

The Insurer's Exploding Bottle: Moving from Good Faith to Strict Liability in Third and First Party Actions

I. INTRODUCTION

Many courts hold that implicit in every insurance contract is a covenant of good faith and fair dealing, the breach of which gives rise to a cause of action in tort.¹ By employing tort concepts in these cases, courts have expanded the traditional rule limiting damages for breach of contract to those arising naturally from the breach² and have awarded to insureds extra-contractual damages far in excess not only of the policy limits, but also of any damages flowing directly from any breach of contract.³ The implied covenant of good faith and fair dealing in insurance contracts is founded on the belief that the primary objective of insurance coverage in this country is to provide peace of mind and a sense of financial security to the insured.⁴ Because policy holders whose claims are not handled in good faith may experience financial ruin⁵ and severe emotional distress,⁶ the insurance companies' refusal to resolve claims against them in good faith clearly frustrates this purpose.

This implied covenant imposes two distinct duties on the insurance company: the duty to settle and the duty to pay. A third party cause of action for failure to settle arises when the insurer fails to act in good faith in settling a claim asserted by a third party against the holder of a liability policy; the first party failure to pay action arises

1. *E.g.*, *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 573, 510 P.2d 1032, 1037, 108 Cal. Rptr. 480, 485 (1973) (insurer may not "unreasonably" withhold payments due under a policy); *Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 52, 375 A.2d 428, 430 (1977) (noting in dicta that plaintiff need not show oppressive behavior in order to prove bad faith); *Amsden v. Grindel Mut. Reins. Co.*, 203 N.W.2d 252, 255 (Iowa 1972) (insured must show "outrageous conduct" on the part of the insurer); *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 67 N.J. 474, 499, 323 A.2d 495, 508 (1974) (insurer must form its decision whether to settle "as though it alone were liable for the entire risk"); *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St. 3d 272, 277, 452 N.E.2d 1315, 1320 (1983) (insurer's refusal to pay cannot be an "arbitrary or capricious one"). *But see Vincent v. Blue Cross-Blue Shield*, 373 So.2d 1054, 1056 (Ala. 1979) (refusing to recognize the tort action, or to award damages "for personal injury, inconvenience, annoyance, or mental anguish and suffering" in a breach of insurance contract action); *Kewin v. Massachusetts Mut. Life Ins. Co.*, 409 Mich. 401, 295 N.W.2d 50 (1980) (awarding of extra-contractual damages may be allowed in matters of life and death, but is not allowed under disability insurance policies); Casenote, *Insurance Law: Ohio Recognizes Tort Duty of Good Faith and Fair Dealing between an Insurer and Its Insured*—*Hoskins v. Aetna Life Insurance Co.*, 6 Ohio St. 3d 272, 452 N.E.2d 1315 (1983), 10 U. DAYTON L. REV. 159 (1984).

2. *Hadley v. Baxendale*, 156 Eng. Rep. 145, 9 Exch. 341 (1854).

3. In *Fellows v. Allstate Ins. Co.*, No. C259993 (C.D. Super. Ct. Cal. 1983) for example, the California jury awarded \$40.5 million for the insurer's failure to pay a \$36,000 claim on an uninsured motorist policy. These tort damages hereinafter will be referred to as "extra-contractual" damages. They are not the same as consequential damages, which may be awarded in contract actions, because the latter are limited to damages that are foreseeable at the time the contract is made; *Hadley v. Baxendale*, 156 Eng. Rep. 145, 9 Exch. 341 (1854); extra-contractual damages compensate for all injuries that flow from the breach, whether or not such injuries could have been foreseen when the contract was made. Depending on the jurisdiction, extra-contractual awards may include compensation for pecuniary loss, for extreme emotional distress, and punitive damages.

4. Note, *Tort of Insurer's Bad Faith Refusal to Pay First-Party Claims*, 82 W. VA. L. REV. 579, 579 (1980).

5. *See, e.g.*, *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St. 3d 272, 278, 452 N.E.2d 1315, 1322 (1983) (insureds alleged that insurer's failure to pay forced the sale of their home to meet medical expenses); *Hart v. Republic Mut. Ins. Co.*, 152 Ohio St. 185, 186, 87 N.E.2d 347, 348 (1949) (insurer's failure to settle liability claim against insured resulted in the impoundment and sale of insured's two trucks, his only means of supporting himself and his family).

6. *See, e.g.*, *Gruenberg v. Aetna Life Ins. Co.*, 9 Cal. 3d 566, 580, 510 P.2d 1032, 1041, 108 Cal. Rptr. 480, 489 (1973).

when the insurer fails to act in good faith in handling and paying a claim asserted by the insured under a non-liability policy. In the third party context, the relationship of an insurance company to its insured is, by way of the company's status as the insured's agent, "one of inherent fiduciary obligation."⁷ When a claim arises against the insured, the company almost always possesses the contractual right to control the "investigation, negotiation, and settlement of any claim or suit as it deems expedient."⁸ Due to this fiduciary obligation, coupled with their sole control of the litigation, insurance companies have been held liable in tort for damages in excess of policy limits when they refused to accept the injured third party's offer to settle at or below the policy limit or in excess of the policy limit by an amount "the insured is willing and able to contribute."⁹ For example: The insured holds with the insurer an automobile liability policy that provides \$100,000 in liability coverage. While driving, the insured tortiously causes injuries to a third party, who, during settlement negotiations with the insurer, offers to settle the claim for \$90,000. If the insurer, hoping to escape with less or no liability, refuses to settle for that amount, which would protect the insured from personal financial outlay, and at trial the third party secures a judgment for \$500,000, the insured may be able to recover the entire amount from the insurer, even though the judgment exceeds the insurer's contractual duty under the policy by \$400,000. The gravamen of the third party failure to settle cases is that an insurer that disregards a settlement offer at or near policy limits and gambles on the outcome at trial does so with its own money, not the insured's.¹⁰

Some courts have adopted the tort action for breach of the covenant of good faith and fair dealing from the failure to settle cases and have imposed a duty upon the insurance company "to act in good faith and fairly in handling the claim of an insured"¹¹ in the first party failure to pay setting, as well. When an insured asserts a fraudulent claim or a claim for losses not covered by the policy, the insurer is clearly under no duty to pay. The first party cause of action arises when the insurer fails to pay a valid claim promptly and forces the insured to bear the loss or seek redress through compromise or litigation. An insurance company's determination not to pay a legitimate claim may be predicated upon inadequate or improper investigation of the claim,¹² the insurer's belief that the claim is not covered based upon wrongful behavior in selling, changing, or terminating the policy,¹³ or on the insurer's desire to hold onto money concededly due the insured for as long as possible.¹⁴ The last of these motivations to withhold payment of valid claims was especially attractive under the traditional doctrine, which provided that even if the insured ultimately prevailed

7. *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 65 N.J. 474, 492, 323 A.2d 495, 505 (1974); *see also Gruenberg v. Aetna Life Ins. Co.*, 9 Cal. 3d 566, 582, 510 P.2d 1032, 1043, 108 Cal. Rptr. 480, 491 (1973).

8. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1137 (1954); *see also Gruenberg v. Aetna Life Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

9. *Yeomans v. Allstate Ins. Co.*, 130 N.J. Super. 48, 324 A.2d 906, 908 (1974) (interpreting *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 65 N.J. 474, 499, 323 A.2d 495, 508 (1974)).

10. *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 65 N.J. 474, 498, 323 A.2d 495, 508 (1974).

11. *E.g.*, *Gruenberg v. Aetna Life Ins. Co.*, 9 Cal. 3d 566, 574, 510 P.2d 1032, 1037, 108 Cal. Rptr. 480, 485 (1973).

12. *See infra* text accompanying notes 72-86.

13. In such a case the court will rule that the loss is covered as a matter of law. *See infra* text accompanying note 87.

14. *See infra* note 15.

at trial, his or her recovery was limited to contractual damages, which usually equalled the amount of payment due under the policy plus legal interest.¹⁵

For example: An insured holds a health and accident insurance policy with the insurer, and the insured is temporarily hospitalized, unable to run the small business the insured owns. The insured files a legitimate claim with the insurer, but the insurer refuses to pay the claim. As a result, the insured is unable to hire someone to run the business during the insured's absence; the business folds, and the insured suffers extreme emotional distress. If the insured then brought suit, under the traditional contract cause of action, recovery would be limited to contractual damages. However, under the first party failure to pay tort cause of action, the insured may be able to recover compensatory damages for pecuniary loss, emotional distress, and perhaps punitive damages. Although first party actions deter wrongful failure to pay, it still may enjoy vitality under certain circumstances.¹⁶ For example, an insurer, "[b]y playing a 'waiting game' with a policyholder who is in dire financial straits following an insured loss . . . may coerce the policyholder into settling for less than the full benefits due him or her."¹⁷

Although the third party failure to settle action and the first party failure to pay action arise in different situations and create disparate duties upon the insurance company, the nexus between them is the concept of good faith in expanding the contours of the insurer's relationship to its insured. Unfortunately, the standard of good faith has proven difficult to define and to apply.¹⁸ A viable alternative to the good faith standard is a strict liability approach that would impute extra-contractual liability to the insurer in the third party context when the insurer's failure to settle at or below policy limits results in personal liability to the insured, and in the first party context when the insurer's failure to pay a valid claim asserted against it results in pecuniary and/or emotional injury to the insured. Courts applying the strict liability approach no longer would consider whether the liability insurer has a good faith belief that the insured is not liable or that the third party's damages are less than the amount of the offer of settlement, or whether the nonliability insurer has a good faith belief that the claim is fraudulent or otherwise not covered.

