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# Bad Faith: Defining Applicable Standards in the Aftermath of *Royal Globe v. Superior Court*

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# BAD FAITH: DEFINING APPLICABLE STANDARDS IN THE AFTERMATH OF *ROYAL GLOBE v. SUPERIOR COURT*

## I. INTRODUCTION

Bad faith litigation has developed extensively over the past twenty-five years in California, where the courts have been the pace-setters in the development of insurance law. California has led the way in expanding the scope of liability of insurance companies. In 1957, a California court of appeal first recognized that an insured has a cause of action against an insurance company for its bad faith refusal to accept an injured claimant's offer to settle a personal injury lawsuit against the insured.<sup>1</sup> The California Supreme Court affirmed this reasoning in a later decision which held that an implied obligation of good faith and fair dealing is a part of every insurance contract and may require the insurer to settle a claim against its insured, even though the express terms of the policy do not impose such a duty.<sup>2</sup>

In 1979, the California Supreme Court decided the landmark case of *Royal Globe Insurance Co. v. Superior Court*.<sup>3</sup> *Royal Globe* held that a third party claimant could sue an insurance company directly for the insurer's bad faith settlement of the third party's claim against the insured.<sup>4</sup> This unprecedented decision startled the insurance industry. Previous cases holding an insurance company liable in bad faith were based on contract and tort principles which required the insurer to act in the best interests of its insured.<sup>5</sup> *Royal Globe*, however, was based upon the Unfair Settlement Practices Act of the California Insurance Code.<sup>6</sup> The resulting

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1. *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

2. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

3. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

4. *Id.*

5. *See, e.g., Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976).

6. CAL. INS. CODE §§ 790-90.10 (West 1972 & Supp. 1983). [hereinafter cited as the Act]. Section 790.03 provides in pertinent part:

The 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 of 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 amount ultimately recovered in actions brought by such insureds, when such 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 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 of 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.

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

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

statutory cause of action based on section 790.03 of the Act<sup>7</sup> deviates from the common law which prevented third parties from directly suing an insurer without an assignment.<sup>8</sup>

The *Royal Globe* decision is presently the cause of many problems for California attorneys. First, the primary difficulty for insurers today in avoiding bad faith causes of action is understanding what constitutes bad faith in this new "statutory" sense. Second, *Royal Globe* failed to articulate factors regarding the stage at which the insurer's duty to settle arises. Third, *Royal Globe* creates in the third party claimant a unilateral weapon of demanding settlement without requiring of the third party claimant the explicit good faith and fair dealing requirements imposed upon insurers. Finally, *Royal Globe*, in its interpretation of Insurance Code section 790.03, raises a host of constitutional problems such as vagueness, the right to a jury trial, and the right to contract.

This comment criticizes the *Royal Globe* decision by examining the development of bad faith law prior to and following *Royal Globe*. Proposals to eliminate some of the problems posed by the *Royal Globe* decision are as follows: first, the common law principles of bad faith should control the *Royal Globe* statutory cause of action; second, the assignment theory should be used as the general procedure under which a third party claimant must undertake to sue the insurer in accord with the common law principles; and third, the concept of mutuality in settlement obligations should be imposed on third party claimants, so as to create parity between the parties in the availability of sanctions arising from bad faith set-

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7. CAL. INS. CODE § 790.03 (West Supp. 1983). Unless otherwise indicated, all statutory references are to the California Insurance Code.

8. See, e.g., *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 53 P.2d 584, 132 Cal. Rptr. 424 (1976). "An assignment in law is the transfer or setting over of property, or some right or interest therein, from one person to another." 7 CAL. JUR. 3d *Assignments* § 1 (1973). In the context of this comment, assignment refers to the acquisition by a third party of an insured's interest to sue an insurer for bad faith following the completion of the initial lawsuit between the third party and the insured. The situation generally arises because of an insured's inability to pay the third party the damage award above the insured's policy coverage. In exchange for the third party's covenant not to execute on the judgment against the insured, the insured assigns the rights to the third party to proceed against the insurer for a breach of the covenant of good faith and fair dealing. Of course, the insured may proceed directly against the insurer, by bringing a first party action in bad faith, as opposed to bringing a third party action, in the case of an assignment. See, e.g., *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

tlement negotiations from both third party claimant and the insurer.

## II. DEVELOPMENT OF THE DOCTRINE OF BAD FAITH IN CALIFORNIA

California initially employed a "good faith" standard to evaluate an insurance company's liability for refusal to settle.<sup>9</sup> Liability was not imposed upon the insurer if it fully, fairly, and honestly considered, but rejected, settlement with the belief that it could defeat the action against its insured, or at least keep the final judgment within the policy limits. The apparent deference afforded insurers, however, was short lived.

In 1957, a California court of appeal in *Brown v. Guarantee Insurance Co.*,<sup>10</sup> held that a bad faith breach of the duty to settle, and not negligence, should be the basis of the insured's cause of action. *Brown* set forth a group of objective factors for subsequent determinations of whether the insurer's refusal to settle constituted a bad faith breach.<sup>11</sup> *Brown* was the first case in California to utilize the doctrine of assignment<sup>12</sup> in a bad faith action. Although *Brown* never specified whether its holding was based on contract or tort principles, it noted that the bad faith cause of action was nevertheless assignable even if based in tort.<sup>13</sup>

*Brown* was followed by the California Supreme Court decision, *Comunale v. Traders & General Insurance Co.*,<sup>14</sup> which held that "[t]here is an implied covenant of good faith

9. See *Christian v. Preferred Accident Ins. Co.*, 89 F. Supp. 888 (N.D. Cal. 1950).

10. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

11. *Id.* at 689, 319 P.2d at 75. These factors are as follows:

The strength of the injured claimant's case on the issues of liability and damages; attempts by the insurer to induce the insured to contribute to a settlement; failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; the insurer's rejection of advice of its own attorney or agent; failure of the insurer to inform the insured of a compromise offer; the amount of financial risk to which each party is exposed in the event of a refusal to settle; the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and any other factors tending to establish or negate bad faith . . . .

*Id.*

12. See *supra* note 8.

13. 155 Cal. App. 2d at 693, 319 P.2d at 78.

14. 50 Cal. 2d 654, 328 P.2d 198 (1958).

and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."<sup>15</sup> While subsequent cases have held that the rejection of the claimant's initial settlement offer could be sufficient to constitute a breach of the implied covenant of good faith and fair dealing,<sup>16</sup> the insurer is not liable in bad faith when the injured claimant has not made a settlement offer to the insured.<sup>17</sup>

*Comunale* was decided upon contract principles, although the court noted that authority existed to support the theory that wrongful refusal to settle had been treated as a tort.<sup>18</sup> It took the court nine years, however, before it held in *Crisci v. Security Ins. Co.*<sup>19</sup> that a bad faith cause of action may be based on tort theory as well.

*Crisci* was a crucial development in the bad faith cause of action because, under the general damages rule in tort, the injured party may recover for all detriment caused, whether it could be anticipated or not.<sup>20</sup> No longer did the excess judg-

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15. *Id.* at 658, 328 P.2d at 200. In *Comunale* the insured, after hitting plaintiffs in a crosswalk with his truck, was notified by the insurer that the truck was not covered under the policy. The insurer refused to settle within the alleged policy limits, and judgment in excess of the policy limits was awarded to the plaintiffs. Plaintiffs obtained an assignment of all of the insured's rights against the insurer and brought suit for breaching the implied covenant of good faith and fair dealing.

16. *See, e.g., Critz v. Farmers Ins. Group*, 230 Cal. App. 2d 788, 41 Cal. Rptr. 401 (1964). The Critz court held that:

Where the potential value of the claim is large in relation to the policy limit, where the claimant's case is comparatively strong and the potential defendant's weak, rejection of an initial offer to settle at or near the policy limit may then and there constitute a breach of the implied covenant of good faith.

