORNBLUM ET AL., CALIFORNIA PRACTICE GUIDE: BAD FAITH § 1:88 (TRG 1990) [hereinafter BAD FAITH].

restricted than tort remedies.<sup>16</sup> Contract law traditionally compensates the promisee for loss resulting from the promisor's breach.<sup>17</sup> Contract damages generally put the injured party in the same position he would have been in had the contract been performed.<sup>18</sup> In contrast, tort law compensates the injured party for all harm proximately caused, whether or not the harm was in the reasonable contemplation of the parties.<sup>19</sup>

An insured may recover contractual damages for the insurer's failure to settle the insured's claim. However, the insurance policy must cover the insured's claim.<sup>20</sup> The insured will receive the benefits under the policy if the insurer is found to have contractual liability.<sup>21</sup>

An insured may also recover extra-contractual damages<sup>22</sup> for breach of the

16. JERRY, *supra* note 15, § 25G, at 120. If applied flexibly, contract law could go a long way to fully compensate an insured for the insurer's breach of the implied covenant of good faith and fair dealing. *Id.* However, contract remedies do not compensate for emotional distress. *Id.* The insured frequently suffers emotional distress when the insurer's nonpayment of a claim puts the insured's financial well-being in jeopardy. *Id.*

The special relationship between the insured and the insurer also further supports imposing tort remedies for bad faith. *Id.* See *infra* notes 37-40 and accompanying text.

17. LON L. FULLER & MELVIN ARON EISENBERG, BASIC CONTRACT LAW 182 (5th ed. 1981). The terms "promisor" and "promisee" are frequently used in contract law to refer to the parties to the contract that was breached. Generally, courts award damages for breach of contract that give the injured party the "benefit of the bargain," or a monetary amount equivalent to the value of performance of the breached contract. 1 MCCARTHY, *supra* note 6, § 1.56. Contract remedies are generally limited to damages that are foreseeable when the contract was executed. *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854). *Hadley* is strictly construed to "limit damages to those specifically related to the rights and duties set forth in the contract." Chris Michael Kallianos, Note, *Bad Faith Refusal to Pay First-Party Insurance Claims: A Growing Recognition of Extra-Contract Damages*, 64 N.C. L. REV. 1421, 1422 (1986). Breach of contract damages generally do not include damages for emotional distress. JOHN D. CALAMARI & JOSEPH M. PERILLO, THE LAW OF CONTRACTS 596 (3d ed. 1987). Punitive damages are also not awarded for a breach of contract unless the breach involved a tort. *Id.*

18. FULLER & EISENBERG, *supra* note 17, at 183.

19. 1 MCCARTHY, *supra* note 6, § 1.56 (comparing tort damages to contract damages). Tort damages include damages for emotional distress and economic loss. WILLIAM L. PROSSER ET AL., TORTS 509 (8th ed. 1988). Economic loss includes loss of future earnings. *Id.* Emotional distress damages include suffering prior to trial and after trial. *Id.* See generally *id.* at 510 n.7 & 511 n.8 (listing damage awards for emotional distress including loss of taste and smell, fear of injury, fear of developing cancer, and scars and disfigurement).

20. BAD FAITH, *supra* note 15, § 1:88.1; see generally *id.* § 2:2-2:24 for a thorough discussion concerning the contractual liability of the insurer to the insured.

21. Kornblum, *supra* note 14, at 48.

22. Extra-contractual damages for bad faith refers to damages that are recoverable under a tort measure of damages and are above and beyond what is payable under the contract. BAD FAITH, *supra* note 15, § 1:4. Consequently, compensatory damages for bad faith include all damages proximately caused by the insurer's bad faith conduct, including emotional distress, economic loss, and attorney's fees. *Id.* Punitive damages are included in extra-contractual damages. *Id.*

covenant of good faith and fair dealing if the insured can prove the elements of a tort or a statutory claim.<sup>23</sup> These extra-contractual damages focus on the manner in which the insurer failed to fully perform its duties under the insurance policy.<sup>24</sup> Extra-contractual damages are awarded because bad faith sounds in tort.<sup>25</sup> Insureds are allowed to recover compensatory damages that include all damages proximately caused, regardless of whether such damages were foreseeable when the contract was executed.<sup>26</sup> An insured will be able to recover for emotional distress when suing an insurer for bad faith; however, the insured may not be required to meet all the elements of the tort of intentional infliction of emotional distress.<sup>27</sup>

The list of injuries for which the insured may be compensated is incomplete. The list of compensable injuries includes emotional distress,<sup>28</sup>

The damages for bad faith will generally not include punitive damages unless the insured can show the appropriate conduct by the insurer. In California, punitive damages are awarded when the insured shows that the insurer acted with intent to "vex, injure, or annoy, or with a conscious disregard of the [insured's] rights." *Fleming v. Safeco Ins. Co.*, 206 Cal. Rptr. 313, 320 (Ct. App. 1984). Not all jurisdictions require the same conduct as California for punitive damages. 1 MCCARTHY, *supra* note 6, § 1.66. Most jurisdictions that recognize bad faith require a showing of some type of willful or aggravated conduct by the insurer. *Id.* This type of conduct is above and beyond the level of conduct by the insurer in a bad faith breach that would result in an award of compensatory damages. For criticisms of the award of punitive damages in bad faith actions, see generally Jerome Murray & Michael Maillet, *Extra-contractual Remedies and Punitive Damages in First-Party Insurance Claims*, 53 INS. COUNS. J. 251, 252 (1986) (considering that punitive damages have been characterized as a subversion of justice and as a windfall to insureds).

23. Kornblum, *supra* note 14, at 48. See *infra* notes 126-32 and accompanying text.

24. BAD FAITH, *supra* note 15, § 1:88.2.

25. See *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967) (Mrs. Crisci was awarded tort damages for emotional distress because the insurer's breach of the implied covenant of good faith and fair dealing constituted a tort). See *infra* notes 59-65 and accompanying text.

26. Compensatory damages in tort represent the closest financial equivalent "of the loss suffered by the plaintiff, and restore him to the position he occupied before the tort." PROSSER, *supra* note 19, at 503. See also *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1041 (Cal. 1973) ("general rule of damages in tort is that the injured party may recover for all detriment caused whether it could have been anticipated or not"); *Fletcher v. Western Nat'l Life Ins. Co.*, 89 Cal. Rptr. 78, 94 (Ct. App. 1970) ("permitting recovery for all proximately caused detriment in a single cause of action . . . engenders public respect for the judicial process"). See generally 1 MCCARTHY, *supra* note 6, § 1.56. See *supra* note 6 and accompanying text.

27. *Gruenberg*, 510 P.2d at 1041. All elements of mental distress do not have to be shown when another theory for the breach of the implied covenant of good faith and fair dealing is also alleged. In *Gruenberg*, the insured did not have to prove outrageous conduct (an element of emotional distress) because the insured had suffered an economic loss apart from emotional distress. *Id.* at 1040.

28. See *supra* note 18. See also *White v. Western Title Ins. Co.*, 710 P.2d 309 (Cal. 1985) (insured awarded emotional distress damages because title insurer failed to report a water easement); *Silberg v. California Life Ins. Co.*, 521 P.2d 1103 (Cal. 1974) (insurer was liable to insured for emotional distress due to insurer's refusal to pay insured's medical bills); *Fletcher v. Western Nat'l Life Ins. Co.*, 89 Cal. Rptr. 78 (Ct. App. 1970) (insured awarded damages for emotional distress

economic loss,<sup>29</sup> all expenses incurred by the insurer in pursuing a valid claim, and the reasonable value of the insured's time and expenses in conferring with an attorney in pursuing a bad faith claim.<sup>30</sup> The individual set of facts in each case will determine if the insurer breached the duty of good faith and fair dealing.<sup>31</sup>

### B. Breach of the Insurance Contract

The implied covenant of good faith and fair dealing imposes duties on both the insurer and the insured.<sup>32</sup> The insurer has the duty not to withhold policy benefits from the insured<sup>33</sup> and to accept reasonable settlements in order to avoid exposing the insured to the risk of excess liability.<sup>34</sup> The insured has a duty to cooperate with the insurer's investigation of the insured's claim,<sup>35</sup> and the insured must not conceal or misrepresent material facts to the insurer when presenting a claim.<sup>36</sup>

Consequently, the insurance policy creates a special relationship between the insured and the insurer.<sup>37</sup> The fiduciary relationship between the insured and the insurer is the key element justifying the use of tort remedies for the insurer's breach of the contractual obligation.<sup>38</sup> When an insured signs an

because the insurer refused to make payments under the policy and attempted to induce the insured to surrender the policy).

29. *Gruenberg*, 510 P.2d at 1040 (insured awarded damages for loss of earnings).

30. *Jarchow v. Transamerica Title Ins. Co.*, 122 Cal. Rptr. 470 (Ct. App. 1975) (attorney's fees and costs of lawsuit provided a sufficient guarantee that the insured suffered emotional distress to warrant damages awarded for emotional distress). See generally 1 MCCARTHY, *supra* note 6, § 1.57.

31. 1 MCCARTHY, *supra* note 6, § 1.56.