The thrust of this Comment is two-fold. First, it will examine the scope of the insurer's duty to settle and to pay under the present good faith standard and will explore the strategies and tactics to be employed by plaintiff's counsel in maintaining these actions and by defense counsel in preventing and defending against them. Second, this Comment will propose a strict liability approach to failure to settle and failure to pay actions that would be simpler and more equitable than the present standards.

15. The legal interest rate in Ohio, for example, is ten percent per annum. OHIO REV. CODE ANN. § 1343.03 (Page Supp. 1983). Therefore, prior to the recognition of the first party failure to pay action, the insurer could invest the amount due to the insured at a rate greater than 10% and benefit from its wrongdoing if its attorney fees for any contract action did not exceed the interest on the amount due to the insured.

16. If the insurer believes that the insured will not seek legal redress or that the insured will not be able to accomplish the difficult task of proving bad faith, then the insurer might try to withhold payment.

17. Note, *supra* note 4.

18. See, e.g., Kornblum, *Using the Claim Expert in Extra-Contract Actions Against Insurers*, 51 INS. COUNSEL J. 185, 185 (1984).

II. THE DUTY OF GOOD FAITH AND FAIR DEALING

A. *The Third Party Failure to Settle Action*

1. *The Standard for Liability*

“As early as 1882, the judiciary recognized the disparity of knowledge, economic resources, and bargaining power that existed between the insurer and the insured, and held that the nature of the insurance contract necessitated mutual confidence and a spirit of good faith and fair dealing.”¹⁹ Early cases emphasized the “correlative”²⁰ obligations of both the insurer and the insured²¹ under the insurance contract. In *Hart v. Republic Mutual Insurance Co.*,²² the Ohio Supreme Court held that the insurer’s refusal of several settlement offers within the policy limit²³ coupled with delay tactics perpetrated by the company’s president²⁴ established a prima facie case of bad faith. The court also recognized the insured’s right to recover damages in excess of the policy limit when the insurer’s failure to settle was fraudulent or in bad faith.²⁵

However, the Ohio courts have held consistently that

the mere fact that an insurer refuses to settle within policy limits is not, in itself, conclusive of the insurer’s bad faith and does not give rise to tort liability. In order to recover for the excess liability, the insured has the burden to show that the refusal to settle was not made in good faith.²⁶

Confined to this rule, the Ohio courts have had considerable difficulty in defining the parameters of “good faith” and “bad faith.”²⁷ In *Slater v. Mutual Insurance Co.*,²⁸ the Ohio Supreme Court said that “[b]ad faith” is a general and somewhat indefinite term. It has no constricted meaning. It cannot be defined with exactness.²⁹ Ultimately, the court resolved the issue in the following language:

[a] lack of good faith is the equivalent of bad faith, and bad faith, although not susceptible of concrete definition, embraces more than bad judgment or negligence. It imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud. It also embraces actual intent to mislead or deceive another.³⁰

19. Comment, *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CAL. W.L. REV. 358, 358 (1978).

20. *Brassil v. Maryland Casualty Co.*, 210 N.Y. 235, 242, 104 N.E. 622, 624 (1914).

21. For an interesting analysis of the insured’s duty of good faith, see Note, *Insurance Settlements: An Insured’s Bad Faith*, 31 DRAKE L. REV. 877 (1981–82).

22. 152 Ohio St. 185, 87 N.E.2d 347 (1949).

23. *Id.* at 188, 87 N.E.2d at 349.

24. *Id.* at 189, 87 N.E.2d at 350.

25. *Id.* at 188, 87 N.E.2d at 349.

26. *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St. 3d 272, 276, 452 N.E.2d 1315, 1320 (1983).

27. Although these cases use the terms “bad faith” and “lack of good faith” interchangeably, see *infra* text accompanying note 29, the burden upon the insured is arguably less under the latter. See *Timmons v. Royal Globe Ins. Co.*, 53 OKLA. B.J. 1898, 1902 (1982) (shifting the emphasis from bad faith to breach of the duty to deal in good faith).

28. 174 Ohio St. 148, 187 N.E.2d 45 (1962).

29. *Id.* at 151, 187 N.E.2d at 48 (1962) (quoting *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 416, 8 N.E.2d 895, 907 (1937)).

30. *Slater v. Motorists Mut. Ins. Co.*, 174 Ohio St. 148, 148, 187 N.E.2d 45, 45 (1962).

Under this standard, the *Slater* court ruled that the insurer's failure to officially disclose the policy limits to opposing counsel did not constitute bad faith "although it may have been arbitrary and a display of bad judgment by the insurer."³¹ More recently, the Ohio Supreme Court has ruled that the primary insurer's requests for contribution from an excess insurer before exhausting policy limits does not give rise to bad faith per se.³² Likewise, the duty of good faith does not require the insurer to offer the full policy limit during negotiations, even though the injured third party demands damages far in excess of the policy.³³ Aggrieved insureds have had considerable difficulty proving the dishonest purpose, moral obliquity, or conscious wrongdoing necessary to establish bad faith under the Ohio rule.³⁴

Although no court has expressly adopted the strict liability approach,³⁵ many jurisdictions have enunciated a standard of damages in third party actions that is more favorable to the aggrieved insured than Ohio's definition of bad faith. In California, recovery of damages in excess of the policy limits "may be based on unwarranted rejection of a reasonable settlement offer and . . . the absence of evidence, circumstantial or direct, showing actual dishonesty, fraud, or concealment is not fatal to the cause of action."³⁶ Under the California rule the mere showing that the insurer's failure to settle was negligent is sufficient to establish a case for extra-contract damages.³⁷ Two commentators have noted that

the difference between 'bad faith' and 'negligence' has become more of a difference in wording than in results. The two tests have tended to coalesce, so that even those courts that reject the negligence test and apply exclusively the test of good faith nonetheless consider the insurer's negligence relevant in determining whether the insurer exercised the requisite good faith.³⁸

2. Scope of the Duty

The insurer's duties under the good faith standard have been defined by case law and to some extent by statute.³⁹ Once the insured proves that the insurer refused to accept an injured third party's offer of settlement at or below policy limits,⁴⁰ some

31. *Id.* at 152, 187 N.E.2d at 48. However, the court also noted that opposing counsel was well aware of the policy limits, since the insurer's agent had unofficially disclosed this information. *Id.*

32. *Centennial Ins. Co. v. Liberty Mut. Ins. Co.*, 62 Ohio St. 2d 221, 225, 404 N.E.2d 759, 763 (1980) (applying the good faith standard to a case involving the subrogation of an excess insurer).

33. *Id.* at 224-25, 404 N.E.2d at 762-63. In this wrongful death case the insurer's final offer before impasse was \$250,000 and the third party's final offer of settlement was \$275,000. The policy limit was \$300,000, which was more than a half million dollars less than the plaintiff's prayer in her complaint.

34. *See, e.g., McDowell-Wellman Eng'g. Co. v. Hartford Accident & Indem. Co.*, 711 F.2d 521, 527-28 (3d Cir. 1983) (applying Ohio law).

35. *But see Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 65 N.J. 474, 500, 323 A.2d 495, 509 (1974) (positing that "one day, in an appropriate issue" that court might impose liability for a refusal to settle without a showing of bad faith).

36. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 430, 426 P.2d 173, 177, 58 Cal. Rptr. 13, 17 (1967).

37. *See Anderson v. St. Paul Mercury Indem. Co.*, 340 F.2d 406, 409 (7th Cir. 1965) (interpreting Indiana law); *Cernocky v. Indem. Ins. Co. of Am.*, 69 Ill. App. 2d 196, 205, 216 N.E.2d 198, 203 (1966) (imposing a dual standard on the insurer to avoid acting negligently or in bad faith).

38. *Harrison & Langerman, Actions Against Insurer for Bad Faith Failure to Settle Claim*, 21 AM. JUR. TRIALS 229, 239 (1974).

39. *See, e.g., Royal Globe Ins. Co. v. Superior Court*, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979) (interpreting California's Unfair Practices Act); *see also CAL. INS. CODE* § 790.03(h) (West Supp. 1984) (imposing certain duties upon the liability insurer).

further proof of the insurer's breach of its good faith duty is required for the insured to collect tort damages. The requisite quantum of proof depends upon the good faith standard in force in the particular jurisdiction. Generally, when the insurer receives notice that an injured third party has filed a claim against the insured demanding damages in excess of the policy limit, the law imposes several duties upon the insurer.⁴¹ The insurer's breach of a particular duty, even when coupled with the failure to settle within policy limits, will not automatically amount to bad faith. Rather, the court will consider the breach only one "of the several factors to be evaluated in the light of all the circumstances surrounding the rejection of the compromise offer."⁴² This Comment will examine some of these duties and assess the weight that their breach will have upon the determination of bad faith.

a. *The Duty to Communicate*

Many of the insurer's duties may be categorized under the rubric of the duty of communication. "As a minimum, the insurer is obligated to inform the insured concerning settlement proposals within the policy limits."⁴³ In order to put teeth into this requirement, the notice of the settlement offer must be "timely and meaningful."⁴⁴ In *Herges v. Western Casualty and Surety Co.*,⁴⁵ the Eighth Circuit ruled that the insurer erred in waiting until the morning of a wrongful death trial to communicate the offer to the insured, but that failure to inform did not, standing by itself, constitute bad faith.⁴⁶

Concomitant with the duty to disclose settlement offers, the insurer often is required to communicate to its insured the "results of any investigation indicating liability in excess of policy limits, and any offers of settlement which were made, so that [the insured] might take proper steps to protect his own interests,"⁴⁷ and to explain these matters thoroughly if the insured cannot determine how to protect himself due to "his limited ability to comprehend."⁴⁸

A duty of disclosure also may exist with regard to the insurance company's communications to the third party claimant. In *Coppage v. Fireman's Fund Insurance Co.*,⁴⁹ the injured third party, who was aware of the insured's acute financial distress resulting from the automobile accident in question, voiced a desire to settle

40. The insured alternatively may prove that the rejected offer was in excess of the policy limit by an amount the insured was willing and able to contribute. See *supra* note 9 and accompanying text. For simplicity, this Comment implicitly includes that situation into the term "at or below policy limits."