*Id.* at 798, 41 Cal. Rptr. at 406. The facts demonstrated what the court referred to as "obvious liability." In addition to the insured driver having been on the wrong side of the road, plaintiff Critz sustained injuries which included a fractured neck and jaw and the loss of vision in one eye. The insured's policy was for \$10,000. The jury returned a \$48,000 verdict in favor of plaintiff Critz. According to the court, the prudent insurer would have eagerly grasped the \$10,000 offer at any stage. *Id.*

17. *See Merrit v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 110 Cal. Rptr. 511 (1973). *Merrit* held that bad faith rules come into effect only when a conflict of interest develops between the insurer and the insured. According to *Merrit*, a conflict of interest arises only when the insurer is offered a settlement demand equal to or above the policy limits and the insured is willing to contribute to the settlement out of his own pocket. *Id.* at 869, 110 Cal. Rptr. at 518.

18. 50 Cal. 2d at 663, 328 P.2d at 203.

19. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

20. *Id.* at 433, 426 P.2d at 178, 58 Cal. Rptr. at 18. In addition to the availability of compensatory damages, that is, the excess amount over the policy limits, damages for mental suffering became available in *Crisci*. These include damages from

ment above the policy limit stand as the highest amount which a successful bad faith plaintiff could recover. Now, plaintiffs could also recover for their mental suffering caused by the bad faith refusal to settle by the insurer.<sup>21</sup> *Crisci's* test in determining bad faith was whether a prudent insurer without policy limits would have accepted the settlement offer.<sup>22</sup>

Three cases following *Crisci* established that these rules also applied to first party bad faith actions by the insured against the insurer for denying coverage under the terms of the policy.<sup>23</sup> In 1970, *Fletcher v. Western National Life Insurance Co.*<sup>24</sup> held an insurer liable in tort for a refusal to indemnify its insured under a disability policy. The court awarded damages for the intentional infliction of emotional distress to the insured. *Fletcher* extended the *Crisci* rule of good faith and fair dealing to situations involving questions regarding the insured's coverage.<sup>25</sup> *Fletcher*, however, like other bad faith decisions failed to articulate a definitive characterization of what is bad faith. Bad faith, nonetheless, was used to describe the insurer's conduct, which was conceded to be "outrageous."<sup>26</sup>

An attempt was made in *Richardson v. Employer's Liability Assurance Corp.*<sup>27</sup> to throw some light on the meaning of bad faith. The court approached the issue in regard to punitive damages in a coverage denial case, and held that the basis for these damages would be limited to proof of malice and oppression.<sup>28</sup> Although *Richardson* characterized oppression by articulating its statutory meaning, it stated that actual malice could be inferred from the circumstances of the case.<sup>29</sup>

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nervousness, grief, anxiety, worry, humiliation, shock and indignity.

21. *Id.* at 433-34, 426 P.2d at 179, 58 Cal. Rptr. at 19.

22. *Id.* at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.

23. Third party bad faith cases typically involve the insurer's duty to accept reasonable settlement demands in handling the claims of third parties against the insured under a liability insurance policy. First party bad faith actions generally involve the insurer's duty not to withhold unreasonably the payments due under a policy. See *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) for a good discussion of this distinction.

24. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

25. *Id.* at 401, 89 Cal. Rptr. at 93.

26. *Id.* at 408, 89 Cal. Rptr. at 99. *Fletcher* also found that Western National's motive for engaging in such conduct was to save itself [Western National] \$50,000. The conduct was found to be premeditated, continuous, and persistent.

27. 25 Cal. App. 3d 232, 102 Cal. Rptr. 547 (1972).

28. *Id.* at 245-46, 102 Cal. Rptr. at 556.

29. Malice may be inferred circumstantially, but the burden of proof still ap-

The third case extending bad faith to first party actions was *Gruenberg v. Aetna Insurance Co.*<sup>30</sup> in which the insurer denied fire insurance coverage to the insured because the insured was suspected of arson. *Gruenberg* articulated the test as "the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy."<sup>31</sup> The California Supreme Court concluded in *Gruenberg* that the analysis of first and third party liability in bad faith involved two aspects of the same duty of good faith and fair dealing.<sup>32</sup>

Excessive punitive damage awards soon became a predominant fear for insurers in bad faith actions. In *Wetherbee v. United Insurance Co. of America*,<sup>33</sup> a jury awarded \$500,000 in punitive damages and only \$1,050 in compensatory damages to an insured who successfully contended that her insurer fraudulently portrayed the benefits of a health and accident policy. Although the \$500,000 award was later reduced to \$200,000, there was a clear indication that no fixed ratio of compensatory to exemplary damages was necessary or useful in future punitive damage consideration.<sup>34</sup> In fact, the \$200,000 award was suggested to be reasonable, as representing less than one week's after-tax income of the insurer.<sup>35</sup>

The magnitude of difficulties encountered by insurers in avoiding bad faith was dramatically heightened in *Johansen v. California State Automobile Association*.<sup>36</sup> In *Johansen*, the California Supreme Court intimated that it was willing to establish strict liability as the standard of assessing insurer liability in bad faith. *Johansen* stated that an insurer's erro-

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pears to be quite high. In *Richardson*, malice was found after it was shown that the insurance agents handling the insured's claim forced the claim into arbitration even though they knew the claim was completely valid. *Id.*

30. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

31. *Id.* at 573, 108 Cal. Rptr. at 485.

32. *See supra* note 23.

33. 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

34. *See, e.g.,* *Wetherbee v. United States Ins. Co. of Am.*, 18 Cal. App. 3d 266, 271, 95 Cal. Rptr. 678, 681 (1971).

35. *Id.*

36. 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975). The claimant, injured in a collision with an automobile owned by insureds, brought an action against the insurer for the unpaid portion of judgment rendered against insureds, including an amount in excess of the policy limits. The insured had assigned his rights against the insurer in exchange for a promise to release him from personal liability on the outstanding judgment. *Id.*



neous belief in "noncoverage affords no defense from liability flowing from the insurer's refusal to accept a reasonable settlement offer."<sup>37</sup> *Johansen* based this proposal on an interpretation of *Crisci* and a general review of the trend in insurer liability since the *Comunale* decision.<sup>38</sup> *Johansen* indicated that the *Crisci* reasonableness test may be met merely by a settlement offer presented to the insurer within the policy limits.<sup>39</sup> *Johansen*, however, did not resolve the question of absolute liability for a refusal to settle whenever an offer was made within the policy limits. The question still remains to be resolved in California.

A unanimous California Supreme Court in *Murphy v. Allstate Insurance Co.*<sup>40</sup> held that the insurer's duty to settle runs to the insured, and *not* to the third party claimant absent an assignment.<sup>41</sup> This was the identical issue presented to the California Supreme Court in *Royal Globe*.

### III. *Royal Globe Insurance Co. v. Superior Court*

Ruth Koepfel slipped and fell in a food market and incurred personal injuries as a result of her fall. Koepfel filed a complaint against the market seeking damages for her injuries, physical and emotional distress, and punitive damages. Also named as defendants were Royal Globe Insurance Co., the issuer of the market's liability policy, and Robert Hunt, an independent adjusting company alleged to be Royal Globe's agent.<sup>42</sup> The complaint alleged that Royal Globe violated section 790.03(h)(5) of the Insurance Code<sup>43</sup> in that it

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37. *Id.* at 16, 538 P.2d at 748, 123 Cal. Rptr. at 292. Although the trial judge found that a bona fide belief in adjustment of the settlement offer would be sufficient to preclude bad faith, the California Supreme Court held that "[a]n insurer who denies coverage *does so at its own risk' regardless of the certainty of his position.*" *Id.* at 15, 538 P.2d at 748, 123 Cal. Rptr. at 292 (emphasis added) (quoting *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d at 660, 328 P.2d at 202).

