

**EGAN V. MUTUAL OF OMAHA INSURANCE CO.:
THE EXPANDING USE OF PUNITIVE
DAMAGES IN BREACH OF INSURANCE
CONTRACT ACTIONS**

In Egan v. Mutual of Omaha Insurance Co., the California Court of Appeal authorized \$2,500,000 in punitive damages for an insurer's breach of contract. Such a large award of punitive damages is unique in contract actions. This Comment examines punitive damages in general and their appropriateness in insurance contract cases. The author first discusses the evolution of the punitive damages doctrine in contract actions. He then critically evaluates the Egan decision, discussing the advantages of, and objections to, punitive damages. The author concludes that punitive damages are an effective tool for discouraging breaches by insurers.

INTRODUCTION

In 1967 the California Supreme Court, in *Crisci v. Security Insurance Co.*,¹ first characterized the breach of an insurance contract as a tort. Since then, several other California decisions have held that defendant insurance companies owe tort duties to their insureds.² As a result, the range of remedies traditionally available in contract actions has been expanded. Compensatory damages for emotional suffering, as well as punitive damages, are now available for certain breaches of insurance contracts. *Egan v. Mutual of Omaha Insurance Co.*³ represents another step in the expansion of the insured's rights against his or her insurer. The California Court of Appeal allowed \$2,500,000 in punitive damages in addition to compensatory damages for future loss. This Comment examines the significance of the *Egan* decision and concludes that punitive damages are a legitimate tool for protecting an insured from abuses by his or her insurer.

1. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

2. *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975); *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

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

The Purposes of Punitive Damages

There are two objectives in tort law. The first is to make the injured party whole. The second is to admonish the tortfeasor. As a general rule, the defendant pays one sum of money to the plaintiff. The law intends that this sum will accomplish both goals. However, depending on the extent of the injury inflicted and the defendant's moral culpability, the single sum often cannot do so.⁴ Thus, the law has developed several devices for adjusting the amount of damages in order to accomplish simultaneously the goals of admonishment and reparation. These include the award of attorney fees, statutory double or treble damages, and, most commonly, punitive damages.

The purposes of punitive damages are deterrence, punishment, compensation, bounty, and vindication. The most often cited purpose is deterrence.⁵ When a defendant's conduct has been particularly reprehensible, such as when the defendant acted with malice or reckless disregard of the consequences,⁶ it is often desirable to discourage repetition by imposing punitive damages. Increasing the severity of the admonition not only punishes the defendant for his or her misconduct, but also discourages the defendant and other potential wrongdoers from similar misconduct. Compensatory damages alone often cannot achieve this goal of admonition because the plaintiff's actual damages are not necessarily proportionate to the degree of the defendant's culpability.⁷

To serve the deterrent goal of punitive damages, the defendant's financial condition must be considered in determining the amount of the award. However, no objective standards exist for determining how large an award is appropriate in a given case. Thus, appellate courts are reluctant to interfere with a jury's award unless it appears that the award was influenced by passion and prejudice.⁸

In other cases punitive damages are used to further compensate the plaintiff.⁹ Generally, each party bears its own legal expenses. How-

4. Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173 (1931).

5. *Acheson v. Shafter*, 107 ARIZ. 576, 490 P.2d 832 (1971); RESTATEMENT OF TORTS § 908, Comment a (1939); D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 3.9, at 205 (1973); W. PROSSER, HANDBOOK OF THE LAW OF TORTS § 2, at 9 (4th ed. 1970); Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1183-84 (1931).

6. Note, *The Expanding Availability of Punitive Damages in Contract Actions*, 8 IND. L. REV. 668, 670 (1975).

7. Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1184 (1931).

8. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 3.9, at 204 (1973); C. MCCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 85, at 296-98 (1935).

9. Note, *The Expanding Availability of Punitive Damages in Contract Actions*, 8 IND. L. REV. 668, 670 (1975).

ever, when the defendant has acted outrageously, it is often desirable to force him or her to bear the plaintiff's legal expenses as well. This burden is often imposed through punitive damages.¹⁰ The plaintiff is awarded attorney fees so that an injured party will not be discouraged from seeking legal recourse because of the expenses involved.¹¹

Bounty is another rationale for punitive damages. The theory is that when an individual's injury is only minor, he or she will be discouraged from seeking recourse. But if the injury results from particularly outrageous conduct, it is desirable to encourage the injured party to protest the act. The law, therefore, makes the potential recovery more attractive.¹² Punitive damages may punish instances of oppressive conduct which are both criminal and civil wrongs but which are never prosecuted criminally. Such cases include slanders and assaults.

Another justification for punitive damages is revenge or vindication. Punitive damages can help salvage a victim's hurt pride. This award may satisfy the plaintiff's vindictive spirit and discourage him or her from seeking self-help.¹³ Thus, when a court desires to achieve any of these ends—deterrence, further compensation, bounty, or revenge—punitive damages are an effective tool.

Punitive Damages in Contract Actions

At early common law, juries had unfettered discretion to fix the amount of money damages.¹⁴ The awards were not labeled "compensatory" or "punitive." Later, however, judges wanted the awards to bear some relation to the injury suffered¹⁵ and began controlling the

10. *The New Orleans, Jackson & Great N. R.R. v. Allbritton*, 38 Miss. 242 (1859); *The New York, Chicago & St. Louis R.R. v. Grodek*, 127 Ohio St. 22, 186 N.E. 733 (1933).