41. These duties may arise when the demand is less than the policy limits if the jurisdiction allows verdicts in excess of the *ad damnum*. Harrison & Langerman, *supra* note 38, at 268. Under FED. R. CIV. P. 54(c), a judgment other than a default judgment may exceed the amount sought in plaintiff's complaint.

42. Younger v. Lumberman's Mut. Casualty Co., 174 So. 2d 672, 679 (La. Ct. App.), cert. denied, 247 La. 1086, 176 So. 2d 145 (1965) (dealing with the duty to inform insured of settlement offers).

43. Harrison & Langerman, *supra* note 38, at 279.

44. Herges v. Western Casualty & Sur. Co., 408 F.2d 1157, 1162 (8th Cir. 1969).

45. *Id.*

46. *Id.*

47. Martin v. Hartford Accident and Indem. Co., 228 Cal. App. 2d 178, 184, 39 Cal. Rptr. 342, 346 (1964).

48. Kinder v. Western Pioneer Ins. Co., 231 Cal. App. 2d 894, 901, 42 Cal. Rptr. 394, 398 (1965). The insured was "a man of below average intelligence" according to the claims manager. *Id.* at 898, 42 Cal. Rptr. at 396.

49. 379 F.2d 621 (6th Cir. 1967).

within the policy limits.⁵⁰ Subsequently, the insurer offered to settle for \$5,000 but failed to inform the claimant that the offer constituted the policy limits. The third party, believing the policy limits to be higher, rejected the offer.⁵¹ The court held that the insurer's failure to disclose the policy limits in this situation "was a circumstance which the jury could consider on the question of bad faith," although the court refused to acknowledge "a general duty to disclose policy limits to a claimant."⁵² Thus, an insurer's failure to disclose matters to a third party may breach the insurer's duty to the insured if this failure to communicate increases the insured's liability.

b. *The Duty to Evaluate*

The duty to evaluate claims encompasses the insurer's duty to investigate⁵³ and some of the insured's other responsibilities as the fiduciary of the insured. Some courts have characterized the duty as "not absolute but . . . one of 'due diligence and good faith.'"⁵⁴ Two aspects of the insurer's evaluation are the determination of the likelihood that liability will be imposed upon the insured and the extent of potential damages. Ascertaining the probability of an imposition of liability at trial is the more vexing dilemma; the proper standard to which the insurer ought to be held has stirred considerable litigation. Clearly the insurer, no matter how extensive its efforts, can never determine to a certainty whether liability will be imposed if the case goes to trial. Regarding the determination of potential damages, "to avoid a finding of bad faith, the insurer may be required to make repeated monetary evaluations of the case with each material development; the fact that it made a good faith evaluation at an early stage of the case may not excuse it."⁵⁵ In finding bad faith in negligent evaluation of potential liability, the California courts have held that

[t]he size of the judgment recovered in the personal injury action when it exceeds policy limits, although not conclusive, furnishes an inference that the value of the claim is the equivalent of the amount of the judgment and that acceptance of an offer within those limits was the most reasonable method of dealing with the claim.⁵⁶

Since an insurer is not automatically held liable for any judgment against the insured that exceeds policy limits, the central issue of the evaluation duty is the extent to which the insurer must consider the insured's interests and the extent to which the insurer may consider its own. The consensus is that the insurance company "may, of course, properly consider its own interest, but it may never, never forget that of its Assured."⁵⁷ The California test "[i]n determining whether an insurer has given consideration to the interests of the insured . . . is whether a prudent insurer without

50. *Id.* at 624.

51. *Id.*

52. *Id.* at 624 n.3.

53. This duty is similar to the nonliability insurer's duty. See *infra* text accompanying notes 72–86.

54. *State Farm Auto. Ins. Co. v. Brewer*, 406 F.2d 610, 612 (9th Cir. 1968) (quoting *Kuzmanich v. United Fire & Casualty Co.*, 242 Or. 529, 532, 410 P.2d 812, 813 (1966)).

55. *Harrison & Langerman*, *supra* note 38, at 284–85.

56. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 431, 426 P.2d 173, 177, 58 Cal. Rptr. 13, 17 (1967).

57. *Smoot v. State Farm Mut. Auto. Ins. Co.*, 299 F.2d 525, 532 (5th Cir. 1962).

policy limits would have accepted the settlement offer.’’⁵⁸ Other courts have held that the insurer must give at least equal attention to the insured’s interests as it does to its own.⁵⁹ Thus, even though the insurer is the insured’s fiduciary in settling third party claims, it may in some instances equate its own interest with the insured’s.

c. *The Duty to Negotiate*

Finally, the insurer has dual negotiation responsibilities concerning its efforts to settle with the injured third party and to seek contribution from the insured. At a minimum, the insurer must demonstrate a willingness to enter into negotiations with the third party claimant. A failure to do so coupled with a verdict in excess of policy limits may be sufficient to establish bad faith. In *Abernethy v. Utica Mutual Insurance Co.*,⁶⁰ the Fourth Circuit stated that “the flat refusal to negotiate, under the circumstances of substantial exposure to liability, a demonstrated receptive climate for settlement and limited insurance coverage, could have been found to show lack of good faith in [the insurer]’s exercise of its exclusive power to settle.”⁶¹

In order to avoid extra-contractual liability for failure to settle, the insurer may ask the insured to contribute funds to the settlement. In Ohio, the insurer may make such a request before it has exhausted its policy limits.⁶² Other courts require the insurer to offer the full policy limits before asking the insured to contribute.⁶³ The question remains whether an insurer who has offered the policy limit is required to seek contribution from the insured in excess of that amount in order to settle below a potential damage award. The majority rule seems to be that the “failure of the insurer to attempt to induce contribution by the insured”⁶⁴ is a factor to consider, but is not by itself determinative of bad faith.⁶⁵

3. *Unfairness of the Present Rule*

The well-settled law concerning the liability insurer’s duty of good faith in settling third party claims against its insured demonstrates that in many situations the insurer may expose the insured to great losses in excess of policy limits without breaching the duty of good faith and fair dealing. If the insured denies liability or requests the insurer not to accept a settlement offer within the policy limit,⁶⁶ saddling

58. *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 429, 426 P.2d 173, 176, 58 Cal. Rptr. 13, 16 (1967).

59. *State Farm Mut. Auto. Ins. Co. v. Brewer*, 406 F.2d 610, 612 (9th Cir. 1968) (quoting *Radcliffe v. Franklin Nat’l Ins. Co.*, 208 Or. 1, 47, 298 P.2d 1002, 1023 (1956)).

60. 373 F.2d 565 (4th Cir. 1967).

61. *Id.* at 570.

62. *Centennial Ins. Co. v. Liberty Mut. Ins. Co.*, 62 Ohio St. 2d 221, 225, 404 N.E.2d 759, 763 (1980) (dealing with the request to an excess insurer).

63. *See, e.g., Boling v. New Amsterdam Casualty Co.*, 173 Okla. 160, 46 P.2d 916 (1935) (a post-judgment settlement offer in excess of the policy limits by an amount insured was willing to contribute refused by insurer).

64. *Young v. American Casualty Co.*, 416 F.2d 906, 910 (2d Cir. 1969), *cert. dismissed*, 396 U.S. 997 (1970).

65. *Id.*

66. An insured, fully aware of the potential exposure to liability from an adverse judgment, nonetheless may refuse to settle for a myriad of reasons. A physician or other professional may not wish to settle a malpractice suit because settlement will appear to be a tacit acknowledgement of fault, bringing into question that person’s skills and perhaps hurting business. Other insureds, such as manufacturers, may refuse to settle product liability suits because settlement would encourage others to bring similar suits.

the insured with any extra-contractual damages granted at trial is clearly equitable. Even if a strict liability standard were imposed, the insured's consent should constitute a defense in a failure to settle action. However, in many other circumstances, the insured may prove the insurer's refusal to accept an offer of compromise within policy limits and even the breach of other duties placed on the insurer, but the insurer may still not be liable for extra-contractual damages under the present system. In light of the insurer's control of the negotiation process, such a result is clearly unfair.