38. *Johansen*, 15 Cal. 3d at 16, 538 P.2d at 748, 123 Cal. Rptr. at 292. Accepting the *Crisci* reasonableness language, *Johansen* stated that a belief in a policy's lack of coverage, or a desire to reduce the amount of future settlements should be independent of a determination of the settlement offer's reasonableness.

39. *Id.*

40. 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976). See also *Shapero v. Allstate Ins. Co.*, 14 Cal. App. 3d 433, 92 Cal. Rptr. 244 (1971).

41. 17 Cal. 3d at 941, 553 P.2d at 587, 132 Cal. Rptr. at 427.

42. *Royal Globe Ins. Co. v. Superior Court*, 23 Cal. 3d 880, 884, 592 P.2d 329, 331-32, 153 Cal. Rptr. 842, 844-45 (1979).

43. *Id.* See *supra* note 6.

had refused to attempt in good faith to effectuate a prompt, fair, and equitable settlement of Koepfel's claim against the market, even though liability had become reasonably clear. The complaint also alleged that Hunt had advised Koepfel not to obtain the services of an attorney in violation of section 790.03(h)(14).<sup>44</sup>

Defendant Royal Globe demurred to the complaint and sought a dismissal on three grounds: First, that the California Insurance Commissioner has the exclusive power to enforce the Act; second, that a third party has no standing to bring such an insured's action because the Act was intended to protect only the interests of the insured; and third, that a plaintiff cannot sue the insurer and the insured in the same lawsuit.<sup>45</sup> The trial court overruled the demurrer and Royal Globe's petition to the California Supreme Court for a writ of mandate was granted. The court specifically held that a third claimant *may* sue an insurer for violating section 790.03(h)(5) and (14), but that the third party's suit may not be brought until the action between the injured party and the insured is concluded.<sup>46</sup>

Section 790.03(h)(5), the basis for the *Royal Globe* decision, provides that an insurer will be liable for consciously failing to attempt "in good faith to effectuate prompt, fair and equitable settlements of claims upon which liability has become reasonably clear" as part of a general business practice.<sup>47</sup> Section 790.03(h)(5) can be characterized as the court's test for bad faith. However, the court gave no indication of how or in what situations to apply this criterion.

The court held that an individual litigant could bring a private cause of action to impose civil liability on insurers for violating section 790.03.<sup>48</sup> The court read the Act in its entirety and found language in section 790.09 to support its position that the Commissioner did not possess the sole authority to enforce the Act: "Section 790.09 provides that a cease and desist order issued by the commissioner under the provisions of the act shall not absolve an insurer from '*civil liability . . . under the laws of this State arising out of the meth-*

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44. 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845. See *supra* note 6.

45. 23 Cal. 3d at 891, 592 P.2d at 336, 153 Cal. Rptr. at 849.

46. 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.

47. CAL. INS. CODE § 790.03(h)(5). See *supra* note 6.

48. 23 Cal. 3d at 885-87, 592 P.2d at 332-34, 153 Cal. Rptr. at 845-47.

ods, acts or practices found unfair or deceptive.'"<sup>49</sup> The court also relied on first party bad faith cases which had interpreted the Act to allow for a private cause of action to enforce provisions of the Act.<sup>50</sup>

The court then addressed the issue of the insurer's duty. Notwithstanding *Murphy*, which had held that the insurer's duty to settle runs only to its insured, the *Royal Globe* court held that the insurer owes a third party a direct duty to settle a claim in good faith.<sup>51</sup> *Murphy* was reconciled simply by holding that *Murphy* was based on contractual principles, while *Royal Globe* is based on statutory principles.<sup>52</sup>

Finally, *Royal Globe* held that a single instance of unfair conduct by an insurer as specified in section 790.03(h), was sufficient for a cause of action in bad faith.<sup>53</sup> Subdivision (h) provides that an insurer will be liable for "knowingly committing or performing with such frequency as to indicate a general business practice any of [a number of enumerated] unfair claims settlement practices." The result of the *Royal Globe* holding is that liability could be imposed either by proof of repetitive prohibited acts or evidence of deliberate miscon-

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49. *Id.* at 885, 592 P.2d at 332, 153 Cal. Rptr. at 845 (emphasis added by the court). California Insurance Code § 790.09 provides:

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.

CAL. INS. CODE § 790.09 (West 1972).

50. See *Homestead Supplies, Inc. v. Executive Life Ins. Co.*, 81 Cal. App. 3d 978, 147 Cal. Rptr. 22 (1978) (private cause of action found under section 790.09 preventing defendant insurance company from charging plaintiff higher than agreed upon premium); *Shernopp v. Superior Court*, 44 Cal. App. 3d 406, 118 Cal. Rptr. 680 (1975) (in class action for damages against title insurers, court allowed to award money damages for past injuries under section 790.03); *Greenberg v. Equitable Life Assurance Soc'y*, 34 Cal. App. 3d 994, 110 Cal. Rptr. 470 (1973) (private cause of action found under section 790.03(c), which prohibits coercion by an insurer resulting in unreasonable restraint of the business of insurance).

51. 23 Cal. 3d at 888, 592 P.2d at 334, 153 Cal. Rptr. at 847. The court picked out particular language in subdivision (h) of section 790.03 and found the word "claimant" mentioned in sections (h)(1), (h)(14), and (h)(15). Because the word "insureds" appeared concurrently in other provisions of section (h) (i.e., (h)(6),(h)(7), (h)(10) and (h)(11)), the *Royal Globe* court concluded that the purpose of legislatively including claimants in the statute was to afford them with direct protection against insurers.

52. *Id.* at 889-90, 592 P.2d at 335, 153 Cal. Rptr. at 848.

53. *Id.* at 890, 592 P.2d at 335, 153 Cal. Rptr. at 848.

duct on merely one occasion.

Ironically, the insurer won the case. The court concluded that because a plaintiff may not sue both insurer and the insured in the same lawsuit, the writ of mandate should be issued and the trial court be directed to vacate its orders and enter judgment on the pleadings for defendant *Royal Globe*.

#### IV. AFTERMATH OF *Royal Globe*

The court in *Royal Globe* did not need to analyze factually whether or not defendant *Royal Globe* was in fact guilty of bad faith; it merely held it could be liable provided the statutory criteria of the Act were met. No court has applied the statutory criteria since *Royal Globe*. However, *Royal Globe* has been recognized by a handful of appellate courts which did not find it necessary to utilize the nascent statutory criteria for bad faith findings.

##### A. Cases

An overview of the utilization of *Royal Globe* by California courts reveals a hesitancy to do anything with the case except to acknowledge its presence by cursory approval.

The court in *Delos v. Farmers Insurance Group Inc.*<sup>54</sup> followed *Royal Globe* in holding that a single instance of unfair conduct pursuant to section 790.03(h) permits a private cause of action. *Delos* involved an action by an insured against his insurer for a bad faith refusal to pay an uninsured motorist claim made by the insured. *Delos* held that the insurer "is liable" for breaching the common law duty of good faith and fair dealing, and it "may" be liable under section 790.03.<sup>55</sup> The common law liability argument took precedent and was fully developed; the reference to *Royal Globe* and the Act was superfluous.

*Doser v. Middlesex Mutual Insurance Co.*<sup>56</sup> addressed the timing problem of when a cause of action against an in-

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54. 93 Cal. App. 3d 642, 155 Cal. Rptr. 843 (1979).

55. *Id.* at 650, 155 Cal. Rptr. at 848.