11. However, only three jurisdictions have expressly recognized this function. *Doroszka v. Lavine*, 111 Conn. 575, 150 A. 692 (1930); *Wise v. Daniel*, 221 Mich. 229, 190 N.W. 746 (1922); *Fay v. Parker*, 53 N.H. 342 (1873); Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 520-21 (1957).

12. *Walker v. Sheldon*, 10 N.Y.2d 401, 179 N.E.2d 497, 223 N.Y.S.2d 488 (1961); W. PROSSER, *HANDBOOK OF THE LAW OF TORTS* § 2, at 11 (4th ed. 1971); Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1183 (1931).

13. Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 520-21 (1957).

14. C. McCORMICK, *HANDBOOK ON THE LAW OF DAMAGES* § 138, at 562 (1935); Note, *The Expanding Availability of Punitive Damages in Contract Actions*, 8 IND. L. REV. 668 (1975).

15. See Washington, *Damages in Contract at Common Law*, 47 LAW Q. REV. 345 (1931), for an in depth discussion of this area.

award of damages.¹⁶ Judges made rulings on evidence, gave jury instructions on the question of amount, and granted new trials when excessive judgments were returned.

As a result of this judicial concern, guidelines developed for regulating damages. For example, a tort defendant is liable only for damages "proximately caused" by his or her acts. Objective standards were also developed for measuring the injury suffered in contract actions. Judges were thus able to limit the juries' discretion in contract suits.¹⁷ This was achieved first by formulating norms for the amount of recovery for specific types of contract actions¹⁸—for example, nonpayment of a debt. In *Hadley v. Baxendale*,¹⁹ the common law adopted the rule of foreseeability.²⁰ *Hadley* held that contract damages are limited to those "in the contemplation of both parties at the time they made the contract."²¹ The standard is what a reasonable person would have foreseen in light of the facts known to the defendant. The *Hadley* standard has been almost universally accepted.²² Because punitive damages are not in the minds of contracting parties when a contract is formed, they were traditionally denied in contract actions.

However, new torts were recognized, and some were closely related to breaches of contract—for example, products liability. In addition, as the law imposed greater duties on contracting parties, the breach of some of these duties was treated as a tort for which punitive damages may be recoverable.²³ Although some courts still steadfastly refuse to allow punitive damages for any contract action, regardless of the circumstances,²⁴ most courts have moved away from a rigid application of *Hadley* and now allow punitive damages under certain conditions.²⁵

16. Note, *The Expanding Availability of Punitive Damages in Contract Actions*, 8 IND. L. REV. 668 (1975).

17. *Sharpe v. Brice*, 96 Eng. Rep. 557 (K.B. 1774); Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 531 (1957); Note, *The Expanding Availability of Punitive Damages in Contract Actions*, 8 IND. L. REV. 668 (1975).

18. For nonpayment of a debt, damages were limited to the amount of the debt plus interest, and then only if evidenced by a receipt. For breach of contract to sell land, damages were limited to the buyer's bare expenses. C. McCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 138, at 562 (1935).

19. 156 Eng. Rep. 145 (K.B. 1854).

20. J. CALAMARI, THE LAW OF CONTRACTS § 206, at 330 (1970).

21. 156 Eng. Rep. at 151.

22. C. McCORMICK, HANDBOOK ON THE LAW OF DAMAGES § 138, at 566 (1935).

23. W. PROSSER, *The Borderland of Tort and Contract*, in SELECTED TOPICS ON THE LAW OF TORTS 380, 402-20 (1953).

24. *Young v. Main*, 72 F.2d 640 (8th Cir. 1934); *Fordson Coal Co. v. Kentucky River Coal Corp.*, 69 F.2d 131 (6th Cir. 1934). Four states—Louisiana, Massachusetts, Washington, and Connecticut—refuse to grant punitive damages unless authorized by statute. *Brown v. Coates*, 253 F.2d 36, 40 (D.C. Cir. 1958).

25. *E.g.*, *Brown v. Coates*, 253 F.2d 36 (D.C. Cir. 1958); *Economopoulos v. Curls*, 377 S.W.2d 522 (Mo. App. 1964).

The first step in the erosion of the *Hadley* rule occurred even before that rule was firmly established. By the time several jurisdictions had accepted the rule, an exception for contracts to marry had already developed,²⁶ and punitive damages were sometimes awarded for breaches of these contracts.

The law has since recognized more and more situations in which punitive damages are appropriate.²⁷ In limited situations the law allowed punitive damages for injuries to passengers caused by a common carrier.²⁸ When the carrier is extremely negligent, its conduct is regarded as a tortious breach of its contract with the passenger and punitive damages are available. Punitive damages have also been awarded for the mishandling of a telegram which indicated on its face that it was important and should be handled carefully.²⁹ There have also been awards of punitive damages for the breach of employment³⁰ and public utility³¹ contracts.

In addition, several decisions have held that a bank is liable in tort for failure to honor a depositor's check when there are sufficient funds on account.³² Absent malice, the depositor's recovery is limited

26. *Smith v. Hawkins*, 120 Kan. 518, 243 P. 1018 (1926) (defendant is activated by bad motives); *Drobnick v. Bach*, 159 Minn. 258, 198 N.W. 669 (1924) (willful intent to break promise); *Johnson v. Travis*, 33 Minn. 231, 22 N.W. 624 (1885) (improper motives); *Baumle v. Verde*, 33 Okla. 243, 124 P. 1083 (1912) (only if defendant is guilty of oppression, fraud or malice); *Kaufman v. Fye*, 99 Tenn. 145, 42 S.W. 25 (1897) (except where the defendant is more than 60 years old at trial); *Klitzke v. Davis*, 172 Wis. 425, 179 N.W. 586 (1920) (wanton, ruthless conduct). It has been suggested that this exception exists because the breach of a contract to marry has many characteristics of a tort. Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 531 (1957).