B. *The First Party Failure to Pay Action*

The first party action is of more recent vintage than the third party action,⁶⁷ and some jurisdictions that recognize the insured's right to sue for the insurer's failure to settle thus far have refused to recognize the failure to pay tort action.⁶⁸ In refusing to extend the implied covenant of good faith and fair dealing to the first party context, the Supreme Court of Florida reasoned that the insurer and its insured "occupy a contractually adversary position toward each other,"⁶⁹ and ruled that "[t]he penalty imposed by [Florida] law on the insurer for its failure to [pay] the claim of the insured within a reasonable time is [limited to] the payment of interest at the legal rate."⁷⁰ Deeming the legal relationship between insurer and insured as that of debtor and creditor rather than as fiduciary and beneficiary, the court concluded that:

It would be a strange quirk in the law to hold that each time a debtor fails or refuses to pay demands made upon it by a creditor, the debtor would be liable for both compensatory and punitive damages even though his failure or refusal was motivated by spite, malice, or bad faith.⁷¹

1. *The Standard*

The Ohio Supreme Court recently joined the growing ranks of courts recognizing the first party failure to pay tort action in *Hoskins v. Aetna Life Insurance Co.*⁷² In *Hoskins*, the court determined that an insured could recover extra-contractual damages, including punitive damages⁷³ if the insurer acted with actual malice in breaching its "duty to act in good faith in handling and payment of the claims of its insured."⁷⁴ The Franklin County Court of Common Pleas previously had allowed recovery of punitive damages for the breach of a nonliability insurance contract in *Kirk v. Safeco Insurance Co.*⁷⁵ The *Kirk* court found that the insurer failed to negotiate with the insureds on the value of their lost household effects and clothing and that the insurer's settlement offer was founded upon "no reasonable basis

67. The first case allowing the first party action was *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

68. *See, e.g., Baxter v. Royal Indem. Co.*, 285 So. 2d 652 (Fla. 1973) (uninsured motorist policy).

69. *Id.* at 656.

70. *Id.* at 657.

71. *Id.*

72. 6 Ohio St. 3d 272, 452 N.E.2d 1315 (1983).

73. *Id.* at 272, 452 N.E.2d at 1317.

74. *Id.* at 272, 452 N.E.2d at 1316.

75. 28 Ohio Misc. 44, 273 N.E.2d 919 (C.P. Franklin County 1970).

whatsoever."⁷⁶ These acts, together with the insurer's general malice, constituted a breach of contract that "amount[ed] to a willful, wanton and malicious tort," which justified punitive damages.⁷⁷

In recognizing the first party cause of action, the *Hoskins* court reiterated the standard enunciated in Ohio's third party failure to settle actions and noted that mere failure to pay a valid claim or negligence in processing a claim does not give rise to insurer tort liability per se.⁷⁸ The court restricted the insured's recovery of punitive damages to situations in which the insured could prove that the insurer acted with actual malice, actual malice being defined as "'that state of mind under which a person's conduct is characterized by hatred or ill will, a spirit of revenge, retaliation, or a determination to vent his feelings upon other persons.'"⁷⁹ The plaintiff has the burden of showing actual malice "[b]ased on the information available to [the insurer]."⁸⁰ In *Hoskins*, the insured was transferred from a general wing of a hospital to its skilled nursing unit, to facilitate physical therapy involving a large and relatively immobile tilt table. In spite of the insured's demands, the insurance company refused to pay for the insured's medical expenses while in the skilled nursing unit. Although the insured's health insurance policy limit had not been reached, the company insisted that the unit was a "convalescent facility," which was not covered under the policy.⁸¹ Despite evidence that more vigorous investigation of the claim would have shown that the skilled nursing unit was not distinct from the hospital and thus was covered by the policy, the court denied the plaintiffs' punitive damages claim,⁸² stating "that the complaint does not allege nor does the record show that there was any affirmative action on the part of the insurer as would support a claim for punitive damages."⁸³

The Ohio rule, as articulated in *Hoskins*, seems to be that a first party tort action cannot be founded upon the insurer's nonfeasance, or lack of action, but only upon its malfeasance, or improper action, and that the insured can recover punitive damages only if the insurer was motivated by actual malice.⁸⁴ Nonfeasance is sufficient to establish a prima facie case for breach of contract, but in the absence of a duty to act, only malfeasance can sound a case in tort.⁸⁵ In Ohio, therefore, an insurer who conducts no investigation whatsoever (nonfeasance) may arguably, under the rule of *Hoskins*, avoid a punitive damages judgment. The *Hoskins* decision therefore may

76. *Id.* at 46, 273 N.E.2d at 921.

77. *Id.*

78. *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St. 3d 273, 277, 452 N.E.2d 1315, 1320 (1983).

79. *Id.* (Quoting *Columbus Fin. v. Howard*, 42 Ohio St. 2d 178, 183-84, 327 N.E.2d 654, 658 (1975)).

80. *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St. 3d 273, 278, 452 N.E.2d 1315, 1321 (1983).

81. *Id.* at 273, 452 N.E.2d at 1317.

82. *Id.* at 278, 452 N.E.2d at 1321. The plaintiffs were awarded \$20,792.91 on their breach of contract claim.

83. *Id.* at 279, 452 N.E.2d at 1322.

84. Notwithstanding the court's pronouncement that nonfeasance is insufficient to establish a tort case for punitive damages, the *Hoskins* court relies on the fact that the insurer "did not blindly ignore [insured's] position." *Id.* Therefore, the court may consider an insurer's gross neglect of a claim sufficient to establish actual malice and justify an award of punitive damages in a future case.

85. See W. PROSSER, HANDBOOK OF THE LAW OF TORTS 614 (4th ed. 1971).

encourage an insurer to take no action rather than to investigate a claim and risk a tort action for improper investigation (malfeasance).⁸⁶

While Ohio predicates the recovery of punitive damages upon a tortious breach of the implied covenant of good faith and fair dealing, coupled with actual malice, other jurisdictions justify the award on other theories such as "fraud by the insurer in dealing with the insured at both the sales and claims levels, the intentional infliction of emotional distress, the invasion of a protected property interest, and violation of a statute."⁸⁷

The California Supreme Court was the first court to recognize the first party cause of action. In *Gruenberg v. Aetna Insurance Co.*,⁸⁸ the insured brought an action against the insurance company for failure to pay under a fire insurance policy.⁸⁹ Reasoning that the duty to settle and the duty to pay "are merely two different aspects of the same duty,"⁹⁰ the court applied the standard applicable in third party actions in California, "namely a duty not to withhold unreasonable payments due under a policy."⁹¹ One commentator suggested that the distinction between the failure to settle and failure to pay actions is more formalistic than substantive.⁹² "In both cases the insurer has contracted to protect the insured against loss. In both cases it has control over settlement of claims. . . . It should be liable for all loss resulting from its bad faith, whether the loss to the insured occurs from legal liability or otherwise."⁹³ The California courts also have allowed the insured or the insured's direct beneficiary to take action against the insurer for unreasonably with-

86. The Ohio Supreme Court recently extended the "duty to act in good faith in the handling and payment of claims" to the issuer of a financial responsibility bond. *Suver v. Personal Serv. Ins. Co.*, 11 Ohio St. 3d 6, 462 N.E.2d 415 (1984). The court noted "that a financial responsibility bond is not the same as an insurance policy," but reasoned that the

differences are not so pronounced as to require the creation of a cause of action in one case and its denial in the other. Precisely the same policy arguments and rationale hold true in both settings. In both cases there is a great disparity of financial resources. Additionally, issuers of financial responsibility bonds are companies clearly affected with a public interest. Moreover, to insulate the issuer of a financial responsibility bond from liability for the deliberate refusal to pay its obligations arising from the bond is to encourage the routine denial of payment of claims for as long as possible. This court should not provide an incentive to act in bad faith.

Id. at 8-9, 462 N.E.2d at 417.

In his dissent, Justice Holmes distinguished *Hoskins*, saying that in that case the imposition of the duty of good faith upon the insurer was justified because of the relationship between the insurer and the insured. There was obviously privity of contract and consideration flowing from both sides. In my view, the contractual relationship between the parties was vital in establishing the duty on the insurer to act in good faith. I fail to see any relationship between the parties herein which was so vital to the *Hoskins* decision.

Id. at 9-10, 462 N.E.2d at 418 (Holmes, J., dissenting).

This extension of the good faith doctrine should have far reaching implications in light of the recently strengthened requirements concerning the financial responsibility of Ohio drivers. See OHIO REV. CODE ANN. § 4507.212 (Page Supp. 1984).

87. Komblum, *Defense of a First-Party Extra-Contract Claims Action Against A Life, Health and Accident Insurer*, 29 AM. JUR. TRIALS 481, 493 (1982).

88. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

89. *Id.* at 570, 510 P.2d at 1034, 108 Cal. Rptr. at 482.

90. *Id.* at 573, 510 P.2d at 1037, 108 Cal. Rptr. at 485.

91. *Id.*

92. Note, *supra* note 4, at 583.

93. Note, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164, 178 n.99 (1976).

holding payment under a health insurance policy,⁹⁴ under the uninsured motorist provision of an automobile policy⁹⁵ and under a disability insurance policy.⁹⁶ Although California adheres to a negligence standard,⁹⁷ the climate in that state is perhaps most favorable to a strict liability approach. Indeed, one federal court interpreting California law adopted a rule resembling such a standard. In *McDowell v. Union Mutual Life Insurance Co.*,⁹⁸ the court disregarded the reasonableness standard and declared that “[t]he lesson of the line of cases in California is that insurance companies that *erroneously* withhold payments from their insureds, and deprive them of the security they bargained for, must be held to account for the consequences of their conduct.”⁹⁹

Some of the other jurisdictions that recognize the first party cause of action also have anchored the insured’s right to recovery upon a reasonableness standard. In Wisconsin, for example, “[t]o show a claim for bad faith, a plaintiff must show the absence of a reasonable basis for denying benefits of the policy.”¹⁰⁰ However, the Wisconsin Supreme Court characterizes the tort of bad faith as an intentional one, and requires the insured to show “the defendant’s knowledge or reckless disregard of the lack of a reasonable basis for denying the claim.”¹⁰¹ Whereas in California, an insurer that fails to pay a valid claim because it negligently investigates or otherwise handles the claim is liable for extra-contractual damages,¹⁰² in Wisconsin, the plaintiff’s mere showing of negligence would be insufficient to impose such damages upon the insurer.¹⁰³

The Supreme Court of Alabama has further restricted the opportunities for recovery under the first party cause of action. In order to prevail in that state, a plaintiff must show not only an intentional refusal to pay the insured’s claim, but also “the absence of any reasonably legitimate or arguable reason”¹⁰⁴ for withholding payment of a claim. Under this standard, the plaintiff’s prima facie case must include a showing “that the insurance company had no legal or factual defense to the insurance claim.”¹⁰⁵ This imposes a considerable burden upon the insured. Applying this rule, in *National Savings Life Insurance Co. v. Dutton*,¹⁰⁶ the court said “[w]hether an insurance company is justified in denying a claim under a policy must be judged by what was before it at the time the decision is made. . . . We cannot agree with the plaintiff’s assertion that the company had an affirmative duty to investigate further.”¹⁰⁷ In *Dutton*, the insurance company refused to pay the plaintiff under a health insurance policy because she erroneously answered in her insurance

94. *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

95. *Richardson v. Employers Liab. Assurance Corp.*, 25 Cal. App. 3d 232, 102 Cal. Rptr. 547 (1972).