56. 101 Cal. App. 3d 883, 162 Cal. Rptr. 115 (1980). In *Doser*, the alleged assignees of an estate brought a bad faith action against the insurer. The assignees were heirs of a passenger killed in a plane crash. A wrongful death action was brought against the beneficiaries of the pilot's estate. After an offer to settle was made to the pilot estate's insurer, assignees brought a bad faith action. The court dismissed the action because the original action was still pending.

surer arises for a third party claimant. *Doser* acknowledged that under *Royal Globe* the third party's suit may not be brought until an action between the injured party and the insured is "concluded."<sup>57</sup> Subsequently, *Nationwide Insurance Co. v. Superior Court*<sup>58</sup> held that *Royal Globe* envisioned that this "conclusion" could only have had reference to a final determination, a "final judgment."<sup>59</sup> This holding, however, was then undercut in *Rodriguez v. Fireman's Fund Insurance Co.*,<sup>60</sup> where the court found the "final judgment" language to be a misstatement of this aspect of the *Royal Globe* decision.<sup>61</sup> *Rodriguez* held that a third party's acceptance of a statutory offer to compromise followed by a dismissal with prejudice of the third party's underlying action against the insured operated as a "conclusion" of the third party's action against the insured.<sup>62</sup> *Rodriguez*, therefore, has extended the reach of *Royal Globe* to settled cases.

*Aetna Casualty & Surety Co. v. Avalos*<sup>63</sup> addressed the question of whether an automobile insurer acted in bad faith by paying a policy limit settlement of \$15,000 to an injured passenger of the insured vehicle when a potential wrongful death claim by the driver's estate also existed. *Avalos* held that no violation of the duty of good faith and fair dealing existed under common law authority. Footnoting *Royal Globe*, *Avalos* stated that a statutory cause of action would have existed if the insurer did not "try in good faith to make a prompt, fair and equitable settlement [of the] personal injury claim."<sup>64</sup>

Perhaps the most important and detrimental decision to insurers since *Royal Globe* is *Colonial Life & Accident Insurance Co. v. Superior Court*.<sup>65</sup> In *Colonial*, the California Supreme Court stated that the Unfair Practices Act and *Royal*

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57. *Id.* at 891, 162 Cal. Rptr. at 120. See *Royal Globe*, 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.

58. 128 Cal. App. 3d 711, 180 Cal. Rptr. 464 (1982).

59. *Id.* at 714, 180 Cal. Rptr. at 466.

60. 142 Cal. App. 3d 46, 190 Cal. Rptr. 705 (1983).

61. *Id.* at 53, 190 Cal. Rptr. at 708-09.

62. *Id.* at 54, 190 Cal. Rptr. at 709.

63. 114 Cal. App. 3d 49, 170 Cal. Rptr. 527 (1980).

64. *Id.* at 58 n.5, 170 Cal. Rptr. at 532 n.5. The *Avalos* court noted that an insurer cannot prudently wait to see if the individual severely injured by its insured dies. *Id.*

65. 31 Cal. 3d 785, 647 P.2d at 86, 183 Cal. Rptr. 810 (1982).

*Globe* indicate that a plaintiff can establish a bad faith claim by showing either that the insurer knowingly committed a harmful act or was frequently engaged in such acts, constituting a general business practice.<sup>66</sup> Therefore, the plaintiff's discovery aimed at determining the frequency of the alleged unfair settlement practices was permitted because it was likely to produce evidence directly relevant to the claim.<sup>67</sup>

An attempt to limit *Royal Globe* was made by the Ninth Circuit Court of Appeals, in *Avila v. Traveler's Insurance Co.*<sup>68</sup> *Avila* involved a third party claim that the insurer had committed unfair settlement practices and was guilty of bad faith in its failure to settle an underlying wrongful death action. Although it expressed its hesitancy in construing what it called a "novel question of state law," the Ninth Circuit held that third party claimants do not have standing to bring a cause of action based upon section 790.03(h)(3).<sup>69</sup> Moreover, *Avila* held that *Royal Globe* should not apply retroactively.<sup>70</sup> While *Royal Globe* specifically held that a third party claimant could sue an insurer directly for violations of section 790.03(h)(5) and (h)(14), it was unclear whether the *Royal Globe* decision encompassed the entire Act. *Avila* specifically took section 790.03(h)(3) out of the *Royal Globe* holding.

Two recent appellate court cases refused to extend *Royal Globe* liability to worker's compensation insurance carriers.<sup>71</sup> In *Ricard v. Pacific Indemnity Co.*,<sup>72</sup> a worker's compensation claimant brought an action against his former employer's worker's compensation insurance carrier alleging that the carrier had refused, after a seven-month delay, to pay a medical claim submitted by the claimant. The claimant framed his

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66. *Id.* at 791, 647 P.2d at 90, 183 Cal. Rptr. at 814.

67. *Id.*

68. 651 F.2d 658 (9th Cir. 1981).

69. *Id.* at 659. Section 790.03(h)(3) provides that an insurer can be liable for "[f]ailing to adopt and implement reasonable standards for the prompt investigation and processing of claims arising under insurance policies." See *supra* note 6.

70. 651 F.2d at 659.

71. See also *Palmer v. R.L. Kautz & Co.*, 141 Cal. App. 3d 155, 190 Cal. Rptr. 139 (1983); *Cervantes v. Great Am. Ins. Co.*, 140 Cal. App. 3d 763, 189 Cal. Rptr. 761 (1983); *Johnson v. Archie Threats*, 140 Cal. App. 3d 287, 189 Cal. Rptr. 447 (1983).

72. 132 Cal. App. 3d 886, 183 Cal. Rptr. 502 (1982). The insured suffered a back injury in the course and scope of his employment in 1969. Shortly afterwards he moved across the country. After the insurer had paid the insured for recurrences of the injury for six years, it terminated payments. The insured then brought a bad faith action.

complaint, in part, by alleging that the carrier had violated section 790.03(h)(2), (4), (5), and (13).<sup>73</sup> The court, however, never reached the *Royal Globe* issue because it held that the claimant's exclusive remedy was under the worker's compensation act. Similarly, in *Depew v. Hartford Accident and Indemnity Co.*,<sup>74</sup> an injured worker who had been awarded worker's compensation benefits brought a section 790.03 action against the worker's compensation insurance carrier for its alleged failure to pay the benefits awarded. *Depew* held that the provisions of the Insurance Code were inapplicable to the worker's case and that the claim was under the exclusive jurisdiction of the Worker's Compensation Appeals Board.

Since *Royal Globe* was decided in 1979, no California court has been presented with *Royal Globe* facts: a third party claimant bringing a direct action against an insurer, without an assignment, pursuant to section 790.03(h)(5). The cases decided after *Royal Globe* illustrate the desire to acknowledge the decision's presence; however, the acknowledgement has not been extended past a general approval. *Avila*, a Ninth Circuit Court of Appeals case, attempted to delineate *Royal Globe*; but, after recognizing the issue as a "novel question of state law," it hesitated to comment further.

## B. Problems

*Royal Globe* presents the following problems: (1) It does not provide guidelines for an insurer to follow in order to avoid bad faith; (2) *Royal Globe's* interpretation of the Act creates a series of constitutional problems; (3) it does not explicitly provide a clear, useful test to determine bad faith; and (4) *Royal Globe* fails to establish mutuality in the duties owed to third parties by insurers.

### 1. Lack of General Guidelines

Bad faith litigation has developed extensively over the past twenty-five years in California based on traditional common law principles of contract and tort. Before *Royal Globe*, insurers were not specifically guided by the courts in determining what constituted bad faith; yet, the precedent was

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73. *Id.* at 891 n.1, 183 Cal. Rptr. at 505 n.1. See *supra* note 6.