32. See *supra* note 6 and accompanying text.

33. *Gruenberg v. Aetna Ins. Co.*, 510 P.2d at 1032, 1037 (Cal. 1973).

34. *Crisci v. Security Ins. Co.*, 426 P.2d 173, 176-77 (Cal. 1967). The duty to settle reasonably within the monetary limits of the insurance policy is imposed on the insurer when a third party presents a claim to the insurer. *Id.* at 176-77.

35. The insured's failure to cooperate with the insurer's investigation allows the insurer to assert breach of contract as a defense, but will not preclude the insured's suit for bad faith. BAD FAITH, *supra* note 15, § 10:38. See *supra* note 6 and accompanying text. However, the insured's refusal to cooperate can also constitute a bad faith refusal to cooperate. *Id.* See *infra* notes 73-74 and accompanying text.

36. *California Cas. Gen. Ins. Co. v. Superior Court*, 218 Cal. Rptr. 817, 822-23 (Ct. App. 1985).

37. JERRY, *supra* note 15, § 25G, at 121. Adding the insurance contract to the list of contracts that create special relationships seems logical because of the public interest aspects of the insured-insurer relationship. *Id.* The breach of contracts that impose special duty, such as innkeeper-guest, bailor-bailee and common carrier-passenger, have also resulted in tort liability when breached. *Id.* See *infra* note 53.

38. JERRY, *supra* note 15, § 25G, at 123.

insurance contract, the insured gives the insurer the exclusive power to settle claims presented by the insured.<sup>39</sup> Thus, the special relationship between the insured and the insurer makes the judiciary more willing to intervene in insurance contract disputes and impose tort liability for the breach of the implied covenant of good faith and fair dealing.<sup>40</sup>

The courts are also motivated to apply tort remedies for the breach of an insurance contract because of the inadequacies of contract remedies<sup>41</sup> to compensate insureds and deter insurers from not performing contractual obligations.<sup>42</sup> Contract remedies are inadequate for two reasons. First, the cost of bringing a suit against the insurer may be more detrimental to the insured than acquiescing to the insurer's demands.<sup>43</sup> Liability for the breach of the covenant of good faith and fair dealing implied in an insurance contract is an incentive to the insurer to consider the vulnerability of the insured.<sup>44</sup> The prospect of tort liability encourages the insurer to spend a relatively small amount of the insurer's money to settle a claim, in order to prevent the insured from being subject to a substantial loss.<sup>45</sup>

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39. Insureds usually purchase insurance policies with the intention that the insurer will litigate any claims against the insured. Marvin F. Milich, *The Evolution of the Tort of Bad Faith Breach of Contract: Current Trends and Future Trepidation*, 94 COM. L.J. 418, 420 (1989).

40. Karanian, *supra* note 5, at 313. See also *Rawlings v. Apodaca*, 726 P.2d 565, 579 (Ariz. 1986) (because of the special relationship between the insured and the insurer, the insured can recover tort damages when the insurer breaches the implied covenant of good faith and fair dealing).

41. In the mid-1900s, courts realized that contract damages as the only remedy for a breach of the insurance policy would benefit the insurer. Michael J. Gainer, *The Overruling of Royal Globe: A "Royal Bonanza" for Insurance Companies, But What Happens Now?*, 16 PEPP. L. REV. 763, 765 (1989) (excellent discussion of the history of the development of bad faith). The insurer would, at most, be held liable for the policy limits for a delay or refusal to settle a claim. *Id.*

42. JERRY, *supra* note 15, § 25G, at 120. For example, an insurer may refuse to settle a claim against the insured by a third party, unless the insured contributes to the settlement. If the insured refuses to contribute, the insurer may let the claim be litigated. The amount of judgment may exceed the policy limits. The insured will be liable for this excess judgment and the insurer will be exposed to little risk. *Id.*

43. If the cost of the suit against the insurer exceeds the amount of contribution the insurer demands, the breach by the insurer will go uncompensated. *Id.* § 25G, at 121.

44. See *Fletcher v. Western Nat'l Life Ins. Co.*, 89 Cal. Rptr. 78 (Ct. App. 1970). See also *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967). The court stated that imposing liability for breach of good faith and fair dealing eliminates danger "that the insurer, faced with a settlement offer . . . will reject it and gamble with the insured's money to further its own interest." *Id.* at 177; *Murphy v. Allstate Ins. Co.*, 553 P.2d 584 (Cal. 1976) (the insurer will gamble with the insured's money in the hope of securing a judgment on favorable terms rather than to obtain the proposed settlement).

45. Weldon S. Wood, *Comparative Fault As A Partial Defense to Actions For Breach of the Implied Covenant of Good Faith and Fair Dealing*, 53 INS. COUNS. J. 566, 569 (1986). For example, an insured may be forced to pay large medical bills because the insurer in bad faith refused to pay the bills, and the insured may lose his home or business as a result. *Id.* at 568. See also *Crisci*, 426 P.2d at 173 (insured was forced to pay \$91,000 when the insurer refused to settle a



Second, the insurer's absolute discretion to settle a claim has been a justification for imposing tort liability.<sup>46</sup> The insured's financial well-being may be put in jeopardy by the insurer's conduct, and the insured may suffer mental anguish, which is not compensated by contract remedies.<sup>47</sup> Theoretically, an insurer with absolute discretion in settling a claim may be able to extort a substantial contribution to the settlement from the insured.<sup>48</sup> This violates the insured's expectations that the insurer would pay all claims that were within the terms of the policy.<sup>49</sup>

The insurer's advantageous position is also a factor weighed by courts when imposing tort liability for breach of the insurance contract.<sup>50</sup> Insurance policies are described as contracts of adhesion;<sup>51</sup> thus, the insurer has the superior bargaining power and the insured has little ability to change the terms of the policy.<sup>52</sup> Insurers are considered to be endowed with the public trust.<sup>53</sup> In order to fully compensate the insureds who are harmed by the insurer's breach

claim).

46. See *infra* notes 61-63 and accompanying text.

47. JERRY, *supra* note 15, § 25G, at 121. Moreover, the plaintiff will not be made whole if the recovery is limited to economic losses. A portion of a recovery for economic losses must be used to pay attorney's fees. Tort remedies more fully compensate insureds for all losses. *Id.*

48. See *infra* notes 61-63 and accompanying text.

49. Peter M. Callahan, *Some Thoughts on the Avoidance of Extra-contractual Damages in California Insurance Litigation*, 14 W. ST. U.L. REV. 73, 94 (1986).

On the other hand, an argument can be made that the insured who purchases a policy with minimum limits and then engages in hazardous activities should bear a part of the responsibility for any conflict of interest, on the part of the insurer, that arises from a claim that exceeds the policy limits. *Id.* If the amount of liability insurance was insufficient to the insured's activity, an insured who faces a claim that is above the policy limits should bear a part of the cost of the claim. *Id.* (quoting STEPHEN S. ASHLEY, *BAD FAITH ACTIONS-LIABILITY AND DAMAGES* § 2.12 (1986)).

50. See Milich, *supra* note 39, at 420.

51. A contract of adhesion is a contract in a standardized form in which the consumer has no realistic opportunity to bargain as to the terms of the contract. BLACK'S LAW DICTIONARY 38 (5th ed. 1979).

Insurance contracts are drafted with the aid of skillful and highly paid legal talent, from which no deviation desired by an applicant will be permitted. The established underwriter is magnificently qualified to understand and protect its own selfish interests.

In contrast, the applicant is a shorn lamb driven to accept whatever contract may be offered on a 'take-it-or-leave-it' basis if he wishes insurance protection.

JERRY, *supra* note 15, § 25C at 104 (quoting 7 SAMUAL WILLISTON, *A TREATISE ON THE LAW OF CONTRACTS* § 900, at 19-20 (3d ed. 1973)).

52. Karanian, *supra* note 5, at 313 (the insured is not given the power to change the terms of the policy).

53. See *Egan v. Mutual of Omaha Ins. Co.*, 598 P.2d 452, 457 (Cal. 1979) (court stated that the insurer provided a public service and therefore was entrusted with the public trust). See also Karanian, *supra* note 5, at 313 n.54.

of the duty of good faith and fair dealing,<sup>54</sup> tort principles are used.<sup>55</sup>

In summary, a court's imposition of tort liability for an insurer's breach of the implied covenant of good faith and fair dealing advances two goals. One goal is to compensate the insured's expectations of coverage under the insurance policy.<sup>56</sup> The California courts recognize this special nature of the insurance policy by imposing tort liability when the insurer breaches the duty of good faith and fair dealing owed to the insured.<sup>57</sup> The second objective is to deter bad faith conduct by insurers on the basis that such conduct is contrary to social policy.<sup>58</sup> The goals advanced by the imposition of tort liability are an attempt to equalize the position of the insured and the insurer.

### C. *The Application of Bad Faith in California*

The California courts have allowed insureds to recover for bad faith against insurers in both first party and third party claims. The California courts first applied bad faith for the breach of the implied covenant of good faith and fair dealing when an insurer failed to settle a third party's claim within the monetary limits of the insurance policy. In *Crisci v. Security Insurance Co.*,<sup>59</sup> Mrs. Crisci, the insured, owned an apartment building in which a third party was injured. The insurer did not settle with the third party within the limits of the insurance policy.<sup>60</sup> Consequently, the third party sued Mrs. Crisci and damages were awarded that exceeded the policy limits.<sup>61</sup> Mrs. Crisci was required to pay the amount that exceeded the policy limit.<sup>62</sup>

Mrs. Crisci sued the insurer for a failure to settle the third party claim. The court held that this breach of the duty of good faith and fair dealing was a

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54. See *supra* notes 32-36 and accompanying text.