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

97. *See id.*

98. 404 F. Supp. 136 (C.D. Cal. 1975).

99. *Id.* at 141.

100. *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 691, 271 N.W.2d 368, 376 (1978).

101. *Id.*

102. *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1975).

103. *See Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 271 N.W.2d 368 (1978).

104. *National Sec. Fire & Casualty Co. v. Bowen*, 417 So. 2d 179, 183 (Ala. 1982).

105. *Id.*

106. 419 So. 2d 1357 (Ala. 1982).

107. *Id.* at 1362.

policy application that she had no heart or circulatory problems, even though hospital records available to but not examined by the insurance company subsequently showed the existence of chest pains.¹⁰⁸ The court held this failure to investigate thoroughly insufficient to sustain plaintiff's claim for excess damages, although in California the facts probably would have been sufficient to establish the plaintiff's prima facie case in a first party action.¹⁰⁹

2. Scope of the Duty

Once the insured has proven that the claim which the insurer refused to pay was valid, the insured also must prove the breach of a specific duty according to the applicable standard in the particular jurisdiction. These duties relate to the insurer's behavior in handling the claim.

a. The Duty to Investigate

To reach an informed decision whether an insured's claim is valid, the insurance company must investigate the claim or hire an outside investigator. The investigative procedure is of great importance to the insured because the results will determine whether the insured will be paid or will have to resort to litigation or compromise. Three pertinent aspects of the duty to investigate are: requirements regarding the insurer's methods of gathering information, requirements regarding the quantity of information to be gathered, and requirements regarding the handling of this information.

Currently in Ohio, the only clear investigative duty upon the insurer is based upon a statutory prohibition of pattern settlements.¹¹⁰ As defined by the statute, a pattern settlement is "a method by which liability is routinely imputed to a claimant without an investigation of the particular occurrence upon which the claim is based and by using a predetermined formula for the assignment of liability arising out of occurrences of a similar nature."¹¹¹ The insurer must investigate the particular occurrence that caused the injury and the particular injuries suffered. In California, on the other hand, the duty to gather information also includes the insurer's prompt investigation of the insurability of the insured.¹¹²

Cases dealing with the compilation of medical records are helpful in determining the amount of information the insurer is required to amass. In Alabama, the insurer has the duty to question the insured to see if the insurer's information is consistent with the insured's articulation of the injuries, but if upon inquiry the insured does not refute the insurer's information, the insurer may rely upon that information without

108. *Id.* at 1358-61.

109. *Cf. McLaughlin v. Connecticut Gen. Life Ins. Co.*, 565 F. Supp. 434, 454 (N.D. Cal. 1983); *Egan v. Mut'l of Omaha*, 24 Cal. 3d 809, 620 P.2d 141, 169 Cal. Rptr. 691 (1979).

110. OHIO REV. CODE ANN. § 3901.21 (Page Supp. 1983).

111. *Id.*

112. *Barrera v. State Farm Mut'l Auto. Ins. Co.*, 71 Cal. 2d 659, 663, 456 P.2d 674, 677, 79 Cal. Rptr. 106, 109 (1969) (automobile liability insurer).

doing more.¹¹³ The California courts require more sensitivity to the nature of the claim and circumstances surrounding the investigation. For example, the insurer's investigation must be more thorough before terminating disability payments, "particularly when the insurer knows . . . that . . . its insured had recently undergone surgery."¹¹⁴

Finally, the insurer may have certain responsibilities regarding the dissemination of information it has gathered. In *Little v. Stuyvesant Life Insurance Co.*,¹¹⁵ the California Court of Appeal ruled that the insured could recover punitive damages based upon its finding that the insurer "purposely ignored the great bulk of the medical information it had and withheld that information from the physicians it selected to examine plaintiff."¹¹⁶ *Stuyvesant* demonstrates that the insurer, in its investigation of the validity of medical claims, must provide its doctors with all available medical information; the insurer cannot shield itself from a bad faith charge with a doctor's report based upon incomplete information.

b. *Misrepresentation and Other Pre-Adjudicatory Practices*

In addition to the duty to investigate, the insurer has certain obligations under law regarding the sale, modification, and termination of a nonliability policy. Some of these duties may be recited in the insurance contract. These duties become relevant when the insurer refuses to pay based upon its belief that the plaintiff is not insured or is not covered for the injury in question. If the insurer's behavior in these matters is tainted with fraud or misrepresentation regarding policy coverage, the court may impose punitive damages to punish the wrongful actor.

Furthermore, "[t]o avoid [first party] liability, an insurance company must refrain from any violation of the supracontractual duties which the law has heretofore recognized or seems likely to recognize in the near future."¹¹⁷ The California courts sanction misrepresentations relied upon in purchasing the policy, if the insurer has no intention of performing,¹¹⁸ and misrepresentations made in attempting to dissuade the insured from terminating his or her coverage.¹¹⁹ In Ohio, supracontractual duties are set forth in the Unfair and Deceptive Practices section of the Insurance statute,¹²⁰ the violation of which in the future may be held to constitute a tort.¹²¹ The primary thrust

113. *National Sav. Life Ins. v. Dutton*, 419 So. 2d 1357 (Ala. 1982).

114. *Egan v. Mutual of Omaha Ins. Co.*, 63 Cal. App. 3d 659, 676-77, 133 Cal. Rptr. 899, 910 (1976).

115. 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977).

116. *Id.* at 462, 136 Cal. Rptr. at 659.

117. Langdon & Sytsma, *The Duty of Good Faith and Fair Dealing and The Pre-Adjudicatory Role of The Insurance Company Advocate*, 45 INS. COUNSEL J. 309, 311 (1978).

118. *Miller v. National Am. Life Ins. Co.*, 54 Cal. App. 3d 331, 338, 126 Cal. Rptr. 731, 734 (1976).

119. *Wetherbee v. United Ins. Co. of Am.*, 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968). The manager sent a letter to the insured who was dissatisfied with the policy because she believed "it could be cancelled at the whim of defendant." This letter assured plaintiff that "[a]ccording to the provisions of your policy, when you are sick or hurt you will draw benefits as long as you live. Your policy cannot be terminated . . . when you are permanently disabled." *Id.* at 925, 71 Cal. Rptr. at 766.

120. OHIO REV. CODE ANN. § 3901.21 (Page Supp. 1983).

121. *Poindexter v. Willis*, 23 Ohio Misc. 199, 208 (C.P. 1970) ("[W]henver the law creates a duty, the breach of such duty coupled with consequent damage will be a tort also. This applies not only to the common law but also such rights and duties as may be created by statute.").

of the statute is the prohibition of any misrepresentation of “the terms of any policy issued . . . or the benefits or advantages promised thereby or the dividends or share of the surplus received thereon”¹²² in trying to sell a policy. The statute also forbids any misrepresentation made to the insured “for the purpose of inducing or tending to induce [an insured] to . . . forfeit, change, or surrender insurance.”¹²³ The insurer also cannot attempt to change a policy by telling the insured that a change is mandated by the Act,¹²⁴ or to convince the insured not to make a claim by making an incomplete comparison to the fact pattern of other claims that were disallowed.¹²⁵

c. *The Duty to Inform*

“One important facet of the insurer’s obligation . . . is the duty reasonably to inform an insured of the insured’s rights and obligations under the insurance policy”¹²⁶ and those under law. The Supreme Court of California said:

[i]n particular, in situations in which an insured’s lack of knowledge may potentially result in a loss of benefits or a forfeiture of rights, an insurer has been required to bring to the insured’s attention relevant information so as to enable the insured to take action to secure rights afforded by the policy.¹²⁷

For example, an insurer has the duty to inform the insured whose employee’s life insurance policy coverage ended with the termination of his employment that the policy afforded the terminated employee a grace period or option period in which he could convert the policy into an individual policy and retain coverage.¹²⁸

The duty to inform the insured of an arbitration clause deserves special attention. Arbitration is of great interest to the insured, the insurer, and to society in general because it often provides “a speedy, economic and inexpensive dispute-resolution process.”¹²⁹ The California Supreme Court has held the insurer’s failure to inform the insureds of the arbitration procedure constitutes a breach of the insurer’s duty of good faith and fair dealing.¹³⁰ The court reasoned that the insurer knew

that in many instances its insureds would not be aware of the arbitration clause and that, despite this knowledge, [the insurer] deliberately decided not to inform its insureds of the arbitration procedure. In this context, the practical effect of the insurer’s practice was to transform its arbitration into a unilateral provision, establishing a procedure to which the insurer could require insureds to resort when [the insurer] deemed it advisable, but one that would not generally [be employed quickly] by the bulk of [the insurer’s] uninformed insureds.¹³¹

122. OHIO REV. CODE ANN. § 3901.21(A) (Page Supp. 1983).

123. *Id.* § 3901.21(J).