74. 135 Cal. App. 3d 574, 185 Cal. Rptr. 472 (1982).

concrete, and traditional legal arguments were available if the insurer believed that factually its case did not merit an action in bad faith. Relying solely on the Unfair Practices Act, *Royal Globe* threatens to extinguish the past twenty-five years of case law regarding bad faith. Since its inception in 1972, the Act has rarely been relied upon by courts and claimants in bad faith actions against insurers. Gradually, a few cases came down which held that the Act was available as a private remedy for insureds in a first party action against their insurers.<sup>75</sup> This was not very alarming due to the protection already afforded the insured under traditional contract and expansive tort theories which may not be available under *Royal Globe*.<sup>76</sup>

## 2. Constitutional Problems

The California Supreme Court's interpretation of the Unfair Practices Act in *Royal Globe* raises a host of constitutional problems. First, the Act as interpreted is subject to a due process attack for vagueness. Second, it deprives an insurer of the right to jury trial. And third, the right to contract is effectively impaired by creating a conflict of interest between the insurance company and the insured. These problems are very illustrative of the practical difficulties insurers are faced with by the *Royal Globe* decision.

### a. Due Process—Vagueness

Vague statutes are often supplied specificity if reference to a standard of practice in the particular profession can be made or by the common knowledge of the members of the particular vocation.<sup>77</sup> But this specificity is not available in the *Royal Globe* context because there is no standard of practice regarding third party statutory bad faith actions in the insurance industry. As demonstrated above there is a lack of interpretation of *Royal Globe* and the Act by the California courts. This hesitancy is suggestive of the lack of understanding of the true meaning of the Act and the *Royal Globe* decision.

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75. See *supra* note 50.

76. See *supra* notes 8 and 17 regarding the objective standards the court has formulated for the insurer to measure its conduct to prevent bad faith.

77. See, e.g., *Beach v. Western Medical Examiners*, 116 Cal. App. 3d 153, 162, 171 Cal. Rptr. 846, 851 (1981).



Civil statutes must be sufficiently clear and definite to provide adequate notice of the prohibited conduct, as well as establish a standard of conduct which can be uniformly interpreted by administrative agencies and the judiciary.<sup>78</sup> If a law forbids the doing of an act in terms so vague that men of common intelligence must necessarily guess at its meaning, it does not comport with due process.<sup>79</sup> A serious question of vagueness is presented as the insurance companies continue to guess at the Act's meaning, as interpreted by *Royal Globe*.

### b. *Right to Jury Trial*

Article 1, section 16 of the California Constitution provides that "[t]rial by jury is an inviolate right and shall be secured to all . . . ."<sup>80</sup> The right to a jury trial is a basic and fundamental aspect of both the state and federal systems of jurisprudence.<sup>81</sup> The right has always been regarded as sacred and has been jealously guarded by the courts.<sup>82</sup>

In the aftermath of *Royal Globe*, the right to jury trial, although not explicitly denied, is effectively discouraged and, in effect, denied. The *Royal Globe* decision inhibits the right to jury trial, by exposing the insurer to a second suit by the third party claimant if the insurer chooses not to settle the claim and exercises its right to litigate the claim at trial. This can be illustrated by the following example. Assume there is a car accident between B and C. C incurs personal injuries and sues B for \$25,000. B is insured by A for \$10,000 under an automobile liability policy, pursuant to which A assumes the defense of B in the lawsuit. C presents A and B with a settlement offer of \$10,000. However, A's investigators and B's account of the accident reveal potentially strong defense argu-

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78. See *People v. Sangiacomo*, 128 Cal. App. 3d 942, 953, 180 Cal. Rptr. 594, 601 (1982); *United Business Comm'n v. San Diego*, 91 Cal. App. 3d 156, 176, 154 Cal. Rptr. 263, 276 (1979); *Hall v. Bureau of Employment Agencies*, 64 Cal. App. 3d 482, 491, 138 Cal. Rptr. 725, 729 (1976); *McMurty v. State Bd. of Medical Examiners*, 180 Cal. App. 2d 760, 766, 4 Cal. Rptr. 910, 914 (1960).

79. See, e.g., *People v. Sangiacomo*, 128 Cal. App. 3d 942, 954, 180 Cal. Rptr. 594, 602 (1982); *McMurty v. State Bd. of Medical Examiners*, 180 Cal. App. 2d 760, 766, 4 Cal. Rptr. 910, 913-14 (1960). See generally 5 B. WITKIN, CONSTITUTIONAL LAW §§ 15.1, 15.2 (1974).

80. CAL. CONST. art. I, § 16.

81. See *Lofy v. Southern Pac.*, 129 Cal. App. 2d 459, 277 P.2d 423 (1954).

82. *People v. One 1941 Chevrolet Coupe*, 37 Cal. 2d 283, 287 n.1, 231 P.2d 832, 835 n.1 (1951).

ments, such as contributory negligence by C, due to his failure to wear a seatbelt. Assume further, that a crucial issue in this case is a factual one—whether B or C ran a redlight immediately prior to the accident. This factual dispute must be resolved by a jury if no other concrete indication of guilt is discovered before the trial. But A is faced with a dilemma: the odds are fifty-fifty that the jury will accept the theory that C, not B, ran the red light. If A decides to try his case and wins, C will potentially receive nothing or at least less than the \$25,000 prayer or the \$10,000 settlement offer. If A loses, and the jury reward is in excess of the policy limit, A could be subject to a second lawsuit in bad faith, brought by C, due to A's refusal to accept the settlement offer made by C. The strong possibility exists that A will not only be required to pay the excess judgment, but also punitive damages to C, regardless of the validity of A's belief in his legal theories in the first lawsuit between B and C.

Because there exists no concrete standard to judge A's potential liability under the statutory bad faith cause of action, A will more often than not choose to accept the initial settlement offer of \$10,000 rather than risk unlimited liability in bad faith. It is fundamental that the law favors settlement.<sup>83</sup> The distinction, however, between favoring and forcing settlement may be a fine line. *Royal Globe's* interpretation of the Act imposes a strong obligation on an insurer to settle third party claims against its insured. On balance, the probability of succeeding at trial probably does not outweigh the potential risk of future sanctions for an insurer. *Royal Globe*, therefore, restricts the insurer's right to jury trial.

### c. *Right to Contract*

Article I, section 9 of the California Constitution provides that a "[l]aw impairing the obligation of contracts may not be passed."<sup>84</sup>

In the example above, a conflict of interest emerges for A, the insurer, once he is presented with C's settlement offer of \$10,000, the policy limit. A's primary duty under the insur-

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83. See, e.g., *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 696, 319 P.2d 69, 79 (1957).

84. CAL. CONST. art. I, § 9.

ance contract is to B, its insured.<sup>85</sup> However, this obligation is impaired by *Royal Globe* because it gives C, the injured third party, a direct action against A if A does not attempt to settle a dispute between B and C in good faith. As a result, the rights of C (the stranger) are elevated above those of B (the insured) because A (the insurer) has a greater fear of subsequent litigation with C than the protection of B's rights under the insurance contract. The statutory creation of a private right of action favoring strangers to the insurance contract directly interferes with the rights and obligations of the parties to the contract.

*Royal Globe* creates an interesting irony. The development of bad faith law in California has uniformly restricted the powers of insurance companies and conversely, the rights of the insureds have been expanded and protected. *Royal Globe*, at first glance, can be characterized as fitting into this general trend. *Royal Globe* has, however, actually *destroyed* the basic right of the insured to contract by advancing the rights of third parties who are not even part of the insurance contract.

Assume, once again, that we are in a situation as posed by the example above, and that C has just presented A and B with the settlement offer of \$10,000. We discussed A's concerns, which would persuade A to accept the offer notwithstanding his belief in the strength of his defense theories. But as noted, A's primary duty under the contract runs to B. In this case B may desire to litigate the case and not accept the settlement offer in an effort to have his driving record cleared, maintain his good name, and ultimately keep his insurance premium at its existing rate. A should be able to afford B this paramount right of protection before considering the rights of third parties.