55. Linda Curtis, Note, *Damage Measurements for Bad Faith Breach of Contract: An Economic Analysis*, 39 STAN. L. REV. 161, 162 (1986) (the author applies an economic analysis to the tort measurement of damages for bad faith and provides an analytic approach to reform the law of damages for bad faith).

56. Sandra Chutorian, Note, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing into the Commercial Realm*, 86 COLUM. L. REV. 377, 386, 391 (1986). See *supra* note 25.

57. See *supra* notes 37-40 and accompanying text.

58. Chutorian, *supra* note 56, at 391.

59. 426 P.2d 173 (Cal. 1967).

60. *Id.* at 175-76.

61. *Id.* at 176.

62. This amount was \$91,000. In order to pay this judgment, Mrs. Crisci was forced to sign an interest in her property to the third party. Mrs. Crisci became indigent and attempted to commit suicide. *Id.*

tort and awarded Mrs. Crisci damages.<sup>63</sup> The court reasoned that the standard to determine whether the insurer had considered the interests of the insured was whether a prudent insurer without policy limits would have accepted the settlement offer.<sup>64</sup> The insurer's failure to accept a reasonable settlement was the basis of liability for a breach of the implied covenant of good faith and fair dealing.<sup>65</sup>

In *Neal v. Farmers Insurance Exchange*,<sup>66</sup> bad faith was extended to an action involving only the insured and the insurer. The insured was injured in an automobile accident and filed a claim with the insurer under the insured's uninsured motorist coverage.<sup>67</sup> The insurer refused to pay the claim.<sup>68</sup> The Neal's attorney attempted to settle with Farmers Insurance on several occasions. Mrs. Neal was injured in 1970, and her attorney was unable to obtain the amount of her claim under the underinsured motorist policy until 1973.<sup>69</sup> The insured subsequently sued the insurer for bad faith and was awarded damages, including punitive damages.<sup>70</sup> The court reasoned that based on these facts, an award of extra-contractual damages was appropriate.<sup>71</sup>

#### D. Comparative Bad Faith

The California courts have limited the insured's recovery in a bad faith claim through comparative bad faith. The duty of good faith and fair dealing is a "two way street" that extends to both the insured and the insurer.<sup>72</sup> Both the insured and the insurer are bound to act reasonably in dealing with each other.<sup>73</sup> Sometimes both the insurer and the insured breach this duty of good faith and fair dealing.<sup>74</sup> When the insured breaches the duty of good faith and

63. *Id.* at 186. Mrs. Crisci was awarded damages for emotional distress. Tort damages were imposed because the insurer failed to accept a reasonable settlement, not because the insurer breached the insurance contract. 1 MCCARTHY, *supra* note 6, § 1.8.

64. *Crisci v. Security Ins. Co.*, 426 P.2d 173, 176 (Cal. 1967).

65. *Id.*

66. 582 P.2d 980 (Cal. 1978).

67. *Id.* at 983.

68. *Id.* at 984.

69. *Id.*

70. *Id.*

71. *Neal v. Farmers Ins. Exch.*, 582 P.2d 980, 986 (Cal. 1978). The court found that Farmers Insurance had no defense to the insured's claim. *Id.*

72. *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038, 1041 (Cal. 1980) ("a duty of good faith and fair dealing in an insurance policy is a two-way street, running from the insured to his insurer as well as vice versa").

73. *Transit Casualty Co. v. Spink Corp.*, 156 Cal. Rptr. 360 (Ct. App. 1979).

74. For instance, an insured is injured in an automobile accident and sustains injuries. The injuries are compensable under the uninsured motorist policy the insured had with the insurer. See *California Casualty Gen. Ins. Co. v. Superior Court*, 218 Cal. Rptr. 817 (Ct. App. 1985). See *infra*

fair dealing and also sues the insurer for bad faith, the insurer may raise the affirmative defense of comparative bad faith.

Comparative bad faith is the application of comparative fault principles to the bad faith insurance context.<sup>75</sup> The insured may breach the implied covenant of good faith and fair dealing<sup>76</sup> by impeding the insurer's investigation of the insured's claim or by submitting incomplete information to the insurer.<sup>77</sup> Any compensatory damages that would be awarded to the insured for the bad faith of the insurer will be reduced according to the bad faith conduct of the insured.<sup>78</sup> Consequently, any emotional distress or economic loss suffered by the insured, and caused by the insured's breach will not be fully compensated.<sup>79</sup>

Comparative bad faith was officially recognized as an affirmative defense in *California Casualty General Insurance Co. v. Superior Court*.<sup>80</sup> In *California Casualty*, the insured was injured in an automobile accident and delayed furnishing the insurer with information that the insurer required in order to pay the claim. The insurer refused to pay the claim, and the insured sued the

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notes 80-83 and accompanying text. However, the insured submits incomplete information concerning the claim to the insurer. The insurer fails to pay any benefits under the policy to the insured. In this circumstance, the insured may bring a bad faith action against the insurer, and the insurer may defend itself by asserting the bad faith conduct of the insured. *Id.* at 823. See *infra* notes 100-01 and accompanying text.

75. The basic principle of comparative negligence is the apportionment of damages between the parties according to the basis of each party's fault. PROSSER, *supra* note 19, at 575. This was first applied by the California courts in *Li v. Yellow Cab Co.*, 532 P.2d 1226 (Cal. 1975). In insurance, the apportionment is based on the bad faith conduct of each of the parties. See *infra* notes 84-87 and accompanying text.

Comparative bad faith has been described as nothing more than "a refinement of the bad faith doctrine," that balances the equities between the insurer and the insured. Karanian, *supra* note 5, at 322, 325. Equitable principles require that a party should not be responsible for the harm that the party did not cause. Wood, *supra* note 45, at 571. The comparative bad faith defense in a bad faith action promotes this idea of fundamental fairness. *Id.* at 571. Bad faith was developed to equalize the relationship between the insurer and the insured. See *supra* notes 50-55 and accompanying text. Comparative bad faith may be defined as a retreat from efforts to strengthen the power of the insured. Karanian, *supra* note 5, at 323.

76. See *supra* notes 72-73 and accompanying text stating that the duty of good faith and fair dealing extends to both the insured and the insurer.

77. *California Casualty*, 218 Cal. Rptr. at 822.

78. See *infra* note 87 and accompanying text.

79. *California Casualty Gen. Ins. Co. v. Superior Court*, 218 Cal. Rptr. 817, 822 (Ct. App. 1985) (if the failure of the insured to promptly and accurately furnish the insurer with all the information pertinent to the claim, and this failure to give all the information delays the insurer's payment of the claim, any economic loss or emotional distress resulting will be partly caused by the insured).

80. 218 Cal. Rptr. 817 (Ct. App. 1985).

insurer for a refusal to pay the policy benefits.<sup>81</sup> The court held that there was no reason why comparative fault principles should not apply to bad faith cases,<sup>82</sup> and allowed the insurer to raise the affirmative defense of comparative bad faith.<sup>83</sup>

When an insurer asserts the affirmative defense of comparative bad faith, the court does not just simply find bad faith conduct by the insured. Previously, in *Fleming v. Safeco Insurance Co. of America*,<sup>84</sup> the California courts reduced extra-contractual damages based on the bad faith conduct of the insured. In *Fleming*, the insured and her attorney delayed in furnishing information to the insurer concerning the insured's claim.<sup>85</sup> When the insured sued the insurer for bad faith failure to pay a claim, the insurer claimed that the insured had

81. *Id.* at 820. After filing its initial answer to the insured's complaint, the insurer moved to amend its answer to include the defense of the insured's bad faith conduct in presenting the claim. *Id.* at 821.

82. *Id.* at 823 ("we perceive no sound reason, nor is any suggested, why the doctrine of comparative fault enunciated and applied to negligent conduct . . . in *Li v. Yellow Cab Co.*, . . . should not be applicable to bad faith cases").

83. *Id.* Comparative bad faith continues to be applied in California. See also Patrick v. Maryland Casualty Co., 267 Cal. Rptr. 24 (Ct. App. 1990) (the insurer was allowed to raise the comparative bad faith defense when the insured claimed he suffered physical injuries from the insurer's bad faith handling of a claim for roof damage – the insured attempted to fix the roof himself).