Some states, however, do not allow punitive damages for breach of a contract to marry. *Trammell v. Vaughan*, 158 Mo. 214, 59 S.W. 79 (1900); ILL. ANN. STAT. ch. 89, § 27 (*Smith-Hurd* 1966); N.J. STAT. ANN. § 2A:23-1 (West 1952).

27. For a detailed discussion of the overlap of tort and contract law, see W. PROSSER, *The Borderland of Tort and Contract*, in SELECTED TOPICS ON THE LAW OF TORTS 380 (1953).

28. *Burrus v. Nevada-California-Oregon Ry.*, 38 Nev. 196, 145 P. 926 (1915).

29. *Williams v. Western Union Tel. Co.*, 138 S.C. 281, 136 S.E. 218 (1927) (telegram informing relative of a funeral).

30. *Peitzman v. City of Illmo*, 141 F.2d 956 (8th Cir. 1944).

31. *Birmingham Waterworks v. Keiley*, 2 Ala. App. 629, 56 So. 838 (1911) (wrongfully terminating service); *Southwestern Gas and Elec. Co. v. Stanley*, 45 S.W.2d 671 (Tex. Civ. App. 1931) (defendant acting intentionally or with gross negligence or malice).

32. *Woody v. National Bank of Rocky Mount*, 194 N.C. 549, 140 S.E. 150 (1927); *Rolin v. Steward*, 139 Eng. Rep. 245 (K.B. 1854); *Marzetti v. Williams*, 109 Eng. Rep. 842 (K.B. 1830). The general debtor-creditor rule is that a debtor is not liable in tort to his creditor for failure to pay the debt. The debtor's liability is based on

to damages reasonably and actually occurring. However, if malice is present, the depositor may recover punitive damages.³³

Brokers have also been held liable for punitive damages in certain situations.³⁴ A broker is ordinarily liable only for the loss actually caused to the principal or for any unjust enrichment the broker received by his or her actions. However, when a real estate broker's actions constitute fraud, malice, or oppression, punitive damages have been awarded.³⁵ Punitive damages have also been extended to other agent-principal situations.³⁶ As in the broker cases, these cases all involve parties who are not dealing at arm's length.

Punitive Damages in Insurance Contract Actions Before Egan

Insurance companies may commit three types of breaches of their insurance contracts. The first is refusal to defend a suit against the insured. This refusal is sometimes due to an erroneous belief that the claim is not covered by the insurance policy. However, if the claim is within the policy's coverage, the insurance company has breached its contract.

The second type of breach is refusal or delay in paying the insured's claim. In this situation the injured insured makes a claim under the policy. Rather than pay the full amount immediately, the insurer refuses to pay, delays payment, or offers the insured less than he or she is entitled to under the policy. The insurer may have some legitimate doubt about the validity or extent of the claim. It may wish to investigate. Meanwhile the insured must wait at a time when he or she may need the money the most. However, it may be against the insurer's interests to pay now and investigate later.³⁷ If the insurer knows of a potential defense to a claim, and yet pays it, it may be precluded from later arguing "mistake of fact" to recover the

contract and is limited to the amount of the debt. The reason for the exception for banks is that failure to honor a depositor's check can have the same effect on an individual's stature in the community as certain slanders or libels.

33. Annot., 126 A.L.R. 206, 227 (1940).

34. Haigler v. Donnelly, 18 Cal. 2d 674, 117 P.2d 331 (1941); Bate v. Marsteller, 232 Cal. App. 2d 605, 43 Cal. Rptr. 149 (1965).

35. Haigler v. Donnelly, 18 Cal. 2d 674, 117 P.2d 331 (1941). The reason for awarding punitive damages is partially because a broker is a fiduciary and holds a position of trust and confidence.

36. Alton v. Rogers, 127 Cal. App. 2d 667, 274 P.2d 487 (1954), *cert. denied*, 348 U.S. 982 (1955) (attorney mishandling client's funds); Rivero v. Thomas, 86 Cal. App. 2d 225, 194 P.2d 533 (1948) (illiterate gave friend power of attorney to dispose of property, and the friend kept the money); Holland v. Moreton, 10 Utah 2d 390, 353 P.2d 989 (1960) (mishandled sale of mining claims).

37. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (dissenting opinion).

money.³⁸ Also, if the insured changes position as a result of the payment, the insurer will not be entitled to restitution.³⁹ As a result, the insurer usually withholds payment. As in the refusal to defend cases, if the claim is valid, the insurer has breached the contract.

The third type of breach is the failure to accept a settlement offer from a third party when the offer is within the policy limits. In the typical situation, the insured has taken out a liability policy with a maximum liability. When the insured injures a third party, that person may offer to settle. If the settlement offer is for less than the policy limits, the insured may favor the settlement. He or she took out the insurance policy as protection against liability, and a settlement will cost him or her nothing. If the settlement offer exceeds or is near the policy limits, the insurer has no interest in settling. Its maximum liability is fixed by the policy. Therefore, if there is any chance of a judgment for less than the settlement offer, the insurer will litigate. If a judgment is returned for more than the policy limit the insurer will only pay the policy amount plus its costs of litigating. The insurer has also had the use of the money for the time it took the claimant to litigate. Thus, the insurer has lost nothing. On the other hand, the insured has no limit to his or her potential liability; he or she must pay the difference between the judgment and the policy limit. Thus, if the third party obtains a judgment in excess of the policy, the insured may have an action against its insurer.