The above discussion of the constitutional problems created by *Royal Globe* is useful not only for the substantive questionability of that case on constitutional grounds, but also as a vehicle to demonstrate a few of the practical problems which have developed since that case was decided.

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85. See *supra* notes 40-41 and accompanying text.

### 3. *The Royal Globe Test for Bad Faith*

Commentators have suggested that the test to be applied to determine bad faith under *Royal Globe* is derived specifically from the language of section 790.03(h)(5).<sup>86</sup> The language of this section translates into a two part test: (1) liability on a claim must have become reasonably clear; and (2) the insurer did not make a good faith effort to effectuate a prompt, fair and equitable settlement of the claim.<sup>87</sup> The following sections will analyze the language of this test in terms of what these words have come to mean in the non-statutory sense of bad faith litigation.

#### a. *Reasonably Clear Liability*

*Royal Globe* does not define "reasonably clear" as it appears section 790.03(h)(5). The notion of reasonably clear liability is a prerequisite to an insurer's duty to undertake settlement negotiations in good faith. Cases after *Royal Globe* have also failed to define applicable criteria to determine reasonably clear liability.

Reasonably clear liability has been characterized as an indication of the particular stage in the settlement process at which the duty to settle arises.<sup>88</sup> On the other hand, it may be an indication of the required amount of evidence possessed by the insurer that mandates the insurer to attempt settlement.<sup>89</sup>

The insurer's relationship with its claims and adjustment officers presents one concern in determining when liability is reasonably clear. Suppose the claims officer makes a preliminary evaluation of "potential" or "probable" liability—is this characterization commensurate with legal liability? Probably not, due to defense theories such as comparative and contributory negligence. Nevertheless, the claims officer's report becomes part of the file and will no doubt be discovered by the claimant.<sup>90</sup>

The point in time at which "reasonably clear" liability must be ascertained is yet another question of concern. It has

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86. See generally Wagenseil, *Royal Globe: Reasonably Unclear Liability for Insurers*, 1979 INS. L.J. 377; Comment, *A Statutory Action for Bad Faith—The Reasonably Clear Remedy for the Third Party Claimant*, 11 PAC. L.J. 945, 953 (1980).

87. See generally Wagenseil, *supra* note 86.

88. See Comment, *supra* note 86.

89. *Id.*

90. See *supra* notes 65-67 and accompanying text.

been suggested that the statutory duty to settle does not arise until after the investigative stage of the claims settlement process is complete.<sup>91</sup> Does this mean prior to the taking of depositions, or the review of medical records?<sup>92</sup> There is no clear and simple answer. In fact, it remains questionable whether or not an attorney must be consulted before the requirement of reasonably clear liability may take effect.

Prior to *Royal Globe*, the courts dealt with notions of "probable cause" in determining whether or not an insurer's denial of claims was reasonable.<sup>93</sup> The withholding of insurance proceeds without "proper" or "probable cause" would constitute prima facie evidence of bad faith. Initially, *Communale v. Traders & General Insurance Co.* stated that settlement would be most reasonable when the insurer faced a "great risk of recovery beyond those policy limits."<sup>94</sup> In *Critz v. Farmers Insurance Group*, the insurer's claims agents had written two reports, the first of which stated that "[t]his appears to be an obvious case of liability . . . ."<sup>95</sup> The *Critz* court found no difficulty in holding that the settlement offer refused by the insurer was reasonable, especially in light of the liability standpoint of these reports and the damages sustained by the claimant.<sup>96</sup>

*Crisci v. Security Insurance Co.* has been widely credited for articulating the reasonableness standard. *Crisci's* facts indicated that the insurer's chances of preventing the claimant from receiving a judgment well in excess of the policy limits depended on the discovery of very speculative evidence.<sup>97</sup> Although the evidence was not discovered, the insurer continued its defense. The resulting jury verdict was well in excess of the policy limits and the insurer was found liable in bad faith for its unreasonable refusal to accept the claimant's settlement offer within the policy limits.<sup>98</sup> In *Merrit v. Reserve Insurance Co.*,<sup>99</sup> however, insurers escaped liability by relying on the in-

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91. See *supra* note 88 and accompanying text.

92. See *Wagenseil, supra* note 86, at 376-77.

93. See *Comment, supra* note 86, at 958.

94. 50 Cal. 2d 654, 328 P.2d 198 (1958).

95. 230 Cal. App. 2d 788, 793, 41 Cal. Rptr. 401, 403 (1964).

96. *Id.* See *supra* note 16.

97. 66 Cal. 2d 425, 428, 426 P.2d 173, 175, 58 Cal. Rptr. 13, 15 (1967).

98. *Id.*

99. 34 Cal. App. 3d 858, 110 Cal. Rptr. 511 (1973). See *supra* note 17 and accompanying text.

vestigative reports of their officers and attorneys which advised the insurer that the case was "an absolute case of non-liability."<sup>100</sup>

Finally, *Johansen v. California State Automobile Association* held an insurer liable in bad faith even though the trial court found that the insurer had a bona fide belief that the insured's claim was not covered under the terms of the policy.<sup>101</sup> *Johansen* stated that the insurer recognized that liability in excess of the policy clearly existed if the insured's claim was covered by the policy.<sup>102</sup> *Johansen* suggested the better approach for the insurer would have been to accept the reasonable settlement offer, then establish the noncoverage of the policy issue, and finally seek reimbursement of the settlement from its insured.<sup>103</sup>

The application of common law principles to the meaning of "reasonably clear liability" suggests that "reasonably clear" will not be very difficult to establish. The cases prior to *Royal Globe* indicate that investigative reports that establish the insurer's liability as "obvious" or "clear" will probably be sufficient to meet the standard of "reasonably clear liability." In addition, the objective determination of the damages involved in the case may also be sufficient to establish "reasonably clear liability."<sup>104</sup> These remain, however, mere speculations due to the absence of a court determination of the meaning of "reasonably clear liability" since *Royal Globe*.

b. *Good Faith Attempt to Settle*

According to *Royal Globe* once liability is shown to have been reasonably clear, the plaintiff must establish that the insurer violated its duty to attempt in good faith to effectuate a prompt, fair, and equitable settlement of the claim.<sup>105</sup> Courts after *Royal Globe* have not evaluated bad faith claims under this language; instead they have utilized the common law standards developed prior to *Royal Globe*.<sup>106</sup>

First and third party bad faith actions have been recog-

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100. 34 Cal. App. 3d at 864-65, 110 Cal. Rptr. at 515. See *supra* notes 36-38 and accompanying text.

101. 15 Cal. 3d 9, 14, 538 P.2d 744, 747, 123 Cal. Rptr. 288, 291 (1975).

102. *Id.*

103. *Id.* at 19, 538 P.2d at 750, 123 Cal. Rptr. at 294.

104. See *supra* note 16.

105. See Comment, *supra* note 86, at 961.

106. See *supra* notes 55 and 64 and accompanying text.

nized as dealing with two aspects of the same duty of good faith and fair dealing.<sup>107</sup> The third party test imposes a duty upon the insurer to accept reasonable settlement offers by claimants, and the first party test requires the insurer to act in good faith in handling the claim of its insured.<sup>108</sup> The determinative factor in both the first and third party cases is reasonableness. As discussed above, *Crisci* and its successors articulated the test to determine good faith as whether a prudent insurer acting without policy limits would have accepted the settlement offer.<sup>109</sup>

In the third party context, it is clear that mere negligence will not be considered unreasonable enough to constitute bad faith in the insurer.<sup>110</sup> Therefore, it is unlikely that a court today would find an insurer liable in bad faith when there is only a mere possibility that the insurer's settlement refusal might result in damage to the claimant.<sup>111</sup>

The reasonableness language was interpreted very strictly in *Johansen*.<sup>112</sup> *Johansen* implied that insurers could be strictly liable for refusing a settlement offer within the policy limits. A subsequent jury verdict in favor of the claimant in excess of the policy coverage would afford the refused settlement offer an inference of reasonableness. Consequently, the insurer would be *per se* liable in bad faith for its refusal of the reasonable offer.<sup>113</sup> *Johansen* has not been followed by the California courts; however, its suggestion combined with the undefined nature of *Royal Globe* creates an uneasiness for insurers speculating about the specificity of the *Royal Globe* test.