In addition to comparative bad faith, insurance companies have asserted other defenses against insureds. See Irwin Waldman & Bruce Warren, Defense of Bad Faith Actions, in BAD FAITH LITIGATION AND INSURER VS. INSURER DISPUTES 1987, at 127, 136 (PLI Com. L. & Practice Course Handbook Series No. 420 (1987)) [hereinafter Waldman & Warren] (short review of defenses available to insurance companies that are sued by insureds for bad faith). The insurer may assert a lack of coverage or a good faith error concerning coverage. *Kopczynski v. Prudential Ins. Co. of Am.*, 211 Cal. Rptr. 12, 14 (Ct. App. 1985) (held an insurer was not liable for bad faith refusal to pay policy benefits because the insured's claim was not covered under the insurance policy); Waldman & Warren, *supra*, at 127. Business justification, industry custom, breach of the cooperation clause, and the insured's lack of cooperation may also be asserted by the insurer. See *Fletcher v. Western Nat'l Life Ins. Co.*, 89 Cal. Rptr. 78 (Ct. App. 1970) (an insurer may assert its legal rights if not asserted in an outrageous manner, but with a good faith belief in the existence of those rights); *Silberg v. California Life Ins. Co.*, 521 P.2d 1103 (Cal. 1974) (court was not persuaded that insurer's delay in payment of insured's medical expenses was customary when the delay caused the insured to conceal financial information from hospital administrators in order to undergo needed surgery and caused the insured to suffer two nervous breakdowns); *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973) (the insurer alleged as a defense that the insured had breached the cooperation clause when the insured failed to submit to an examination under oath); *Othman v. Globe Indem. Co.*, 759 F.2d 1458 (9th Cir. 1985) (held that under California law if an insured's failure to cooperate substantially prejudices the insurer's investigation of a claim, the insurer may deny coverage based on the insured's failure to cooperate); 1 MCCARTHY, *supra* note 6, § 1.20-1.23; JERRY, *supra* note 15, § 85.

84. 206 Cal. Rptr. 313 (Ct. App. 1984).

85. *Id.* at 316.

acted in bad faith.<sup>86</sup> Consequently, the compensatory damages that were awarded to the insured for the insurer's breach of the duty of good faith and fair dealing were reduced according to the insured's bad faith.<sup>87</sup>

Thus, an insured whose claim has not been settled by the insurer may sue the insurer for a breach of the covenant of good faith and fair dealing. The insured may recover the amount of proceeds under the insurance policy and extra-contractual damages. However, other parties may also be injured by the insurer's refusal to settle a claim. These injured persons are the third parties who are not parties to the insurance policy between the insured and the insurer.

## II. THE NEED FOR THE THIRD PARTY CLAIM

Although the insured may recover for bad faith, the status of an injured third party under California law remains unsettled. For example, a third party who sustains injuries that require medical attention as a result of an automobile collision with an insured, has a claim against the insured. Although the insured's liability is clear, if the insurer fails to settle the third party's claim, the third party will be unable to receive compensation for his injuries.

The insurer's refusal to settle the third party's claim may cause the third party considerable economic loss. If the third party's injuries were severe, the third party may be unable to work and may suffer a loss of income.<sup>88</sup> The loss of income, in turn, may drive the third party into debt due to his inability to pay his medical bills and support his family. As a result, the third party may also suffer mental anguish.<sup>89</sup>

Despite the fact that an insured can sue his insurer for a breach of the implied covenant of good faith and fair dealing,<sup>90</sup> a third party injured by the insured may have difficulty recovering for injuries if the insurer refuses to settle with the third party.<sup>91</sup> The third party may not be able to sue the insurer on a common law bad faith cause of action because privity is lacking between the

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86. *Id.*

87. *Id.* Comparative bad faith was not officially recognized in *Fleming* because the parties had stipulated to each party's respective comparative fault. *BAD FAITH*, *supra* note 15, § 10:48.

88. Allan E. Ceran, Comment, *Extending the Insured's Duty of Good Faith and Fair Dealing to Third Parties Under Liability Insurance Policies*, 25 *UCLA L. REV.* 1413, 1424 (1978).

89. *See supra* notes 46-47 and accompanying text.

90. *See supra* notes 20-27 and accompanying text.

91. Insurance disputes involving third parties focus on the insurer's failure to settle the third party's claim, and the insurer's duty to defend the insured when a third party sues the insured. Kornblum, *supra* note 14, at 50. The duty to defend extends only to the insured. *Id.* at 51. This Note considers only the third party's cause of action against the insurer for a bad faith failure to settle. *See generally id.*

insurer and the third party.<sup>92</sup> Since the third party is not a party to the contract with the insurer, privity is not present between the third party and the insurer.<sup>93</sup> For a brief time,<sup>94</sup> the third party could sue the insurer under a statutory cause of action.<sup>95</sup>

Other existing remedies that may be used by the third party are inadequate and do not fully compensate the third party.<sup>96</sup> Since the statutory cause of action has been foreclosed, at least one California appellate court has allowed the third party to directly sue the insurer.<sup>97</sup> However, other California appellate courts have held that a third party has no standing to sue the insurer.<sup>98</sup>

If the third party is not allowed to sue the insurer for failure to settle the claim, the insurer will not be deterred from refusing to settle third party claims.<sup>99</sup> The third party will not be able to recover for damages stemming from the insurer's refusal to settle, such as damages for mental anguish.<sup>100</sup> The third party must be allowed to sue the insurer to ensure that the third party's injuries are compensated through a cause of action for bad faith. This section will discuss the inadequacies of existing remedies available to the third party when faced with an uncooperative insurer<sup>101</sup> and propose model legislation to reinstate a direct cause of action to be asserted against the insurer.<sup>102</sup> But in extending this right to third parties, a correlative concern arises regarding potentially unlimited liability for insurers. Thus, a limitation on direct third party suits is necessary to protect the insurer from unlimited liability and to establish, within third party suits, the balance that exists in first

92. Without privity, the suit for bad faith does not exist. Consequently, if no cause of action for bad faith is allowed, tort liability will not be allowed for a breach of the covenant of good faith and fair dealing for failure to settle a third party's claim. *BAD FAITH*, *supra* note 15, § 1:11. An insured is able to sue the insurer for a breach of the duty of good faith and fair dealing because this duty runs with the insurance contract that is between the insured and the insurer. *See supra* notes 6-10 and accompanying text.

93. *BAD FAITH*, *supra* note 15, § 1:11. The duty of good faith and fair dealing is intended to protect only the insured. *Id.*

94. A private third party cause of action existed for eleven years. *See infra* notes 126-32.

95. *See infra* notes 126-31 and accompanying text.

96. *See infra* notes 104-25 and accompanying text.

97. *See infra* notes 157-65 and accompanying text.

98. *See infra* note 156, 166 and accompanying text.

99. Ceran, *supra* note 88, at 1425. *See supra* notes 41-49 and accompanying text.

100. Ceran, *supra* note 88, at 1425. If the injured party had been the insured, and the insurer did not pay the claim in bad faith, the insured would be able to sue the insurer and receive compensation. *See supra* notes 22-27 and accompanying text.

101. *See infra* notes 104-25 and accompanying text.

102. *See infra* notes 171-72 and accompanying text.

party suits where the insurer raises the defense of comparative bad faith.<sup>103</sup>

#### A. Existing Remedies For the Injured Third Party

Although privity is absent between the third party and the insurer, the third party has several alternative remedies to obtain damages when the insurer refuses to settle. These remedies include assignment, filing a complaint with the insurance commissioner, filing a complaint against the insured, and attempting to file a tort suit against the insurer. None of these remedies, however, will fully compensate the injured third party.

The third party can sue the insurer for failure to settle a claim based on an assignment from the insured,<sup>104</sup> but the third party's recovery under an assignment is limited. A third party who sues the insurer based on an assignment from the insured will not be able to recover the whole amount of bad faith damages that the insured would be able to recover.<sup>105</sup> An insured would recover all damages for bad faith, even if this amount exceeded the monetary limits of the insurance policy.<sup>106</sup> An insured may recover damages for

103. See *supra* notes 72-87 and accompanying text. See also *infra* note 174. This Note proposes that a comparative bad faith defense to be asserted against a third party be a component to a third party statutory cause of action.

104. The insured may assign his right to sue the insurer to the injured third party. I MCCARTHY, *supra* note 6, § 2.59. In California, an insured may assign his right to sue the insurer for failure to settle a third party claim to the third party. Kornblum, *supra* note 14, at 50. An insured will usually assign his rights against the insurer to the third party when the insured's rights have been violated by the insurer, and the insurer fails to settle the third party's claim. The insured assigns his right in exchange for a covenant from the third party not to use the insured's personal assets to satisfy a judgment. Ray Bourhis, *Practical Concerns for Civil Litigators in Light of Moradi-Shalal*, 18 F.: OFFICIAL PUBLIC. CAL. TRIAL LAW. ASS'N 365, 367 (1988).

A third party or insured who attempts to recover against the insurer on a theory of a breach of the implied covenant of good faith and fair dealing must plead and prove the following elements:

1. That the carrier received timely notice of the insured's claim and had a reasonable opportunity to settle within policy limits;
2. That the insurer unreasonably rejected or refused a settlement offer within the policy limits;
3. That an excess judgment was returned against the insured and that the judgment is final (or that the underlying case has been otherwise concluded); and
4. For an action by a third party, that the excess judgment against the insured was assigned to the third party.

Kornblum, *supra* note 14, at 50.