The measure of damages for these three types of breaches has undergone extensive transformation in recent years. First, in 1914, in *Brassil v. Maryland Casualty Co.*,⁴⁰ an insurance company was held liable for the costs its insured incurred when the insurer declined to defend. It was soon established that when the insurer fails to defend its insured, it is liable for resulting damages,⁴¹ even when the insurer honestly believes that the claim is fraudulent or false; so long as the claim alleges facts which if true would subject the insurer to liability, the insurer must defend. However, the insurer's liability is limited to the policy limits, plus the insured's expenses (attorney and court costs).⁴² The rationale is that the insurer's failure to defend did not

38. *Meeme Mut. Home Protection Fire Ins. Co. v. Lorfeld*, 194 Wis. 322, 216 N.W. 507 (1927).

39. RESTATEMENT OF RESTITUTION § 69(1) (1937).

40. 210 N.Y. 235, 104 N.E. 622 (1914).

41. *Liberty Mut. Ins. Co. v. Atlantic Coast Line R.R.*, 66 Ga. App. 826, 19 S.E.2d 377 (1942); Annot., 49 A.L.R.2d 694, 711 (1956).

42. *Continental Ins. Co. v. United States Fidelity & Guar. Co.*, 528 P.2d 430 (Alaska 1974); Annot., 49 A.L.R.2d 694, 717-37 (1956).

subject the insured to any loss other than the expenses incurred in defense.⁴³

In 1924 the New Hampshire Supreme Court, in *Douglas v. United States Fidelity & Guarantee Co.*,⁴⁴ held that an insurer has an implied duty of good faith and fair dealing in disposing of third party claims.⁴⁵ The insurer's failure to exercise reasonable care to protect the insured's rights can subject the insurer to liability for negligence. Wisconsin accepted the negligence theory in 1930 in *Hilker v. Western Automobile Insurance Co.*,⁴⁶ where the insurer failed to interview eyewitnesses to an accident. The insurer then negligently failed to accept a reasonable settlement offer and a judgment was entered in excess of the policy. The insurer was held liable for the excess.

In California, two separate developments have evolved in the area of insured's rights against its insurer. First was the emergence of tort theories of liability, and second was the increased availability of punitive damages.

California, in its development of tort liability, first rejected the negligence theory of recovery which Wisconsin had accepted in *Hilker*. Instead, California substituted an implied breach of contract cause of action.⁴⁷ Negligence alone was insufficient to support a judgment in excess of the policy limits; there must also have been bad faith. Then, in 1967, in *Crisci v. Security Insurance Co.*,⁴⁸ the California Supreme Court held that the insured can sue in either tort or contract for its insurer's failure to settle a third party claim within policy limits. *Crisci* also set forth the standard of care for defendant insurers in negotiating with third parties: the prudent insurer without policy limits.⁴⁹ *Crisci* outlined the policy behind this decision: "[A]n insurer should not be permitted to further its own interests by rejecting opportunities to settle within the policy limits unless it is also willing to absorb losses which may result from its failure to settle."⁵⁰

In 1970, in *Fletcher v. Western National Life Insurance Co.*,⁵¹ applying *Crisci*, a California court held that a covenant of good faith and fair dealing is implied in every insurance contract. This covenant

43. *Mannheimer Bros. v. Kansas Cas. & Sur. Co.*, 149 Minn. 482, 184 N.W. 189 (1921).

44. 81 N.H. 371, 127 A. 708 (1924).

45. *Id.* at 373-74, 127 A. at 710-11.

46. 204 Wis. 1, 231 N.W. 257 (1930).

47. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958); *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

48. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

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

50. *Id.* at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17.

51. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

imposes a duty on the insurer not to do anything to deprive its insured of the benefits of the policy. A breach of that duty is a tort, although it may also constitute a breach of contract.⁵²

Fletcher was upheld in 1973 in *Gruenberg v. Aetna Insurance Co.*⁵³ The implied duty of good faith and fair dealing was found to be independent of any contractual obligations. This duty creates other duties for the insurer. The first of these is to accept reasonable settlement offers, and the second is to not unreasonably withhold payments due an insured under a policy. Failure to pay reasonably subjects the insurer to tort liability.

Finally, in *Silberg v. California Life Insurance Co.*,⁵⁴ the California Supreme Court found a breach of the insurer's implied duty of good faith and fair dealing without finding that the breach was malicious.⁵⁵ This development of tort liability often allows an insured to maintain a cause of action against his or her insurer when contract law alone provides no remedy.

The availability of punitive damages developed at the same time as did the tort theory of recovery. Previously, punitive damages were only available for a cause of action for fraud but not for breach of contract alone.⁵⁶ Later, punitive damages were allowed when the insurer knowingly and falsely misrepresented the terms of a disability policy, even though actual damages were nominal.⁵⁷ The *Fletcher* decision upheld the traditional view forbidding punitive damages for breach of any contract no matter how willful or fraudulent. But the court did allow punitive damages if there was tortious conduct plus fraud or oppression, even though the conduct also constituted a breach of contract. The court held that a breach of the covenant of good faith and fair dealing is a tort that would allow "in a proper case punitive damages."⁵⁸ In *Silberg*, the court reaffirmed that a

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

53. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

54. 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

55. *Id.* at 460-62, 521 P.2d at 1108-09, 113 Cal. Rptr. at 718-19.

56. *Sharp v. Automobile Club of S. Cal.*, 225 Cal. App. 2d 648, 653, 37 Cal. Rptr. 585, 588-89 (1964).