124. *Id.*

125. *Id.* § 3901.21(A).

126. *Davis v. Blue Cross of N. Cal.*, 25 Cal. 3d 418, 428, 600 P.2d 1060, 1065, 158 Cal. Rptr. 828, 833 (1979).

127. *Id.* at 428, 600 P.2d at 1065–66, 158 Cal. Rptr. at 833–34.

128. *Walker v. Occidental Life Ins. Co.*, 67 Cal. 2d 518, 432 P.2d 741, 63 Cal. Rptr. 45 (1967) (insurer also has implied duty to notify the insured of the date on which the option period began to run).

129. *Davis v. Blue Cross of N. Cal.*, 25 Cal. 3d 418, 429, 600 P.2d 1060, 1066, 158 Cal. Rptr. 828, 834 (1979).

130. *Id.* at 430, 600 P.2d at 1067, 158 Cal. Rptr. at 835 (the insurer who failed to pay, forcing the insureds to litigate the matter, forfeited any right subsequently to compel its insureds to submit their disputes to arbitration).

131. *Id.*

In light of the rule concerning arbitration, in California the insurer has the duty to inform the insured of any right under the contract of which the insured is likely to be unaware.

3. *The Role of Counsel*

In failure to pay actions, the largest segment of an extra-contractual damages judgment against the insurer may be comprised of punitive damages.¹³² Therefore, the primary concern of plaintiffs' counsel is laying the groundwork for such recovery. The defense counsel, on the other hand, should endeavor to vanquish the claim for punitive damages before the issue reaches the jury,¹³³ or to create conditions conducive to minimizing such damages.

Regardless of the theory or theories pursued, it is essential that a plaintiff should specifically demand relief in the form of punitive damages, even though such a demand may not be required under the rules of procedure.¹³⁴ Although actual malice, a prerequisite to recovery of punitive damages in Ohio, may be averred generally,¹³⁵ averments of fraud in cases in which misrepresentations by the insurer induced the insured to purchase, maintain, or surrender coverage, must be stated "with particularity."¹³⁶ Failure to do so will subject the claim to a motion to dismiss¹³⁷ or at least a motion for a more definite statement.¹³⁸ Plaintiffs who predicate their claim for punitive damages upon the theory of intentional infliction of emotional distress, as is required in Wisconsin, must specifically aver that the defendant's behavior constituted extreme and outrageous conduct that caused both emotional injury and substantial pecuniary loss.¹³⁹

Although a defense attorney may be able to attack successfully a complaint using a motion to dismiss or a motion for a more definite statement, "the chances of successfully obviating a punitive claim may be enhanced by deferring the attack until most of the discovery is completed, and the facts on which the punitive claim is fairly well established by depositions and interrogatories, so that a summary judgment motion may be made."¹⁴⁰ Another defense tactic that may minimize the impact of a claim for extra-contractual damages is the removal of the suit to a federal court. In some instances the federal forum will provide a more conservative and insurance company oriented jury and a requirement of jury unanimity, which may not be required in the state court.¹⁴¹ Also, if the case is appealed, the defense avoids the risk of encountering the judge or judges who first recognized the right to recover extra-

132. See, e.g., *Fellows v. Allstate Ins. Co.*, No. C259993 (C.D. Super. Ct. Cal. 1983) (jury awarded \$40.5 million upon failure to pay a \$36,000 claim).

133. Kornblum, *supra* note 87, at 543.

134. FED. R. CIV. P. 8(a)(3).

135. FED. R. CIV. P. 9(b).

136. *Id.*

137. FED. R. CIV. P. 12(b)(6); see, e.g., *Shapiro v. Miami Oil Producers, Inc.*, 84 F.R.D. 234, 236-39 (D. Mass. 1979).

138. FED. R. CIV. P. 12(e).

139. *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 694-95, 271 N.W.2d 368, 378 (1978).

140. Kornblum, *supra* note 87, at 543.

141. *Id.* at 541.

contractual damages in that state's first party actions and who may be disposed to expand the right of recovery in these cases. Federal judges in diversity cases are bound by state law precedent and, thus, usually cannot expand current doctrines.¹⁴² A plaintiff may frustrate defense counsel's efforts to remove by joining local company personnel in the action to destroy diversity jurisdiction if plaintiff can allege that these employees acted tortiously towards plaintiff. However, "[i]f defense counsel can show that no claim can be stated against these defendants and that their joinder was for the ulterior motive of preventing removal, the case may be removed and an effort to remand successfully resisted."¹⁴³

In addition to properly pleading punitive damage claims, the insured's counsel should correctly and completely aver its claim for compensatory damages flowing from the insurance policy itself. Although future policy benefits are not recoverable under a contractual cause of action for failure to pay,¹⁴⁴ they may be recovered in a valid tort cause of action for the breach of the implied covenant of good faith and fair dealing. In *Pistorious v. Prudential Insurance Co. of America*,¹⁴⁵ the plaintiff prevailed on its demand for \$17,000 in future policy benefits under a disability insurance policy, this amount constituting the "present cash value of future policy benefits."¹⁴⁶ All defendants likewise should seek to reduce any judgment for future policy benefits to present cash value, and plaintiff's counsel should be especially sensitive to potential policy benefits, which may be recovered in permanent and total disability cases.¹⁴⁷

In the discovery stage of a first party failure to pay action, plaintiff's counsel must secure information that will demonstrate the insurer's bad faith in handling the insured's claim, and defense counsel has the responsibility of protecting privileged or irrelevant information from being discovered. For example, the plaintiff's attorney should be sensitive to all information pertaining to the company's method of recording pertinent data. In *Egan v. Mutual of Omaha*,¹⁴⁸ the plaintiff's attorney was able to trace a supposedly low level error in the handling of the claim to persons of greater authority when he learned of the company's recording method. In that case the insurer routinely recorded the route that the file traveled through the firm onto a special file jacket, which the insurer had failed to produce along with the file itself. The plaintiff's counsel was able to establish high level bad faith when he secured this file jacket.¹⁴⁹

Also, the plaintiff's counsel has a responsibility to oversee closely the insurer's utilization of an independent medical examination in assessing the validity of a claim

142. See *Erie R.R. Co. v. Tompkins*, 304 U.S. 64 (1938).

143. Kornblum, *supra* note 87, at 541-42.

144. *Erreca v. Western States Life Ins. Co.*, 19 Cal. 2d 388, 402, 121 P.2d 689, 695 (1942).

145. 123 Cal. App. 3d 541, 176 Cal. Rptr. 660 (1981).

146. *Id.* at 550 n.6, 176 Cal. Rptr. at 665 n.6.

147. At trial, plaintiff's attorney may wish to use attorneys and independent claims personnel as expert witnesses to testify on a wide variety of subjects. Such experts may testify about the reasonable settlement value of a claim, insurance industry standards, or even about the ultimate issue of whether the insurer acted in bad faith. *Groce v. Fidelity Gen. Ins. Co.*, 252 Or. 296, 448 P.2d 554 (1968); see also Kornblum, *supra* note 18, at 186-88. For insurance industry standards, see *Miller v. Los Angeles County Flood Control Dist.*, 8 Cal. 3d 689, 505 P.2d 193, 106 Cal. Rptr. 1 (1973).

148. 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976).

149. For an interesting rendition of the facts, see TOBIAS, *THE INVISIBLE BANKER* 134-35 (1982).

of injury or other physical disability or in attempting to avoid charges of insufficient investigation. "The validity and strength of an independent medical examination report will to a large extent depend on the information made available to the doctor conducting the independent medical examination."¹⁵⁰ Thus, the plaintiff should discover all medical records pertaining to the insured that were in the possession of the insurer at the time of the examination to determine whether the insurer made full disclosure of the records to the independent doctor. Failure to provide the doctor with all pertinent medical records may constitute outrageous conduct sufficient to support a cause of action for breach of the duty of good faith and fair dealing, fraud, or the intentional infliction of severe emotional distress.¹⁵¹ Also, "plaintiff's attorney should investigate whether the doctor conducting the independent medical examination has been selected by the insurer because the doctor has a long history of consistently supporting the insurer's position with regard to the denial of insurance benefit claims."¹⁵² Evidence that the doctor is a so-called hired gun may be particularly damaging to the defense at trial.

Since the plaintiff greatly needs to obtain information possessed by the insured, an important role of the defense attorney during the discovery stage is that of overseer of the release of information.

Whether documents such as claim files and company manuals are discoverable usually depends on the local rules. Before they are produced, they should be screened to prevent discovery of portions of the claim file that may be privileged because they are communications between records of transactions involving corporate counsel and company personnel, or because they reflect the contents of communications between trial and corporate counsel. In addition, any manuals outlining company procedures or policies should be reviewed prior to disclosure so that only those relevant to the lawsuit for discovery purposes are disclosed.¹⁵³

To avoid charges of not disclosing properly discoverable documents, "counsel should keep a careful record of documents produced, as well as those not disclosed because of objection,"¹⁵⁴ and also should record the objection relied upon.