105. BAD FAITH, *supra* note 15, § 1:11.

106. Kornblum, *supra* note 14, at 50. The insurer is liable to the insured for all damages proximately resulting from the insurer's wrongful conduct, whether the damage was anticipated or not. *Id.* The insurer may be liable for compensatory damages, including emotional distress, mental suffering, and punitive damages. *Id.*



emotional distress, mental suffering, and punitive damages.<sup>107</sup> By contrast, the third party who sues under an assignment will not receive the full damage amount that an insured would receive. The third party will only recover the amount of the judgment that exceeds the monetary limits of the policy.<sup>108</sup>

Other problems arise when an insured assigns a cause of action to the third party. First, general and punitive damages cannot be assigned.<sup>109</sup> Personal injury claims and emotional distress claims are also not assignable to the third party.<sup>110</sup> Consequently, the third party's damage recovery is extremely limited.

Although the insured's tort cause of action is not assignable to the third party, the third party may attempt to bring his own tort suit against the insurer. The third party could attempt to sue the insurer for intentional infliction of emotional distress.<sup>111</sup> Damages for emotional distress will not be awarded to the third party unless the third party can show outrageous conduct by the insurer.<sup>112</sup> Consequently, the third party will not be awarded damages if the insurer simply delayed or refused to settle with the third party.<sup>113</sup> In most suits, the third party will not be able to meet this standard of conduct because most collateral injuries will be financial.<sup>114</sup> The third party will also not be able to sue the insurer for fraud or libel.<sup>115</sup>

The third party might also choose to sue the insured. The insured would then sue the insurer for failure to settle with the third party, asking for indemnification. This method creates needless litigation and does not guarantee

107. *Id.*

108. *Id.* Consequently, if the judgment from the assigned cause of action is less than the policy limits, the third party will receive nothing.

109. Bourhis, *supra* note 104, at 367; *see also* Murphy v. Allstate Ins. Co., 553 P.2d 584 (Cal. 1976).

110. BAD FAITH, *supra* note 15, § 1:11. *See supra* note 41, at 790. Assigning a claim to the third party has dangers for the insured. An insured must be careful to not extinguish any of the insured's rights by "improperly splitting a cause of action." *Id.* An assignment that is not carefully worded may not preserve the insured's right to general and punitive damages. *Id.*

111. Ceran, *supra* note 88, at 1436; Gainer, *supra* note 41, at 790-91.

112. Ceran, *supra* note 88, at 1436.

113. Ceran, *supra* note 88, at 1436-37 & 1437 n.102 (citing Little v. Stuvesant Life Ins. Co., 136 Cal. Rptr. 653 (Ct. App. 1977) (where a court awarded damages for outrageous behavior in refusal to settle)).

114. Ceran, *supra* note 88, at 1437.

115. *Id.* at 1435 nn.97, 98. Fraud cannot be sued upon because the third party was not a party to the insurance contract and cannot claim misrepresentation. *Wetherbee v. United Ins. Co. of Am.*, 71 Cal. Rptr. 764 (Ct. App. 1968). A third party may only sue for defamation if the insurer has made statements about the third party that injure the reputation of the third party. Ceran, *supra* note 88, at 1435 n.98. An insurer will rather delay in settlement than risk defamation. Thus, defamation will rarely protect a third party who has suffered economic loss. *Id.*

that the third party will receive damages.<sup>116</sup> An assignment is a more suitable alternative for the third party.

If the insured does not assign a bad faith cause of action to the third party, the third party may file a complaint with the Insurance Commissioner.<sup>117</sup> Upon finding that the insurer acted deceptively, the Insurance Commissioner shall issue a cease and desist order.<sup>118</sup> The insurer will be fined for violations of a cease and desist order.<sup>119</sup> The Insurance Commissioner does not have the power to order the insurer to pay damages to the third party.<sup>120</sup> Not only does filing a complaint with the Insurance Commissioner not provide damages to the third party, but this method has been criticized as lacking effectiveness to protect consumers against insurer practices.<sup>121</sup>

Courts have relied on the third party beneficiary theory to obtain relief for the third party.<sup>122</sup> This theory states that the parties to a liability insurance contract intend that the amount of funds available under the policy will be paid

116. Although the third party may obtain a judgment against the insured, the insured may be unable to pay the judgment. The insured may then be forced to sue the insurer in order to pay the judgment obtained by the third party. Diana C. White, Comment, *Liability Insurers and Third-party Claimants: The Limits of Duty*, 48 U. CHI. L. REV. 125, 128 (1981). This will create considerable delay in compensating the third party in addition to forcing needless litigation. *Id.* Furthermore, the insured may declare bankruptcy and any unpaid debts, which could include the judgment, will be discharged. *Id.* at 136 & nn.41-44.

117. The Insurance Commissioner is empowered to investigate practices of insurance companies and assess penalties for violations of the insurance code. CAL. INS. CODE § 790.04 (West 1987).

118. CAL. INS. CODE § 790.05 (West 1987 & Supp. 1991).

Whenever the commissioner shall have reason to believe that . . . such person has been engaged or is engaging in . . . any unfair competition or any unfair or deceptive act or practice . . . the commissioner should issue an order to that person to . . . cease and desist those methods, acts, or practices or any of them.

*Id.*

119. CAL. INS. CODE § 790.07 (West 1987 & Supp. 1991).

Whenever the commissioner shall have reason to believe that any person has violated a cease and desist order issued pursuant to Section 790.05 . . . the commissioner may . . . order that person to forfeit and pay to the State of California a sum not to exceed five thousand dollars . . . if the violation is found to be wilful, the amount of the penalty may be a sum not to exceed fifty-five thousand dollars plus the penalty due under Section 790.05.

*Id.*

The fines imposed by the Insurance Commissioner are paid to the state and not to the third party. See also Elise Suzanne Rose, Comment, *A Statutory Action For Insurer Bad Faith-The Reasonably Clear Remedy For The Third Party Claimant*, 11 PAC. L.J. 945, 948 (1980).

120. See *supra* notes 118-19.

121. Tom Dresslar, *Bill would Overturn Moradi-Shalal*, L.A. DAILY J., Jan. 27, 1989, at 3, col. 2.

122. This is a theory that has been relied upon by courts other than in California. White, *supra* note 116, at 141 n.57.

to persons injured by the insured.<sup>123</sup> However, an inference that the third party was to be a beneficiary beyond the policy limits is difficult to extract from the policy language.<sup>124</sup> Public policy dictates that the third party beneficiary theory would change the rights and duties of the insurer and the insured, along with changing the nature of the insurance policy.<sup>125</sup>

Consequently, the available avenues for a third party to recover damages when an insurer refuses to settle with the third party are extremely limited. Either the third party will be undercompensated or not compensated at all. Since third parties suffer substantial injuries and losses that are not adequately compensated, a uniform method of recovery must be developed to fully compensate third parties.

### B. A Statutory Cause of Action

The Unfair Practices Act has been the subject of a third party private cause of action in California. For eleven years the Unfair Practices Act was interpreted to support a cause of action for third parties to directly sue insurers. The controversy surrounding the third party cause of action can be attributed to

123. Professor Corbin states the third party beneficiary theory as follows:

[Liability and indemnity insurance] policies may be worded as to make it clear that they are intended solely for the protection and indemnity of the insured. Indeed, the promise may be merely to reimburse the insured in case he is compelled to pay damages to some third party. If the contract is clearly for the sole benefit of the promisee, being merely for his indemnification or reimbursement, no third party has an enforceable right by virtue of the policy. There is a tendency, however, for the states to require by legislation the carrying of liability insurance for the protection of third parties. Policies that are issued by virtue of such legislation should be interpreted as being for the benefit of the third party and should be held to give him an enforceable right against the insurer. Even in the absence of such legislation the injured third party should have an enforceable right against the insurer if the policy is so worded as to indicate that it was executed for the protection of third persons, or as to amount to a promise to pay the debt of the insured to the injured party.

White, *supra* note 116, at 140 n.56 (citing 4 ARTHUR CORBIN, CORBIN ON CONTRACTS § 807, at 213-16 (footnotes omitted)).

124. White, *supra* note 116, at 142. Three arguments support the theory that the third party was not meant to be a beneficiary. First, even though the insured may sue the insurer for a wrongful failure to settle as a breach of the fiduciary duty to the insured, and not to the adverse party, the insured intended for the third party to assert a claim against the insurer. *Id.* Second, the insurer's wrongful failure to settle negates part of the policy language. "It is as if a new policy came into existence at the moment of the breach, and the only limitation on the amount of the new policy were the insured's legal obligation to pay." *Id.* The third party then becomes only an incidental beneficiary. *Id.* Third, the third party may be seen as the direct beneficiary of the insurance policy. Thus, once the third party is identified, the insurer and the insured intended for the third party to "take advantage of more of the contract's covenants than the promise to pay within policy limits." *Id.* at 193. This interpretation makes nonsense out of the insurance policy. *Id.*

125. *Id.* at 144.

the language of the statute and the legislative history of the Unfair Practices Act.

The California Supreme Court allowed a third party to directly sue an insurer under a statute in *Royal Globe Insurance Co. v. Superior Court*.<sup>126</sup> In *Royal Globe*, the third party was injured in the insured's supermarket. The supermarket's liability was clear, but Royal Globe, the supermarket's insurer, failed to settle the third party's claim. The third party sued Royal Globe under section 790.03 of the California Unfair Practices Act<sup>127</sup> alleging that Royal

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126. 592 P.2d 329 (Cal. 1979).