57. *Weatherbee v. United Ins. Co. of America*, 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

58. 10 Cal. App. 3d at 402, 89 Cal. Rptr. at 94. The court reasoned that an insured is entitled to at least as much protection from its insurer as it is from a stranger. The court noted that a party to a contract can recover damages caused by a third party's interference with his rights under the contract. In a proper situation the contracting party could recover punitive damages from the third

breach of the covenant of good faith and fair dealing is, in and of itself, not sufficient to justify punitive damages.⁵⁹ To warrant an award of punitive damages, there must be an intent to injure. Finally, the *Fletcher* rule of no punitive damages without a finding of fraud was modified by *Egan v. Mutual of Omaha Insurance Co.* In *Egan* the court of appeal held that fraud in the ordinary sense of the word is sufficient to support an award of punitive damages and that legal fraud need not be shown.⁶⁰

Both of these developments—the emergence of tort theories of liability and the increasing availability of punitive damages—indicate the courts' overriding concern for the insured and a desire to make recovery easier and to increase the measure of recovery.

A CRITICAL EVALUATION OF *EGAN*

The Egan Decision

The facts of *Egan* involve the mishandling of an insured's claim. Egan purchased a \$200 per month disability policy from Mutual of Omaha in 1962. The policy provided for life benefits in the event of Egan's total disability as a result of an accidental injury or a sickness confining him to home. Benefits were limited to three months' payment in the event of a "nonconfining" sickness.

On May 11, 1970, Egan fell off a roof, injuring his back. He filed a claim under his policy and received \$600 in September, 1970. A month later, Mutual's claims manager accused Egan of fraud and laughed at Egan's request for further payments. In February, 1971, Mutual sent Egan a "final" payment of \$626.66. In May, Egan was reclassified as "sick" by Mutual. Mutual then attempted to buy the policy from Egan, but he refused to surrender the policy. Later, a \$700 check was given to Egan, but he did not cash it.

During this time, Egan was unable to work and his family suffered severe financial stress. Egan's physical condition was not thoroughly investigated by Mutual. Prior to suit, Egan learned that he would never be able to work again. He again attempted to settle with Mutual but no agreement was reached.

At the trial the court found Mutual liable in tort for a bad faith denial of the insurance benefits. The jury awarded \$45,600 compensatory damages, \$78,000 for emotional distress, and \$5,000,000 puni-

party. Therefore, there is no reason to allow an insurer to do what a stranger cannot.

59. 11 Cal. 3d 452, 462, 521 P.2d 1103, 1110, 113 Cal. Rptr. 711, 718 (1974).

60. 63 Cal. App. 3d at 678, 133 Cal. Rptr. at 911.

tive damages. The appellate court found that benefits were clearly due under the policy and that even a good faith failure to pay can give rise to tort liability.⁶¹ The court held that there need not be legal fraud to support an award of punitive damages.⁶² Gaining advantage by means of dishonest acts, bad faith, or overreaching⁶³ will support an award of punitive damages.⁶⁴ The court found, however, that the amount of punitive damages bore no reasonable relation to the compensatory damages and reduced the award to \$2,500,000.⁶⁵ Finally, the court ruled that compensatory damages are to be computed under the tort rather than the contract standard⁶⁶ and allowed an award of compensatory damages for future loss. *Egan* is thus significant in at least two respects: the size of the award affirmed and the award of punitive damages where there is no legal fraud.

In considering the conduct of the defendant, the court of appeal changed the rule outlined in *Fletcher*. Under *Egan*, the plaintiff is no longer required to prove legal fraud to recover punitive damages. The plaintiff need only show fraud in the common usage sense of dishonesty, bad faith, or overreaching. This holding is consistent with the trend of California law to increase the availability of punitive damages in the area of insurer's breach of contract.

Regarding the size of the award, punitive damages must bear some reasonable relation to the defendant's wealth and the compensatory damages awarded.⁶⁷ Because the assets of the defendant will vary from case to case, the same conduct will support different awards of punitive damages. In addition, there is no theoretical limit to the award which could be justified. Although this limitless ceiling may appear appalling, it is consistent with the purposes of punitive damages. For an award to deter, it must be painful. Because the defendant's conduct determines how painful the punishment should be, and because his or her wealth is a function of how much money is neces-

61. *Id.* at 677, 133 Cal. Rptr. at 910.

62. *Id.* at 678, 133 Cal. Rptr. at 911.

63. *Id.*

64. It was necessary for the court to find some sort of fraud in view of the requirements of CAL. CIV. CODE § 3294 (West 1970):

In an action for the breach of an obligation not arising from contract, where the defendant has been guilty of oppression, fraud, or malice, express or implied, the plaintiff, in addition to the actual damages, may recover damages for the sake of example and by way of punishing the defendant.

65. 63 Cal. App. 3d at 692, 133 Cal. Rptr. at 920.

66. *Id.* at 685, 133 Cal. Rptr. at 915.

67. D. DOBBS, HANDBOOK ON THE LAW OF REMEDIES § 3.9, at 210 (1973).

sary to inflict that punishment, there is no practical way to develop a formula to compute punitive damages.

The Arguments Favoring Egan

The policy justifying the *Egan* award of punitive damages is in many ways the same policy which justifies the use of punitive damages in any action. But, due to the peculiar nature of insurance contracts, there are other factors which must be considered.