#### 4. Mutuality

*Royal Globe* does not impose upon the third party claimants any similar duty to act fairly and in good faith in the settlement process as it does on insurers. Consequently, third

107. See *supra* notes 23 and 32 and accompanying text.

108. See *supra* note 23 and accompanying text.

109. 66 Cal. 2d at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16. See *supra* notes 19-22 and accompanying text.

110. See *supra* notes 10-13 and accompanying text. See also *Doser v. Middlesex Mutual Ins. Co.*, 101 Cal. App. 3d 883, 891, 162 Cal. Rptr. 115, 119-20 (1980).

111. *Id.*

112. *Johansen v. California State Automobile Ass'n*, 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975). See *supra* notes 36-39 and accompanying text.

113. 15 Cal. 3d at 15, 538 P.2d at 748, 123 Cal. Rptr. at 292.

party claimants are equipped with a unilateral weapon in the settlement process by making demands<sup>114</sup> upon the insurer without the fear of reprimand should the *demand* be found unreasonable. The need to impose a mutual obligation of good faith and fair dealing seems inherently fair and is discussed as a proposal in this comment.

## V. PROPOSALS

### A. *Test For Statutory Bad Faith*

The bulk of the problems encountered by insurers are directly related to lack of direction resulting from the *Royal Globe* decision. It is conceivable that the California Supreme Court believed that a factual application and development of the nascent statutory authority would soon follow the *Royal Globe* decision. No court has made such an attempt. In fact, the trend since *Royal Globe* has been to evaluate the bad faith claim consistently with the well developed common law principles of contract and tort.

If *Royal Globe* is correlative to common law principles, then *Royal Globe's* test to determine bad faith should be that of the developed common law doctrine of California bad faith. Currently in California, negligence alone does not constitute bad faith and the development of strict liability principles has not extended past one forceful suggestion in *Johansen*. Nevertheless, the test in California for bad faith still appears to be grounded in terms of reasonableness. Exemplary bad faith damages are only available against insurers if it can be shown that in addition to acting unreasonably, the insurer acted with malice and oppression in denying the insured's or third party claim.<sup>115</sup>

The ambiguity of the *Royal Globe* decision, and the difficulty in the interpretation of phrases such as "reasonably clear liability" and "good faith attempts to settle" indicate the need for greater definition for insurers. Therefore, the test in *Royal Globe* should be governed by common law principles, since no court has attempted to characterize the statutory cause of action differently from the common law cause of ac-

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114. See, e.g., Levine and Patrick, *Bad Faith Litigation—1982*, A Bar Ass'n of San Francisco Program.

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



tion in bad faith.

The key to the common law test for bad faith is the requirement that the third party secure an assignment of the insured's rights against the insurer. *Royal Globe* explicitly rejected the need for such an assignment under the statutory cause of action in bad faith.<sup>116</sup> However, the lack of case law implementing *Royal Globe* together with *Royal Globe's* questionable reasoning for not requiring an assignment, suggests a need for reconsideration on this issue.

*Royal Globe* was decided by a margin of four to three. In his dissenting opinion, Justice Richardson was not convinced of the majority's distinction between the statutory cause of action and the holding in *Murphy* that an insurer's duty to settle runs to the insured and not to the injured party.<sup>117</sup> *Royal Globe's* majority did not disapprove of *Murphy*; it simply held that it was inapplicable due to the statutory authority of the Act which allowed a direct action by the third party absent an assignment.<sup>118</sup> The majority reached this conclusion basically under two theories: (1) Section 790.09 of the Act afforded claimants a private cause of action; and (2) the legislative intent of the Act was to afford third party claimants a private cause of action directly against an insurer.

The dissent believed that section 790.09 "preserved" rather than "created" new liability under existing state law.<sup>119</sup> Justice Richardson criticized the majority's reliance on *Greenberg v. Equitable Life Ins. Co.*<sup>120</sup> which in his words stated only that "the fair construction [of section 790.09] is that the person to whom the civil liability runs may enforce it by an appropriate action."<sup>121</sup> In third party actions, the "person to whom civil liability runs" was unanimously decided in *Murphy* to be the insured.<sup>122</sup>

Although section 790.03(h)(5) does not contain the word "claimants," the court in *Royal Globe* concluded that it "ap-

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116. 23 Cal. 3d at 890, 592 P.2d at 335, 153 Cal. Rptr. at 848.

117. *Id.* at 893, 592 P.2d at 338, 153 Cal. Rptr. at 851 (Richardson, J., dissenting). See also notes 40-41 and accompanying text.

118. 23 Cal. 3d at 890, 592 P.2d at 335, 153 Cal. Rptr. at 848.

119. *Id.* at 898, 592 P.2d at 341, 153 Cal. Rptr. at 854 (Richardson, J., dissenting).

120. 34 Cal. App. 3d 994, 110 Cal. Rptr. 470 (1973). See *supra* note 93 and accompanying text.

121. 23 Cal. 3d at 898, 592 P.2d at 340, 153 Cal. Rptr. at 853.

122. *Id.* at 898, 592 P.2d at 341, 153 Cal. Rptr. at 854.

pears"<sup>123</sup> to cover both claimants and insureds. The majority reasoned that when subsection (h) was added to the Act in 1972, a representative of the Department of Insurance testified before various legislative committees that the measure "could be construed to affect third parties" and since "nobody argued against that position," the committee's inaction represented a deliberate decision that third party claimants were included under the protection of subsection (h) of the Act.<sup>124</sup>

This comment proposes that the need for a proper formal assignment by the insured to the third party claimant of the insured's rights against the insurer be reconsidered as a requirement under the Act. *Royal Globe*, however, is the law in California. If *Royal Globe* was decided in order to afford claimants greater protection against unscrupulous insurance companies, then its purpose is meritorious. If we assume that *Royal Globe* does not add substantively to present common law bad faith analysis, *Royal Globe* should be made an exception to the common law. This exception of allowing private third party rights against the insurer without an assignment from the insured would only be available if the third party can prove that the insurer's conduct was more than unreasonable, that is, the insurer acted in conscious disregard for the claimant's rights during settlement.

This proposal can be illustrated by reference to *Depew v. Hartford Accident and Indemnity Co.*<sup>125</sup> which denied the extension of section 790.03 actions to worker's compensation claims. In holding that the Worker's Compensation Appeals Board had exclusive jurisdiction over the claim, the court stated that an exception exists when, and if, the worker can prove that the insurance carrier intentionally committed outrageous and extreme conduct in the investigation of the worker's claim. If the worker successfully proves the prohibited conduct, he has a remedy in common law and potentially statutory bad faith.

*Depew* illustrates the mechanics of this comment's proposal. Third party actions in bad faith would be under the exclusive jurisdiction of the common law, which would require the acquisition of a valid assignment before the third party

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123. *Id.* at 888, 592 P.2d at 334, 153 Cal. Rptr. at 847.

124. *Id.* at 889, 592 P.2d at 335, 153 Cal. Rptr. at 848.