The defense counsel probably will wish to engage in at least the following discovery: Primarily, the defendant will seek to expose the plaintiff's version of what transpired between the insured and the insurance company's claims personnel, and, if plaintiff alleges fraudulent inducement, between the insured and the sales agent. Defendant also will want to determine the type and extent of damages claimed. With this in mind, "it is advantageous to take the plaintiff's deposition at an early stage, whether he or she is the insured on a health or accident policy or a beneficiary under a life policy."¹⁵⁵ Another potential source of information is the plaintiff's attorney. In

150. Shernoff & Blickenstaff, *Investigating for Bad Faith: The Role of Plaintiff's Attorney*, 14 FORUM 132, 137 (1978).

151. *Id.*

152. *Id.*

153. Kornblum, *supra* note 87, at 547.

154. *Id.*

155. *Id.* at 559.

Fireman's Fund Insurance Co. v. Superior Court of Los Angeles,¹⁵⁶ the court allowed defense counsel to inquire at deposition whether plaintiff's attorney furnished all of the medical information available to examining doctors or to the insurer itself.¹⁵⁷ The California Court of Appeal held in this case that "in those cases . . . in which bad faith is alleged and punitive damages are sought based upon that allegation of bad faith, . . . we think the facts fall outside attorney-client privilege, and outside the work product rule, and the deposition of the attorney may be taken, subject to all proper objections."¹⁵⁸ The attorney's deposition may reveal how plaintiff's counsel handled information or if counsel provided the insurer with the opportunity to settle the claim for benefits in a good faith manner. As a practical matter, the deposition of an opposing attorney may be of somewhat limited utility because the attorney not only is likely to invoke the attorney-client privilege, but also is apt to be recalcitrant and well-versed in avoiding release of legally damaging information.

Finally, the defense attorney's preadjudicatory role can prevent the insurer's exposure to liability for bad faith altogether. The insurer's counsel should begin by recommending that the insurer use great care in the selection of sales agents and claims personnel.¹⁵⁹ "The old objective of the claims man 'to find the loophole' is at an end."¹⁶⁰ Insurance company counsel should advocate "the adoption of procedures whereby all [sales agents and claims adjusters] are fully acquainted with the various prohibitions contained in the Unfair Trade Practices Act. [The companies] should also adopt procedures for checking on the performance of claims adjustment personnel in light of the said prohibitions."¹⁶¹ The procedures adopted by the insurer should be reduced to writing and be applied uniformly because "the existence of formalized procedures governing fair claim settlement practices could easily bolster a good faith defense."¹⁶²

4. *The Need for a New Standard*

First party actions have successfully attacked some abuses perpetrated by insurance companies in handling nonliability policy claims. "The successful prosecution of such a case also helps bring abuses to the attention of the public, legislatures, and the courts, thereby destroying the climate within which such abuses thrive."¹⁶³ Arguably, insurers will be encouraged to act in good faith because they will not want to pay large extra-contractual damage awards. The shareholders of insurance companies will pursue the firm's management personnel to avoid this drain upon their

156. 72 Cal. App. 3d 786, 140 Cal. Rptr. 677 (1977).

157. *Id.* at 789, 140 Cal. Rptr. at 679.

158. *Id.* at 790, 140 Cal. Rptr. at 679-80.

159. Langdon & Sytsma, *supra* note 117, at 313.

160. Dillard, *The Bomb Fell on California—Punitive Damages*, 22 AMERICAN LIFE INSURANCE COUNSEL PROCEEDINGS 965, 986 (1973).

161. Langdon & Sytsma, *supra* note 117, at 315. Ohio's unfair and deceptive practices statute pertaining to insurance is codified in OHIO REV. CODE ANN. § 3901.21 (Page Supp. 1983).

162. Langdon & Sytsma, *supra* note 117, at 315.

163. Shernoff & Blickenstaff, *supra* note 150, at 141.

profit margin.¹⁶⁴ Also, the denunciation effect of adverse judgments will drive away insurance purchasers, and further strain the profit margin. Plaintiffs' attorneys have found these cases to be an "excellent opportunity to participate in the definition of the reasonable scope of insurance investigations."¹⁶⁵ Similarly, vigorous work by defense counsel has narrowed the parameters of the recovery in failure to pay cases. For example, in *Twentieth Century-Fox Film Corp. v. Harbor Insurance Co.*,¹⁶⁶ the defense successfully persuaded the California Court of Appeal that the federal bad faith rule allowing plaintiffs to recover attorneys' fees in addition to punitive damages should not be adopted in that state.¹⁶⁷ In light of the large attorneys' fees often expended in pursuit of bad faith cases,¹⁶⁸ this precedent has been extremely beneficial to California insurers. Other defense arguments have been less successful; an Oklahoma attorney recently contended that "[t]he judicially created classification of insurance contract cases allowing punitive damages in those cases while all other contract cases preclude punitive damages is a violation of the equal protection and due process clauses of the United States and Oklahoma Constitutions."¹⁶⁹ The Oklahoma courts, nonetheless, continue to recognize the action.

However, establishing bad faith is a time consuming and expensive process. In addition, the variety of theories and standards employed by the courts encourages forum shopping.¹⁷⁰ Also, the very nature of bad faith, which involves some sort of consciousness of wrongdoing, is difficult to apply to an insurance company made up of many individuals operating in different capacities. Often the denial of payment is based upon a tacit agreement between the company's personnel to do so.¹⁷¹ These factors favor a strict liability approach so that the insured whose valid claim is denied can seek redress without the difficult burden of establishing bad faith.

III. THE STRICT LIABILITY APPROACH

A. Introduction

Strict liability refers to the imposition of liability for injury without a showing of fault or negligence.¹⁷² The theory has been applied in a variety of circumstances, including liability for harm caused by wild animals,¹⁷³ escaped water,¹⁷⁴ and de-

164. Note, *supra* note 4, at 605.

165. Shernoff & Blickenstaff, *supra* note 150, at 141.

166. 85 Cal. App. 3d 105, 149 Cal. Rptr. 313 (1978).

167. However, an insured may recover attorneys' fees expended during negotiations engendered by insurer's conduct. *Mustachio v. Ohio Farmers Ins. Co.*, 44 Cal. App. 3d 358, 363-64, 118 Cal. Rptr. 581, 584-85 (1975). For an argument favoring recovery of attorneys' fees in bad faith failure to pay actions, see Note, *Attorney's Fee Recovery in Bad Faith Cases: New Directions for Change*, 57 S. CAL. L. REV. 503, 522-30 (1984).

168. In *Harbor Insurance*, for example, the plaintiff sued for \$43,000 in attorney's fees.

169. Woodard, *Punitive Damages For Bad Faith Breach of an Insurance Contract: It's Unconstitutional*, 54 OKLA. B.J. 1125, 1125 (1983).

170. Cf. *supra* text accompanying notes 97-98.

171. Cf. *Egan v. Mutual of Omaha Ins. Co.*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976).

172. BLACK'S LAW DICTIONARY 9 (5th ed. 1979).

173. See McNeely, *A Footnote on Dangerous Animals*, 37 MICH. L. REV. 1181 (1939).

174. See, e.g., *Filtrol Corp. v. Hughes*, 199 Miss. 10, 23 So. 2d 891 (1945) (water collected in an inappropriate place); *City of Barberton v. Miksch*, 128 Ohio St. 169, 190 N.E. 387 (1934) (water allowed to percolate); cf. *Stevens-Salt Lake City v. Wong*, 123 Utah 309, 259 P.2d 586 (1953) (escaped water from household pipes).

fectively built or packaged products.¹⁷⁵ It has even been employed in a criminal context for the imposition of guilt for the commission of an act without any showing of intent.¹⁷⁶ In tort cases, the strict liability theory has been confined to things or activities that are extraordinary or exceptional; “[t]here must be ‘some special use’ bringing with it increased danger to others.”¹⁷⁷ For example, storers of dynamite have been held strictly liable for damages inflicted upon people from an explosion, not caused by the storer’s illegal storage or negligence, “upon the ground that the use of dynamite is so dangerous that it ought to be at the owners’ risk.”¹⁷⁸ Perhaps the best known strict liability cases deal with the imposition of the doctrine against manufacturers or bottlers of soft drinks¹⁷⁹ or beer¹⁸⁰ bottles that unexpectedly explode. In *Escola v. Coca-Cola Bottling Co. of Fresno*,¹⁸¹ Justice Traynor, in a concurring opinion articulated the explanation for the doctrine of strict liability in tort:

Even if there is no negligence . . . public policy demands that responsibility be fixed wherever it will most effectively reduce the hazards to life and health inherent in defective products that reach the market. It is evident that the manufacturer can anticipate some hazards and guard against the recurrence of others, as the public cannot. Those who suffer injury from defective products are unprepared to meet its consequences. The cost of an injury and the loss of time or health may be an overwhelming misfortune to the person injured, and a needless one, for the risk of injury can be insured by the manufacturer and distributed among the public as a cost of doing business.¹⁸²

This Comment proposes that the Ohio Supreme Court adopt a strict liability approach for both third party failure to settle cases and first party failure to pay cases. In both settings, such an approach would mean that the plaintiff no longer would have to prove bad faith on the part of the insurance company in order to establish a prima facie case.