127. The relevant section of 790.03 provides:

[t]he following are hereby defined as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance. . . .

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

- (1) Misrepresenting to *claimants* pertinent facts or insurance policy provisions relating to any coverages at issue.
- (2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
- (3) Failing to adopt and implement reasonable standards for the prompt investigation and processing of claims arising under insurance policies.
- (4) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the *insured*.
- (5) Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.
- (6) Compelling *insureds* to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by the *insureds*, when the *insureds* have made claims for amounts reasonably similar to the amounts ultimately recovered.
- (7) Attempting to settle a claim by an *insured* for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.
- (8) Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the *insured*, his or her representative, agent, or broker.
- (9) Failing, after payment of a claim, to inform *insureds* or beneficiaries, upon request by them, of the coverage under which payment has been made.
- (10) Making known to *insureds* or *claimants* a practice of the insurer of appealing from arbitration awards in favor of *insureds* or *claimants* for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.
- (11) Delaying the investigation or payment of claims by requiring an *insured*, *claimant*, or the physician of either, to submit a preliminary claim report, and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.
- (12) Failing to settle claims promptly, where liability has become apparent, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.
- (13) Failing to provide promptly a reasonable explanation of the basis relied on in the insurance policy, in relation to the facts or applicable law, for the denial of a claim or for the offer of a compromise settlement.

Globe failed to settle the claim in good faith.<sup>128</sup>

Royal Globe claimed that the statute did not allow third parties to bring a private cause of action, but that the statute was to be enforced by the Insurance Commissioner through a cease and desist order.<sup>129</sup> The court held that a cease and desist order issued by the Insurance Commissioner under the Unfair Practices Act does not release the insurer from civil liability.<sup>130</sup> Consequently, private litigants, including third parties, would be allowed to sue the insurer for unfair practices under the Unfair Practices Act.<sup>131</sup>

However, in *Moradi-Shalal v. Fireman's Fund Insurance Cos.*,<sup>132</sup> the California Supreme Court overruled *Royal Globe* and held that a third party could not bring a private cause of action under the Unfair Practices Act. In *Moradi-Shalal*, the insured and the third party were driving automobiles when the insured's car hit the third party's car. The insurer did not settle the third party's claim for damages. Consequently, the third party sued the insurer under the Unfair Practices Act for failure to settle the claim.<sup>133</sup>

The California Supreme Court denied the third party's claim and stated several reasons for overruling *Royal Globe*. The court first looked to other jurisdictions' reactions to the *Royal Globe* decision. The court noted that several

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

(15) Misleading a *claimant* as to the applicable statute of limitations.

CAL. INS. CODE § 790.03 (West 1987 & Supp. 1991) (emphasis added). The Unfair Practices Act regulates the business and affairs of insurance companies doing business in California. For example, the Act regulates advertising, unfair methods of competition, rates, etc. BAD FAITH, *supra* note 15, § 9:2. The legislature amended section 790.03 to include subsection (h). Rose, *supra* note 119, at 948. See generally Wylie A. Aitken & James B. Abelton, *When Does "The Fat Lady Sing" for Purposes of a Royal Globe Action? Endless Litigation over What Does or Should Constitute the Resolution of a Claim*, 14 W. ST. U.L. REV. 55, 56 (1986) (brief history of the California Unfair Practices Act).

128. *Royal Globe*, 592 P.2d at 332.

129. *Id.* *Royal Globe* contended that the Insurance Commissioner had exclusive power to enforce section 790.03(h) of the Insurance Code, that the code was only meant to protect the insured, and that third parties lacked standing to bring a cause of action under the code. *Id.*

130. *Id.* at 334. CAL. INS. CODE § 790.09 (West 1987).

No order to *cease and desist* issued under this article directed to any person or subsequent administrative or judicial proceeding to enforce the same shall in any way relieve or absolve such person from any administrative action against the license or certificate of such person, *civil liability* or criminal penalty under the laws of this State arising out of the methods, acts or practices found unfair or deceptive.

*Id.* (emphasis added).

131. *Royal Globe Ins. Co. v. Superior Court*, 592 P.2d 329, 333 (Cal. 1979).

132. 758 P.2d 58 (Cal. 1988).

133. *Id.* at 63. The third party alleged that the insurer did not promptly investigate or attempt in good faith to effectuate a prompt settlement of the claim. See *supra* note 127.

states with Unfair Practices Acts had not construed the statutes as creating a private cause of action for third parties.<sup>134</sup> The court also considered the legislative response to *Royal Globe*. The court construed both the legislature's failure to explicitly codify *Royal Globe* and the California Senate's one attempt to overrule *Royal Globe* as an indication that *Royal Globe* should be overruled because it was inconsistent with the legislative intent of the statute.<sup>135</sup> Furthermore, the court gave considerable weight to the scholarly criticisms of the *Royal Globe* decision in making its decision to overrule *Royal Globe*.<sup>136</sup>

The court justified overruling *Royal Globe* by citing to the remedies that were still available against insurers. Although the Insurance Commissioner would still be able to impose administrative sanctions against insurers, such as cease and desist orders, fines, and suspensions of insurers' licenses,<sup>137</sup> the court stated that the California courts could still award damages against the insurers in appropriate common law actions.<sup>138</sup> The court further stated that the legislature was free to create new civil remedies or to create a private cause

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134. *Moradi-Shalal*, 758 P.2d at 63. Many states have enacted Unfair Practice Statutes. MCCARTHY, *supra* note 6, § 2.24. Thirteen states allow a third party to bring a private cause of action under an unfair practices statute. *Moradi-Shalal*, 758 P.2d at 63. The California Supreme Court stated that nineteen other states had dealt with whether a private cause of action had been created for third parties under the Unfair Practices Act. *Id.* Seventeen of these courts did not recognize a private cause of action for third parties. *Id.* However, eight states have acknowledged the *Royal-Globe* decision, but have not followed it. *Id.* Nine states have rejected the *Royal-Globe* holding. *Id.* The *Moradi-Shalal* court cited with approval to a decision by the Minnesota Supreme court holding that the Minnesota Unfair Practices Act did not create a private third party cause of action because the Act provided for administrative regulations of insurance practices and did not mention a private cause of action. *Id.* at 64 (citing *Morris v. American Family Mut. Ins. Co.*, 386 N.W.2d 233 (Minn. 1986)).

135. *Moradi-Shalal*, 758 P.2d at 65. In May 1979, the California Senate introduced a bill that provided that section 790.03(h) of the Insurance code did not impose civil liability upon insurance companies found in violation of the insurance code. *Id.* at 65. This bill became "stalled" in the California legislature's Ways and Means Committee and was never considered by the whole legislature. *Id.* At most, the short history of this bill can be construed that the legislature was far from agreement on the existence of a private third party cause of action under section 790.03(h). The court concluded that even though this legislative history was inconclusive, it still casts doubt on the reasoning in *Royal Globe*. *Id.* at 66. Compare notes 142-45 and accompanying text.

136. *Moradi-Shalal*, 758 P.2d at 64-65. The court cited several law review articles that criticized the *Royal Globe* decision. The court also stated that the National Association of Insurance Commissioners Model Unfair Claims Practices Act did not create an individual private cause of action. *Id.*

137. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58, 68 (Cal. 1988).

138. *Id.* at 68-69. The court stated that damages could be imposed on insurance companies in common law actions that were based on traditional theories, such as fraud, emotional distress, and the breach of the implied covenant of good faith and fair dealing (a cause of action for the breach of the implied covenant would be available only to the insured). *Id.* This list of common law remedies may be construed to mean that a third party may be allowed to sue under a common law theory that does not involve the covenant of good faith and fair dealing.

of action under the Unfair Practices Act.<sup>139</sup> After *Moradi-Shalal*, third parties were returned to the pre-*Royal Globe* status of inadequate remedies.<sup>140</sup>

The dissent in *Moradi-Shalal* refuted the majority's reasoning and called the reversal of *Royal Globe* a "Royal Bonanza."<sup>141</sup> The dissent objected to the majority opinion for several reasons. The dissent objected to the emphasis that the majority placed on legislative inaction, the efficacy of disciplinary proceedings instituted by the Insurance Commissioner, and the majority's rejection of prior case law in interpreting the Unfair Practices Act.

The dissent particularly disagreed with the majority's interpretation of the legislative action subsequent to the *Royal Globe* decision. The dissent emphasized that since *Royal Globe*, the California Legislature had failed to pass legislation specifically overruling *Royal Globe*.<sup>142</sup> In 1983, the Legislature actually amended section 790.03, but did not change subsection (h).<sup>143</sup> The dissent argued that legislative inaction was thus an indication of legislative intent to leave the law as it stood.<sup>144</sup> In 1979, the insurance industry unsuccessfully attempted to persuade the legislature to overrule *Royal Globe*.<sup>145</sup>

The dissent also considered the failure of the Insurance Commissioner to commence disciplinary proceedings against insurers for deceptive and unfair acts involving claimants such as third parties.<sup>146</sup> Since 1959, when section 790 of the Insurance Code was enacted, not one case had been reported in the California Reports or the California Appellate Reports involving disciplinary action against insurers.<sup>147</sup> Although the majority stated that after *Moradi-Shalal* the Insurance Commissioner will continue to "police" insurers, such "policing" seems unlikely.<sup>148</sup> A third party's remedy against the insurer is therefore very limited after *Moradi-Shalal*.<sup>149</sup>

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139. *Id.* at 69.