125. 135 Cal. App. 3d 574, 185 Cal. Rptr. 472 (1982).

could proceed against the insurer. However, if the third party can prove the insurer's conduct was "outrageous and extreme," or specifically, in conscious disregard of the third party's rights in settlement, then the statutory cause of action would be available.

A roadblock to this proposal, seemingly, exists in the language of section 790.03(h)(5) of the Act. Subdivision (h)(5) of 790.03 speaks in terms of reasonableness and good faith, with no indication that a higher finding of bad faith is required to be proved. However, subsection (h) has language that forces claimants and insureds to show that the insurer's acts in bad faith were done "knowingly" or constituted a "general business practice." This infers a higher proof standard than merely showing that the insurer acted unreasonably. Therefore, perhaps the Act should be reconsidered in terms of an explicit amendment which incorporates language to the effect that the insurer's "knowing" conduct must be shown to be in conscious disregard for the the claimant's rights. Otherwise, the interpretation of this language by the *Royal Globe* court might be reconsidered in light of the lack of use the statutory cause of action has received in California courts.

### B. *Mutuality*

A necessary complement to establishing clear standards in the statutory bad faith action is to require similar obligations of good faith and fair dealing be imposed on third party claimants. Common law notions of good faith and fair dealing are mutual in the first party context.<sup>126</sup> Analogizing these first party cases to the current state of bad faith in California strongly suggests that third parties should be required to undertake their settlement negotiations in good faith.

If pre-statutory cases serve as an indicator of what the good faith standard will be in the statutory context, perhaps their insight will provide the foundation for this mutuality argument. Mutuality was initially made explicit in the contractual context in *Comunale*, where the court held that in every insurance contract an implied covenant of good faith and fair dealing exists that "neither party will do anything which will injure the right of the other to receive the benefits under the

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126. See *supra* note 15 and accompanying text.

agreement."<sup>127</sup> This principle was widely followed and was extended to apply to the tort of bad faith.<sup>128</sup>

Recent cases continue to embrace this mutuality language.<sup>129</sup> In *Kaiser Foundation Hospitals v. North Star*,<sup>130</sup> the court stated that the "covenant [of good faith and fair dealing] is not a one-way street but requires that neither party—not the insured, nor the insurer—will do anything to injure the rights of the other to receive the benefits of the agreement."<sup>131</sup> This principle was also illustrated by an appellate court in *Blake v. Aetna Life Insurance Co.*,<sup>132</sup> which held that a claimant is required to present the insurer with an articulated theory of why it should receive the insurance proceeds in dispute.<sup>133</sup> The basis of this holding was that the duty of good faith and fair dealing had developed equally upon the insured or his beneficiary.<sup>134</sup>

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127. 50 Cal. 2d at 658, 328 P.2d at 200.

128. See *supra* notes 24-32 and accompanying text discussing the application of *Crisci v. Security Ins. Co.* See also *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974) (action by insured against insurer for bad faith in insurer's refusal to make medical payments due to insured's pending workmen's compensation claim in which court accepts the mutual obligations of good faith and fair dealing). *Id.* at 460-61, 521 P.2d at 1108-09, 113 Cal. Rptr. at 716-17.

129. See, e.g., *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979) (insurers found liable in bad faith for not properly investigating its insured's claim). See also *National Life and Accident Ins. Co. v. Edwards*, 119 Cal. App. 3d 326, 174 Cal. Rptr. 31 (1981) (for post-*Royal Globe* acceptance of mutuality language).

130. 90 Cal. App. 3d 786, 153 Cal. Rptr. 678 (1979).

131. *Id.* at 792, 153 Cal. Rptr. at 682 (court held that duty of good faith and fair dealing was owed to excess insurer by both insured as well as by liability insurer, which was the primary insurer).

132. 99 Cal. App. 3d 901, 160 Cal. Rptr. 528 (1979).

133. *Id.* at 925-26, 160 Cal. Rptr. at 541-42. *Blake* stated that a dispute as to the cause of death for insurance policy provisions should be resolved at trial with the burden on the plaintiff to prove cause. It held further that the insurer did not act unreasonably in taking the position prior to trial that good faith doubts as to whether the death was an accident or a suicide should be resolved against the claimant. The insurer could not be held in bad faith because it withheld payments until it could find out on its own, to a measure of certainty, the validity of the claim. Therefore, the insurer was found to have met its obligation of good faith to the plaintiff and to its other policy holders and stockholders not to dissipate its reserves through the payment of a meritless claim. *Id.* at 924-25, 160 Cal. Rptr. at 541-42.

134. See *Liberty Mutual Ins. Co. v. Altfillisch Constr. Co.*, 70 Cal. App. 3d 789, 139 Cal. Rptr. 91 (1977) (covenant of good faith extended to third parties who damage insurer's expectation of subrogation). A California trial court recently awarded an insurer compensatory and punitive damages against an insured and two of its owners totalling more than \$1 million for presenting a fraudulent burglary claim for more than \$450,000. The court rejected the insured's \$10 million bad faith claim after the

The statutory cause of action availed by *Royal Globe* currently seems to impose the duty of good faith and fair dealing upon the third party of the insurer as if the third party assumed the place of the insured in the insurance contract, and hence the settlement negotiations.<sup>136</sup> It is a logical extension to state that this implied covenant of good faith and fair dealing should be imposed upon the third party claimant, with the resulting liability if the third party is found in breach thereof. This liability should take the form of a civil action by the insurer against the third party to strike a balance in ongoing settlement weapons.

## VI. CONCLUSION

In 1979, *Royal Globe* held that a person who is injured by the alleged negligence of the insured may sue the negligent party's insurer for certain violations of California Insurance Code section 790.03, which prohibits insurers from engaging in enumerated unfair claims settlement practices, though the third party's suit may not be brought until the liability of the insured is first determined. Before *Royal Globe*, a person not a party to an insurance contract first had to receive an assignment of the insured's rights to proceed directly against the insurance company, before having a direct action against the insurance company. The statutory cause of action sanctioned by *Royal Globe* did not overrule previous cases in bad faith which relied on common law principles of contract and tort.

*Royal Globe* has caused many problems to the insurance industry. In establishing new law in the area of bad faith, this unprecedented case failed to accomplish its most important goal: to define and direct. As a result, the problems continue to hemorrhage and take the form of over-aggressive plaintiff claimants that assert the equivocality of the decision in a unilateral declaration of beware—or else. The “or else” generally translates into a bad faith cause of action. Bad faith, however,

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jury found that the insured had committed fraud and engaged in false swearing, voiding the insurance policy. *Orient Handel v. United States Fidelity & Guaranty*, Los Angeles Superior Court, Docket No. C280090 (June, 1983) (conversation with attorney Richard B. Wolf, January, 1984).

135. *Id.* at 797, 139 Cal. Rptr. at 95. The court articulated the power of contractual principles and the relationship to the covenant of good faith and fair dealing. Any action by the insured contrary to the covenant of good faith would certainly lead to a “garden variety breach of contract.”

is not subject to simple translation or definition, especially in the statutory sense.

Cases after *Royal Globe* have failed to define or utilize the *Royal Globe* decision. The courts, ironically, have continued to grasp and utilize the traditional theories of bad faith, virtually ignoring statutory bad faith. Redefinition is desperately needed.

*Royal Globe* forces insurance companies and their counsel to undertake a skillful game of chance. Without clear standards, reasonableness can be a difficult goal to realize. Reasonable under its most general interpretation connotes objectivity. Defined standards provide objectivity. The absence of objectivity leads to a subjective guessing game. Insurers and attorneys alike should not have to guess, for "the gift of prophecy has never been bestowed on ordinary mortals."<sup>136</sup>

*William J. Casey*

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136. *Georgia Casualty Co. v. Mann*, 242 Ky. 447, 451, 46 S.W.2d 777, 779 (1932).