Fiduciary Relationship

The first argument favoring large awards of punitive damages centers on the conflict of interest inherent in insurance contracts. This conflict becomes apparent when a claim is filed; and it exists whether the claim is made by the insured or a third party. The insurance company considers its own interests. Failure to protect the stockholders' investment could expose the executives to claims of mismanagement. However, due to the fiduciary nature of the insurance relationship, the insurer cannot ignore the insured's interests. Indeed, the interests of the insured should be paramount. The insured has contracted for payments by the insurer. In addition to whatever contract duties the insurer has assumed, the law imposes the implied duty of good faith and fair business dealing.⁶⁸ Thus, the insurer has a duty to promptly pay legitimate claims by the insured and not to jeopardize its insured's position in negotiations with third parties.

In this context, punitive damages serve two functions. First, they discourage the insurer from engaging in misconduct. Second, as a possible bounty, they encourage the insured to seek complete recovery from his or her insurer when it tries to force the insured to settle for less than he or she is entitled.

In *Egan*, the court found that Mutual's claims adjuster was "more interested in Egan's then existing financial condition than in Egan's medical condition."⁶⁹ But it was Egan's medical condition which was determinative of his rights under the policy. Therefore, by failing to properly investigate, Mutual had ignored the only true indication of the extent of its obligations. This failure was a breach of Mutual's fiduciary duty to Egan.

Adhesive Nature of Insurance Contracts

The second major argument favoring punitive damages is the adhesive nature of insurance contracts. As mass production and large

68. *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958); *Hilker v. Western Auto. Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930).

69. 63 Cal. App. 3d at 675, 133 Cal. Rptr. at 910.

scale businesses developed in the United States, so did the use of standardized contracts.⁷⁰ The transportation, banking, and insurance industries led the way with standardized contracts.⁷¹ Typically, standardized contracts are used by a party in a strong bargaining position. The weaker party needs the goods or services and is unable to bargain for better terms; the stronger party either has a monopoly or is using an industry-wide contract.

Courts have attempted to protect the weaker party without upsetting "the elementary rules" of contract law.⁷² While acknowledging the rule that courts can interpret contracts but not make them, the courts have strained to find interpretation issues. Insurance cases have shown the courts' skill at interpreting "ambiguous" clauses to protect the policyholder when in fact there was no ambiguity.⁷³

Courts have also tried to protect the weaker party in cases where an insurance company unreasonably delays action on an application for insurance and a loss results. The law of contracts will not support recovery for the applicant.⁷⁴ The application is merely an offer, and until it is accepted no contractual duties arise. Yet the applicant can recover in many states.⁷⁵

The applicant often recovers on a negligence theory.⁷⁶ The law imposes on the insurer a duty to act without undue delay on applications. Professor Kessler states that "the courts pay mere lip service to the dogma that the common law of contracts governs insurance contracts. With the help of the law of torts they nullify those parts of the law of contracts which in the public interest are regarded as inapplicable."⁷⁷

Professor Kessler then asks: "[C]an the unity of the law of contracts be maintained in the face of the increasing use of contracts of adhesion?"⁷⁸ As evidenced by the development of tort liability in the insurance cases, the answer appears to be "no." When the insurer's

70. Kessler, *Contracts of Adhesion—Some Thoughts About Freedom of Contract*, 43 COLUM. L. REV. 629, 631 (1943) [hereinafter cited as Kessler, *Contracts of Adhesion*].

71. *Id.*

72. *Id.* at 633.

73. *Id.* at 632.

74. Annot., 32 A.L.R.2d 487, 493 (1953).

75. *Id.* at 510. See Kessler, *Contracts of Adhesion*, *supra* note 70, at 635.

76. Annot., 32 A.L.R.2d 487, 510 (1953).

77. Kessler, *Contracts of Adhesion*, *supra* note 70, at 635.

78. *Id.* at 636.

actions cause the insured injuries for which contract law offers no redress, the courts have invoked tort standards to permit recovery. At first, this was merely a duty to act on the application without undue delay.⁷⁹ Later, courts found a duty to defend.⁸⁰ Then, the courts permitted recovery when the insurer unreasonably refused to settle a third party claim.⁸¹ Finally, the court allowed recovery for delay in the handling of a claim by its own insured.⁸²

The expanding measure of damages further demonstrates the disfavor with which courts regard adhesion contracts. For a delay in acting on an application, the measure of damages could not exceed the amount of insurance for which the plaintiff applied.⁸³ For a failure to defend, damages were expanded to the policy limits plus expenses and attorney fees.⁸⁴ For failure to settle a third party claim, or delay or refusal to pay a claim by its insured, the measure of damages included recovery for mental distress and punitive damages.⁸⁵ In each of these steps, tort principles were applied to contract actions. This development was necessary, however, if any remedies were to be available to the policy holder. The insured is unable to protect himself or herself. Punitive damages and other tort principles help to balance the inequities caused by the adhesive nature of insurance contracts.

It should be noted that when courts find an adhesive contract in other areas of the law, the typical judicial action is to disregard clauses in the contract,⁸⁶ or sometimes void the entire contract.⁸⁷ However, in insurance contracts neither remedy would be appropriate. Courts have thus adopted tort principles and permit the insured

79. Annot., 32 A.L.R.2d 487 (1953). See Kessler, *Contracts of Adhesion*, note 70 *supra*.

80. *Brassil v. Maryland Cas. Co.*, 210 N.Y. 235, 104 N.E. 622 (1914).

81. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958); *Hilker v. Western Auto. Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930).

82. *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Egan v. Mutual of Omaha Ins. Co.*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

83. *Stark v. Pioneer Cas. Co.*, 139 Cal. App. 577, 34 P.2d 73 (1934); Annot., 32 A.L.R.2d 487, 536 (1953).

84. *Continental Ins. Co. v. United States Fidelity & Guar. Co.*, 528 P.2d 430 (Alaska 1974); Annot., 49 A.L.R.2d 694 (1956).