Under this proposal, if a liability insurer refuses to accept an offer of settlement from an injured third party at or below the policy limit and at trial the third party secures a judgment in excess of the policy limit, the insurer would be liable for the entire judgment. Even though the insurer’s contractual duty under the policy only extends to the policy limit, the excess amount could be recovered by the insured¹⁸³ as extra-contractual damages. In effect such a rule would serve as a warning to insurance companies: If they wish to refuse an offer of settlement within the policy limit and gamble that they may escape from liability altogether, they will have to gamble with their own money, not the money of the insured. In establishing a case against the insurer for the excess damages plaintiff must prove that the injured third party made an offer of settlement within the policy limit that was rejected by the

175. W. PROSSER, *supra* note 85, at 656–58.

176. KADISH, SCHULHOFER, & PAULSON, *CRIMINAL LAW AND ITS PROCESS* 323–39 (1983).

177. W. PROSSER, *supra* note 85, at 506 (interpreting English law); *see also* RESTATEMENT (SECOND) OF TORTS § 520(b) (1976).

178. *Exner v. Sherman Power Constr. Co.*, 54 F.2d 510, 513 (2d Cir. 1931).

179. *Barbeau v. Roddy Mfg. Corp.*, 431 F.2d 989 (6th Cir. 1970).

180. *Falstaff Brewing Co. v. Williams*, 234 So. 2d 620 (Miss. 1970).

181. 24 Cal. 2d 453, 150 P.2d 436 (1944).

182. *Id.* at 462, 150 P.2d at 440–41.

183. *See infra* section III.B.

insurer. If the plaintiff, after being properly notified of a settlement offer, told the negotiating insurance company not to accept the settlement offer, the refusal to accept would operate as a waiver, and the insurance company could use the waiver as a defense.

In the first party setting, if the nonliability insurer refused to pay a valid claim properly and the insured suffered further damages as a result of the insurer's refusal to pay, then the insurer would be liable for the damages caused in excess of the amount of the valid claim. This recovery is another form of extra-contractual damages,¹⁸⁴ and as such may exceed the policy limit. Under this rule the *Hoskins*¹⁸⁵ case would come out differently; because of the insurer's failure to investigate thoroughly, the plaintiffs in *Hoskins* suffered injury that should be remedied. This rule is not one of absolute liability, however.¹⁸⁶ The plaintiff still would have to show that the original claim was valid, that the insurer failed to pay within a reasonable time, that the plaintiff suffered injury, and that the injury was caused by insurer's failure to pay. As in the proposed third party rule, proof of actual malice would not be a prerequisite to recovery in excess of policy limits. The proposed first party rule also would serve as a warning to insurance companies: because they promise to protect the insured and the insured relies on this promise, the insurer must pay valid claims promptly. If the insurer wishes to gamble that a trier of fact will find the claim invalid and loses, the insurer must pay not only for the claim but also must pay extra-contractual damages for its conduct.

The size of the insurance industry in the United States is staggering;¹⁸⁷ Americans pay \$500 billion in premiums each year according to one estimate.¹⁸⁸ Yet the insurance industry is poorly regulated by statute, especially at the federal level,¹⁸⁹ and only the federal judiciary has controlled the industry with any success.¹⁹⁰ In contrast, the individual insured, who usually cannot match the sheer economic strength of the insurance company in the first place, is often in a worse financial position as a result of the "death, sickness, disability, or other misfortune"¹⁹¹ that has given rise to the claim. The insured or beneficiary may have lost its sole source of income, making it impossible to meet other financial obligations.

Against this backdrop, the strict liability approach has great appeal as a method of risk apportionment. The insurer is better able to shoulder the risk of an adverse judgment in the third party setting and the risk that the claim may not be covered in the first party case. Insurance is by definition a risk spreading institution; it is a method by which society as a whole shares the burden of the individual's loss. The concept of strict liability is consistent with this ideal; in the case of the dynamite

184. *See id.*

185. *See supra* text accompanying notes 78-86.

186. Absolute liability, as used here, would mean that insurers would be liable for all claims they refused to pay, whether or not the claims were valid.

187. Approximately 1,895,000 Americans are employed by the insurance industry. TOBIAS, *supra* note 149, at 1.

188. *Id.* at 13.

189. *Id.* at 8.

190. *Id.* at 9.

191. Comment, *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CAL. W.L. REV. 358, 376 (1978).

storer, for example, the storer has been characterized as an insurer against loss suffered within the community it operates.¹⁹²

Although the imposition of strict liability envisions that the insurance company will be colossal, the rule is not unduly harsh on the smaller insurer. One of the considerations in the assessment of punitive damages is the wealth of the defendant.¹⁹³ Therefore, the smaller insurer is protected from excessive punitive awards.

B. *Fiduciaries and Fairness*

In the third party context, the insurer acts as the insured's fiduciary in attempting to settle the claim. This fact alone should be sufficient to force the insurer to place the interests of the insured ahead of its own, although some courts have not so held.¹⁹⁴ In *Rova Farms Resort, Inc. v. Investors Insurance Co.*,¹⁹⁵ the New Jersey Supreme Court advocated the implementation of a strict liability standard, commenting that "there is more than a small amount of elementary justice in a rule that would require that in this situation where the insurer's and insured's interests necessarily conflict, the insurer, which may reap the benefits of its determination not to settle, should also suffer the detriments of its decision."¹⁹⁶ The insurer that decided to gamble and reject a settlement offer at or below policy limits would do so at its own risk. The *Rova* court also pointed out that the standard would be an easy one to apply;¹⁹⁷ establishing a case against the insurer would be far less expensive and time consuming for the insured.

Some proponents of the imposition of strict liability in third party cases believe that the approach would be inappropriate in the first party setting because it "would abrogate the insurer's right to investigate and reject invalid claims."¹⁹⁸ This argument neglects the fact that under a strict liability approach, the insurer's ability to refuse payment of *illegitimate* claims remains undiminished. A prerequisite to the recovery of extra-contractual damages is a legitimate claim for policy benefits. If the plaintiff cannot convince the jury that the insurance company breached the insurance contract, the jury will be precluded from considering bad faith in the insurer's investigation or refusal to pay the claim and will not even reach the issue of extra-contractual damages. The argument against strict liability suggests that under this approach, the insurer will be forced to pay huge punitive damages on many spurious claims. This simply is not the case. The practical effect of the rule would be to encourage more thorough investigation by the insurer. The insurer would not merely perform a perfunctory investigation to avoid a charge of bad faith, but would investigate in earnest to determine the merits of the claim in order to make an informed

192. *Exner v. Sherman Power Constr. Co.*, 54 F.2d 510, 512 (2d Cir. 1931).

193. RESTATEMENT (SECOND) OF TORTS § 908(2) (1977).

194. See *supra* text accompanying notes 41-42.

195. 65 N.J. 474, 323 A.2d 495 (1974).

196. *Id.* at 502, 323 A.2d at 510 (quoting *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 431, 426 P.2d 173, 177, 58 Cal. Rptr. 13, 17 (1967)).

197. *Id.*

198. Note, *supra* note 4, at 596.

decision whether the claim was valid. Considering the insurer's resources and the claims assessment expertise,¹⁹⁹ such a burden would be equitable.

C. Damages

Extra-contractual damages in the insurance setting may include compensatory damages for pecuniary loss and for emotional distress, even if such damages could not have been foreseen when the insured bought the policy. Thus, such damages may exceed consequential damages awarded in contract actions. Extra-contractual damages are sometimes referred to as punitive damages, although in fact the two are not synonymous. Punitive damages are one type of extra-contractual damages. In the third party setting, extra-contractual damages should equal the size of the judgment that arose from the insurer's refusal to settle. In the first party setting, the award should fully compensate the insured for injuries sustained as a result of the insurer's failure to pay. To fully remedy harm to the insured, a liberal standard, allowing recovery for all financial injury and emotional distress, should be adopted.

Traditional punitive damages, damages imposed solely to punish the defendant, also should be available to plaintiffs in these actions. Failure to pay or settle valid claims is a violation of public policy attempting to equalize bargaining power between insurer and insured and should be deterred by imposing heavy sanctions on wrongdoers. The actual malice standard currently in force in Ohio, thus, is only appropriate in deciding whether the insurer should be punished beyond the damages assessed for the insured's financial outlay and emotional distress.

D. Conclusion

As emphasized by the court in *McDowell v. Union Mutual Life Insurance Co.*,²⁰⁰ the case that most closely resembles a strict liability approach in first party actions, "[t]he risks flowing from error must be placed on the insurance company, not the insured. California has learned that contrary rules place disproportionate bargaining power in the hands of the insurance companies and permit them to compel the acceptance of unreasonable settlements."²⁰¹ Strict liability would strike a better balance between the insurer and the insured. The good faith rules in effect today go a long way towards protecting the rights of the insured. However, the standard allows many pecuniary and emotional injuries suffered by the insured due to the insurer's miscalculations to go without redress. Since the insured's financial status may be worsened by a failure to pay and will certainly be worsened by a failure to settle and because the insured's emotional distress caused by the injury or accident is likely to be exacerbated, a more stringent rule is needed.

The liability insurer that refuses to accept an offer of compromise at or below policy limits without the insured's consent should be liable for the entire judgment against the insured, including amounts in excess of the policy limits. Similarly, the

199. Comment, *supra* note 19, at 380-81.

200. 404 F. Supp. 136 (C.D. Cal. 1975).

201. *Id.* at 141.

nonliability insurer that refuses to pay a valid claim should be liable for the pecuniary damage and severe emotional distress caused by the failure to pay. Local rules may require that emotional distress always be accompanied by contemporaneous physical harm, but in any event, the recovery should not be predicated upon a showing of bad faith.

The bad faith standard has proven to be a difficult and confusing one to apply, and has failed to give the insured the protection expected under an insurance policy. Adoption of a strict liability standard is the logical and fair step beyond the good faith standard.

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