140. Gainer, *supra* note 41, at 790.

141. *Moradi-Shalal*, 758 P.2d at 75. Judge Mosk, the dissenter, stated that the overruling of *Royal Globe* creates "total immunity for unfair and deceptive practices committed on innocent claimants." *Id.*

142. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58, 77-78 (Cal. 1988).

143. *Id.* at 78.

144. *Id.* The dissent stated that the legislature's refusal to pass a bill that would expressly overrule *Royal Globe* was not legislative silence, but approval of the *Royal Globe* decision. *Id.*

145. *Id.* at 77. This Senate bill would have amended section 790.03 of the Unfair Practices Act to specifically deny private causes of action for third parties. *Id.* This bill was rejected by the Ways and Means Committee and eventually died. *Id.* at 78.

146. *Moradi-Shalal*, 758 P.2d at 77.

147. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58, 77 (Cal. 1988).

148. *See supra* notes 117-21 and accompanying text.

149. *See supra* notes 104-25 and accompanying text.

The dissent also construed case law prior to *Royal Globe* as an indication that the Unfair Practices Act allowed a third party cause of action. In support of third party causes of action, the dissent discussed three cases that stated that the Unfair Practices Act contemplated private liability for insurers in addition to sanctions by the Insurance Commissioner.<sup>150</sup>

Since the decision in *Moradi-Shalal* closed the door on third party causes of action, subsequent attempts have been made by the legislature to force this door back open.<sup>151</sup> In 1988, the California voters were asked to vote on Proposition 103, which regulated insurance practices.<sup>152</sup> Proposition 103 was designed to "regulate insurance companies, give good driver discounts, and end anti-trust exemptions."<sup>153</sup> Proposition 103 also contained a provision that allowed "any person" to enforce Proposition 103.<sup>154</sup> The voters approved Proposition 103 and the legislature subsequently codified it.<sup>155</sup> However, the California courts have construed Proposition 103 as not creating a private statutory cause of action for third parties to sue insurers.<sup>156</sup> Attempts by the people of California to reinstate the third party cause of action have been futile.

150. *Moradi-Shalal*, 758 P.2d at 78-79 (citing *Homestead Supplies, Inc. v. Executive Life Ins. Co.*, 147 Cal. Rptr. 22 (Ct. App. 1978) (the nature of the conduct proscribed in § 790.03 is to protect the public; thus § 790.03 contemplates civil liability to the public); *Shernoff v. Superior Court*, 118 Cal. Rptr. 680 (Ct. App. 1975) (the Insurance Commissioner's sanctions restrain future illegal conduct and do not enter money judgments to the third party for past injuries); *Greenberg v. Equitable Life Assurance Society*, 110 Cal. Rptr. 470 (Ct. App. 1973) (the insurance code contemplates private causes of action against insurance companies and any other reading of the insurance code would overturn *Crisci* by implication)).

151. See generally Tom Dressler, *Bill Would Overturn Moradi-Shalal*, L.A. DAILY J., Mar. 27, 1989, at 3, col. 2 (remarks concerning a bill that was to reverse the effects of *Moradi-Shalal*). Rick Kushman, *The Insurance-reform Stampede*, 19 CAL. J. 417 (1988) (discussing five proposals concerning automobile insurance that were put before the California voters in 1988).

152. BAD FAITH, *supra* note 15, § 9:171. Proposition 103 was mainly aimed at insurance rate regulation. *Id.*

153. Kushman, *supra* note 151, at 419.

154. CAL. INS. CODE § 1861.10(a) (West Supp. 1991).

Any person may initiate or intervene in any proceeding permitted or established pursuant to this chapter, challenge any action of the commissioner under this article, and enforce any provision of this article.

155. CAL. INS. CODE § 1861-1861.16 (West Supp. 1991).

Proposition 103 was titled a "Prohibition on Unfair Insurance Practices." Section 1861.03(a) concerns unfair insurance practices.

The business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act . . . the antitrust and unfair business practices laws (Parts 2 (commencing with Section 16600) and 3 (commencing with Section 17500) of Division 7 of the Business and Professions Code).

CAL. INS. CODE 1861.03(a) (West Supp. 1991).

156. *Maler v. Superior Court*, 270 Cal. Rptr. 222 (Ct. App. 1990) (Proposition 103 does not create a private of action for third parties to directly sue insurers using § 790.03).



Although courts have construed Proposition 103 and the Unfair Practices Act to preclude a third party cause of action, a third party successfully sued an insurer under the Unfair Competition Statute<sup>157</sup> in *Beatty v. State Farm Mutual Automobile Insurance Co.*<sup>158</sup> In *Beatty*, a third party was injured when an automobile driven by the insured hit the third party's automobile.<sup>159</sup> The insurer refused to pay the claim, and the third party sued the insurer. The third party alleged that the insurer's refusal to pay the third party's claim was an unfair business practice under the Unfair Competition Statute.<sup>160</sup>

The court allowed the third party to recover damages based on this statutory cause of action and held that the Unfair Competition Statute had a broad function to protect consumers.<sup>161</sup> The court held that limiting statutes other than the Unfair Practices Act under *Moradi-Shalal*<sup>162</sup> would be inconsistent with this broad protective function.<sup>163</sup> The *Beatty* court considered the list of remedies that the court in *Moradi-Shalal* stated were still available.<sup>164</sup> However, the *Beatty* court considered the remedies to be illustrative, not exhaustive, and added a suit under the Unfair Competition Statute to this list.<sup>165</sup>

Since *Beatty*, several courts have decided cases in which a third party

157. The Unfair Competition Statute protects consumers (as well as competitors) from unfair business practices. Unfair business practices constitute business practices that are forbidden by law. BAD FAITH, *supra* note 15, § 9:179.

"As used in this chapter, unfair competition shall mean and include unlawful, unfair or fraudulent business practice and unfair, deceptive, untrue or misleading advertising and any act prohibited by Chapter 1 (commencing with section 17500) of Part 3 of Division 7 of the Business and Professions Code."

CAL. BUS. & PROF. CODE § 17200 (West 1987).

Although Proposition 103 was not used in *Beatty*, Proposition 103 specifically makes applicable the unfair business practice laws of the Business and Professions Code. BAD FAITH, *supra* note 15, § 9:176.

158. 262 Cal. Rptr. 79 (Ct. App. 1989). The California Supreme Court denied review and ordered the opinion to be officially unpublished. But the opinion was inadvertently published and subsequently cited as authority in *Marenger v. Hartford Accident & Indem. Co.*, 268 Cal. Rptr. 290 (Ct. App. 1990). Commentators have also discussed the *Beatty* decision. See, e.g., Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1121 n.16 (1991); Archie S. Robinson, *The Statutory Bad Faith Hydra Grows Another Head in California*, 31 FOR DEF. 21 (1989); 1 MCCARTHY, *supra* note 6, at § 2.23.

159. *Beatty*, 262 Cal. Rptr. at 80.

160. *Id.* at 81. See *supra* note 157.

161. *Beatty*, 262 Cal. Rptr. at 86. This broad protective function meant that an insurer's practice only had to be unfair and not necessarily unlawful to violate the unfair competition act. *Id.*

162. *Moradi-Shalal* specifically limited the enforcement of the Unfair Practices Statute to the insurance commissioner. See *supra* note 138.

163. *Beatty v. State Farm Mut. Auto. Ins. Co.*, 262 Cal. Rptr. 79, 86 (Ct. App. 1989).

164. *Id.* at 86. See *supra* notes 138-40.

165. *Beatty*, 262 Cal. Rptr. at 86.

sued an insurer on a private cause of action. Among these cases, *Beatty* appears to be the exception. These courts have held that no private cause of action for third parties is available under the Unfair Competition Statute.<sup>166</sup>

Thus, existing remedies for the injured third party are few and inadequate. The best remedy available to the third party is a private cause of action based on a statute because it provides certain advantages.<sup>167</sup> A statutory cause of action eliminates the problems associated with privity that prevent the third party from suing the insurer for a breach of covenant of good faith and fair dealing.<sup>168</sup> Furthermore, a statutory cause of action enables the third party to recover damages and be fully compensated.<sup>169</sup>

### C. Proposed Third Party Cause of Action

The absence of a firmly established statutory cause of action in California may be explained by a lack of communication between the California legislature and the California courts.<sup>170</sup> Although the legislature has attempted to overrule *Moradi-Shalal*, the courts are unwilling to follow the legislature and create an implied third party cause of action. Because the courts are unwilling to develop a cause of action that will fully compensate the third party, a statute should be enacted that clearly and explicitly creates a third party cause of action

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166. *Safeco Ins. Co. of Am. v. Superior Court*, 265 Cal. Rptr. 585 (Ct. App. 1990) (a different California appellate court held that the Unfair Competition Statute did not create a private third party cause of action); *Industrial Indem. Co. v. Santa Cruz County Superior Court*, 257 Cal. Rptr. 655 (Ct. App. 1989) (private litigants do not have a cause of action for damages under the Business & Professions Code).