85. *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967); *Egan v. Mutual of Omaha Ins. Co.*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

86. *Henningsen v. Bloomfield Motors, Inc.*, 32 N.J. 358, 161 A.2d 69 (1960). See Kessler, *Contracts of Adhesion*, *supra* note 70, at 635.

87. *Tunkl v. Regents of the Univ. of Cal.*, 60 Cal. 2d 92, 383 P.2d 441, 32 Cal. Rptr. 33 (1963).

to recover non-contractual damages. And recently the courts have allowed less traditional measures of recovery: mental distress, punitive damages, and, in *Egan*, compensatory damages for future loss.

Deterrence

Finally, large punitive damages are necessary in insurance contract cases to serve the goal of deterrence. The rationale is that if an individual or corporation is punished severely enough, it will alter its conduct to avoid future punishment. In the case of a corporation, the stockholders will not tolerate executives who subject the corporation to large punitive damages. Therefore, the executives will either act to avoid punitive damages and protect their jobs, or be replaced by someone who will.⁸⁸ The award of \$2,500,000 against Mutual will discourage continued misconduct by Mutual. It will also serve to warn other insurers to deal fairly with their insureds.

This rationale reinforces arguments based on the adhesive nature of insurance contracts and the fiduciary relationship between the insurer and the insured. Sufficiently large punitive damage awards may be a more effective tool to combat the use of adhesive contracts than is disregarding the adhesive clauses in the contract. Punitive damages may also discourage abuses of a fiduciary relationship, especially when the insurer's liability is otherwise limited.

The Arguments Opposing Egan

There are numerous objections to punitive damages. Those discussed first are applicable to punitive damages for any action. Those objections discussed later are peculiar to insurance contracts.

Objections to Punitive Damages in General

The first general objection is that punishment is not a proper function of civil law.⁸⁹ It is the purpose of criminal law to punish

88. RESTATEMENT OF TORTS § 909 (1939), says:

Punitive damages can properly be awarded against a master or other principal because of an act by an agent if, but only if, . . . (c) the agent was employed in a managerial capacity and was acting in the scope of employment, or (d) the employer or a manager of the employer ratified or approved the act.

Comment a referring to (c) and (d) says that "where a person acting in a managerial capacity either does an outrageous act or approves of such an act by a subordinate, the imposition of punitive damages upon the employer serves as a deterrent to the employment of unfit persons for important positions."

89. *Walker v. Sheldon*, 10 N.Y.2d 401, 408, 179 N.E.2d 497, 501, 223 N.Y.S.2d

anyone who commits a public wrong. The plaintiff has been compared to a prosecuting attorney paid by the number of convictions he or she obtains.⁹⁰ The obvious fear is that anyone in that position becomes more interested in obtaining a conviction than in punishing the guilty.

Another objection rests on the procedural differences between a civil and a criminal trial. Many of the safeguards afforded a criminal defendant are absent in a civil suit. A civil defendant is tried without indictment or information, denied the opportunity to face accusers when depositions are introduced at trial, and denied the opportunity for executive clemency. In addition, a civil defendant can lose at trial by a preponderance of the evidence although the criminal prosecution must prove its case beyond a reasonable doubt.⁹¹ Also, the civil jury has great discretion as to the amount of damages. In a criminal suit the maximum punishment is limited by statute.

However, these two objections prove too much; they apply as much to the admonitory function of compensatory damages as they do to punitive damages. If these arguments are ignored with respect to compensatory damages, they should be rejected with respect to punitive damages.⁹² An additional rebuttal to these objections is that there is a difference between a criminal fine and a civil judgment. Because a slighter stigma is attached to losing a civil suit than to a criminal conviction, and because there is no chance of imprisonment in a civil suit, the safeguards normally available to criminal defendants are unnecessary. The safeguards protect the accused's interest in personal liberty. In *Egan*, Mutual was never threatened with criminal fines, and none of Mutual's employees was threatened with imprisonment.

Another objection is that punitive damages are a windfall to the plaintiff.⁹³ The plaintiff has been repaid for his or her loss through compensatory damages. Awards for pain, suffering, humiliation, indignity, and loss of reputation adequately compensate the plaintiff. Any additional recovery is a windfall. Therefore, punitive damages

488, 493 (1961) (dissenting opinion); Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1176 (1941).

90. Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1178 (1931).

91. *Murphy v. Hobbs*, 7 Colo. 541, 5 P. 119 (1884); Willis, *Measure of Damages When Property is Wrongfully Taken by a Private Individual*, 22 HARV. L. REV. 419, 421 (1909).

92. Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1183 (1931).

93. *Riewe v. McCormick*, 11 Neb. 261, 9 N.W. 88 (1881); *Spokane Truck & Dray Co. v. Hofer*, 2 Wash. 45, 52-54, 25 P. 1072, 1074 (1891); *Pegram v. Stortz*, 31 W. Va. 220, 242-43, 6 S.E. 485, 497 (1888); Willis, *Measure of Damages When Property is Wrongfully Taken by a Private Individual*, 22 HARV. L. REV. 419, 421 (1909).

might better be paid to the state. Under such a plan, the jury might be more objective toward the defendant, and there is less risk that the jury will be swayed by sympathy for the plaintiff.⁹⁴ However, the compensation and revenge functions of punitive damages justify the award of punitive damages to the plaintiff rather than the state.⁹⁵ Also, if the money were paid to the state, the plaintiff would have less incentive to bring an action when his or her actual damages are small; thus, the bounty function of punitive damages would be defeated.