Several concerns have been raised pertaining to *Beatty*. See Robinson, *supra* note 158. One troubling aspect of *Beatty* is what an unfair business practice is under the Business and Professions Code. *Id.* at 24. The Unfair Competition Statute lists insurance practices that are unfair. *Id.* The Business and Professions Code does not describe what an unfair practice involves, but unfair at least means tortious. *Id.* This definition of "unfair" renders the Business and Professions Code needless because a "tortious practice and otherwise unlawful practice" have independent remedies. *Id.*

167. This private statutory cause of action should be similar to the third party suit in *Royal Globe*.

168. Privity prevents the third party from directly suing the insurer for a breach of the duty of good faith and fair dealing.

169. See *supra* notes 20-27 and accompanying text.

170. For example, both the majority and the dissent in *Moradi-Shalal* interpreted differently the actions of the legislature following *Royal Globe*. The dissent also considered cases where the appellate courts construed the Unfair Practices Act as allowing a third party cause of action. See *supra* note 150. Yet the California Supreme Court decided that the cause of action did not exist. See *supra* notes 134-40 and accompanying text. The legislature may have thought that the cause of action already existed. See *supra* note 144. See also *supra* note 166 and accompanying text discussing that at least one appellate court has allowed a third party cause of action and another appellate court has rejected the cause of action.

that would allow a third party to fully recover.<sup>171</sup>

In order to provide third parties with a procedure for recovering fully for their losses, the following addition to Section 790.03 of the Unfair Practices Act should be made:

- (i) A claimant is any person, either an insured or a third party, who has been subject to unfair practices by an insurer.
- (j) Unfair practices are conduct by an insurer as defined in subsection (h) of this section (790.03).
- (k) A claimant or an insured may enforce this Act
  - (i) by directly bringing a suit against the insurer under subsection (h) of this Act, or
  - (ii) through the Insurance Commissioner under section 790.05 of this Act.
- (l) An insurer who is found liable for unfair practices may raise the conduct of the claimant as a defense, if the claimant
  - (i) fails to promptly and adequately furnish the insurer with all pertinent information and evidence, and
  - (ii) the claimant's failure to furnish information and evidence delays or impedes the insurance carrier's investigation and payment of the claim.<sup>172</sup>
  - (iii) Any conduct of the claimant defined by (i) and (ii) of this subsection will reduce the claimant's damages comparatively with the claimant's conduct.
- (m) Any conduct by a claimant that conforms to conduct defined in subsection (l) may be considered if the claimant's conduct is not raised by the insurer.

This proposed amendment will treat the third party and the insured as equals. The third party will be able to directly sue an insurer for failing to reasonably settle a third party claim. The third party will be able to recover for emotional distress and other loss proximately caused by the insurer's bad faith conduct.<sup>173</sup>

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171. At least one author predicted that the California Supreme Court may hold that the Business and Professions Code does not support a private third party cause of action. *BAD FAITH*, *supra* note 15, § 9:198. Thus, the legislature should solidify a private cause of action for third parties before the California Supreme Court totally precludes the statutory cause of action.

172. This is in essence the language from *California Casualty* creating the comparative bad faith defense against first parties. *California Casualty Ins. Co. v. Superior Court*, 218 Cal. Rptr. 817, (Ct. App. 1985).

173. See generally Kornblum, *supra* note 14; see also *supra* notes 22-27 and accompanying text.

However, this statute also protects the insurer from unlimited liability by limiting the amount of damages that could be recovered by the third party.<sup>174</sup> This limitation is in response to a concern about an increase in both litigation and damage awards against the insurer.<sup>175</sup> The judicial development of comparative bad faith has created a balance between the insurer and the insured.<sup>176</sup> Although third parties must be allowed to recover damages against the insurer, third parties should not be given a windfall through a statutory third party suit.<sup>177</sup> Consequently, a comparative bad faith defense for the insurer creates a balance between the third party and the insurer, similar to the one that

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174. The third party's delay or incomplete settlement offer may be contributed to the insurer's failure to settle the claim. If a third party is able to sue the insurer, then the insurer should be able to assert a comparative bad faith defense. Although comparative bad faith was first applied between the insured and the insurer, comparative bad faith can be, and should be, extended between the insurer and the third party. DONALD T. MCMILLAN & LEONARD J. PUGATCH, *BAD FAITH LITIGATION: DEFENSE VIEWPOINT—TACTICS AND STRATEGY*, reprinted in *BAD FAITH LITIGATION AND INSURER VS. INSURER DISPUTES 1988*, at 83, 90 (PLI Com. L. & Practice Course Handbook Series No. 455 (1988)) (stating that a comparative bad faith defense should exist in third party statutory actions, but *not* discussing any basis or framework for such a defense). The situation between an injured third party and an insurer is sufficiently similar to the situation between the insured and the insurer to warrant the extension of comparative bad faith. Ceran, *supra* note 88, at 1424 (considering the similarities between the insured and the injured third party: both parties are injured, both must deal directly with the insurer, and both may incur further injury if the insurer fails to settle). See *supra* notes 47-49 and accompanying text. The underlying policies of comparative bad faith apply to the third party's conduct when the third party sues the insurer. See *supra* notes 72-79 and accompanying text. Consequently, the third party's damage award should be reduced according to the third party's conduct.

175. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58, 66 (Cal. 1988).

176. See *supra* notes 72-87 and accompanying text.

177. There are situations when a third party engages in delay and supplies fraudulent information. As this is taken into account in comparative bad faith analysis when an insured supplies fraudulent information, the third party should also not benefit from this conduct.

Certain defenses based on the conduct of the third party may be raised by the insurer. These defenses include the absence of a settlement offer by the third party, the third party's failure to allow the insurer reasonable time to consider a settlement offer, and the third party's submission of an incomplete settlement offer. See *Merrit v. Reserve Ins. Co.*, 110 Cal. Rptr. 511 (Ct. App. 1973) (absence of settlement offer); *Critz v. Farmers Ins. Group*, 41 Cal. Rptr. 401 (Ct. App. 1964) (reasonable settlement time); *Coe v. State Farm Mut. Auto. Ins. Co.*, 136 Cal. Rptr. 331 (Ct. App. 1977) (incomplete settlement offer); 1 MCCARTHY, *supra* note 6, §§ 2.46-2.49, 2.50. These defenses are ineffective because they do not adequately consider the bad faith conduct of the third party. When an insurer raises these defenses, the third party's damage award is not comparatively reduced. The third party's bad faith conduct is only considered to determine if the insurer acted in bad faith. Ronald S. Range, Note, *The "Set Up" Defense and the Comparative Bad Fault Defense: New Wrinkles in Bad Faith Claims Against Insurers*, 45 WASH. & LEE L. REV. 321 (1988). Thus, the third party's claim is either allowed or precluded. *Critz*, 41 Cal. Rptr. at 419 (if the third party's incomplete settlement offer was partly responsible for the insurer's failure to settle, the third party's claim will be precluded). If the third party's claim is precluded, the injured third party will not be compensated.

exists between the insured and the insurer.<sup>178</sup>

### CONCLUSION

The development of the bad faith cause of action has given an insured a method of recovering all damages caused by the insurer's breach of the insurance policy. However, in California, a third party who is injured by an insured may not receive compensation from the insurer. The third party will not be able to sue the insurer based on a common law theory of bad faith because the duty of good faith and fair dealing is limited to privity relationships and does not extend to third parties.

In order to fully compensate the third party, a statutory cause of action, which would circumvent the common law privity requirement, should exist for the third party. The third party would then be able to sue the insurer for damages caused by the insurer's failure to settle. The statute proposed by this Note creates a remedy for the third party. The proposed statute also addresses liability concerns by limiting a third party's recovery if the third party has acted unreasonably in presenting information to the insurer. This statute creates a balance between the insurer and the third party similar to the balance between the insured and the insurer created by comparative bad faith. In so doing, the proposed statute will solve the problem of the injured and undercompensated third party.

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178. See *supra* notes 72-87 and accompanying text. Although the proposed comparative bad faith defense to operate against the third party is statutory, an analytic basis for it may be found in tortious interference with contract. The application of tortious interference with contract to the insurance industry is not new. In *Fletcher v. Western National Life Insurance Co.*, 89 Cal. Rptr. 78 (Ct. App. 1970), an insurer was held liable for wrongfully withholding disability benefits from an insured. In *Fletcher*, the insurer wrongfully withheld benefits by intentionally misconstruing the insured's medical reports. The court awarded damages to the policy holder by analogizing to tortious interference with contract. The court stated that if a third party had interfered with the insured's rights under the policy, the third party would be liable to the insured. Thus, the insurer should be held liable on the same principles. *Id.* at 91.

The comparative bad faith defense asserted against the third party is based on the relationship between the third party and the insurer. Although the third party is justified in suing an insurer that refuses to settle the third party's claim, any bad faith conduct by the third party may be seen as an interference with the policy between the insured and the insurer. Because the third party has interfered with the insurance contract, by acting in bad faith, the third party's damages should be reduced in comparison to the third party's conduct. However, a complete analysis of the interaction between the principles of tortious interference with contract and a reduction of the third party's damage award is beyond the scope of this Note.