A final general objection is that there is little control over excess judgments. If the court ignores the punitive aspect of compensatory damages, large punitive awards become even more excessive.⁹⁶ To curb excess damages, courts often insist that punitive damages bear some relationship to actual damages. However, there has never been any agreement as to a proper ratio, and this lack of consistency has led to some questionable results. This fact is illustrated when a grossly negligent defendant fortuitously causes only minor damage and when a barely negligent defendant through a series of unfortunate coincidences causes mass destruction.⁹⁷ Clearly, it is desirable to punish the former to a greater degree than the latter. Yet, a ratio test would support a greater award of punitive damages in the second case.

However, denying punitive damages altogether would seem too extreme a response to this argument. If inequities exist in the ratio test, the better solution is to relate punitive damages to the probable result of the defendant's conduct—as opposed to the actual result—than to deny punitive damages altogether.

94. Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 525 (1957).

95. *Id.*

96. In West Virginia, the jury is instructed regarding the punitive effect of compensatory damages:

If, after the jury has assessed damages to fully compensate the plaintiff for the injury, such damages are still not sufficient in amount to punish the defendant . . . and . . . to prevent the repetition of the same or the commission of similar wrongs, they may add such further sum, in their judgment, as may be necessary for this purpose. But if the damages assessed as compensatory are sufficient in amount to operate at the same time as a punishment and a warning, the jury are not authorized to add still a further and greater sum, and thus subject the defendant to a double punishment in the same case for the same wrong.

Mayer v. Frobe, 40 W. Va. 246, 260, 22 S.E. 58, 63 (1895). A similar instruction was approved in *Hess v. Marinari*, 81 W. Va. 500, 94 S.E. 968 (1918).

97. This example is set forth at Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1180 (1931).

As a result of these general criticisms some jurisdictions refuse to award punitive damages.⁹⁸ In the jurisdictions which do allow punitive damages, they are often frowned upon.⁹⁹ And many jurisdictions which do award punitive damages, do so only under limited conditions.¹⁰⁰

Objections to Punitive Damages in Insurance Contracts

The Hadley v. Baxendale Precedent

The first objection is the *Hadley v. Baxendale* precedent. The law is concerned with precedent because of the necessity of certainty.¹⁰¹ "Obviously a man needs certainty in the law to protect his property rights and his contract rights against a practice of changing the rules in the middle of the game."¹⁰² A party to a contract is entitled to rely on the rules of law which existed when he created and performed the contract. Thus, the adoption of a rule which would allow punitive damages for contracts might be better left to legislatures. But in insurance contracts, the acts of the insurer also border on tort. For an insurer to claim that it acted in reliance on some rules of law would be to admit wanton conduct or premeditation.

In addition, modern courts are less reluctant to tamper with precedent than they were at earlier times. This willingness may be due to the recognition that the realities of life demand that we follow sound rules and laws; and when we discover that a principle by which we have lived is erroneous we must change it to conform with the new norm. For these reasons, the *Hadley* precedent may be the weakest argument for denying punitive damages.

Passion and Prejudice when an Insurance Company is Involved

A second objection concerns the possibility that passion and prejudice have clouded juries' decisions. It is generally accepted that juries are more hostile toward insurance companies than toward individuals.¹⁰³ For this reason, the fact that a defendant has liability insur-

98. *E.g.*, *Ganapolsky v. Park Sanders*, 439 F.2d 844 (1st Cir. 1971) (applying Puerto Rico law); *Conrad v. Lakewood Gen. Hosp.*, 67 Wash. 2d 934, 410 P.2d 785 (1966).

99. *E.g.*, *Anderson v. Dalton*, 40 Wash. 2d 894, 246 P.2d 853 (1952).

100. *E.g.*, *City of Lowell v. Massachusetts Bonding & Ins. Co.*, 313 Mass. 257, 47 N.E.2d 265 (1943) (no punitive damages unless authorized by statute).

101. *Austad v. Austad*, 2 Utah 2d 49, 269 P.2d 284, (1954).

102. *Hare & Hare, Stare Decisis*, 31 ALA. LAW. 273, 276 (1970).

103. *Star Furniture Co. v. Holland*, 273 Ky. 617, 624, 117 S.W.2d 603, 607 (1938), stated: "we, as well as all courts, have held that the average juror is either unconsciously or otherwise influenced by the fact that the alleged negligent actor carries insurance." *Holman v. Cole*, 242 Mich. 402, 404, 218 N.W. 795, 796 (1928) noted: "It is a fact of which we cannot but take judicial notice, that, in

ance is generally kept from juries.¹⁰⁴ There are situations in which the fact that a defendant is insured is admissible, such as when it is relevant to ownership, agency or control, or to a witness' credibility.¹⁰⁵ But normally the jury does not learn of the insurer's existence. Yet, in direct suits against insurers, such as in *Egan*, it obviously is impossible to keep the insurer's identity a secret. Therefore, the potential for excessive verdicts returned out of passion and prejudice is greatly enhanced.

However, this objection loses its impact in view of the recent relaxation of the rule of secrecy.¹⁰⁶ Although courts may still believe that juries are swayed by the knowledge of a defendant's insurance, an insurer may sometimes be named as a party defendant and held liable for punitive damages even when it has done nothing of a culpable nature.¹⁰⁷ Therefore, the objection that an insured should not be subjected to punitive damages where it is guilty of improper conduct is unpersuasive.

*No Alternative Conduct when the Insurer Doubts
the Claim's Validity*

A third objection is that punitive damages force an insurer to pay its insured's claim even though the insurer may have some doubt about the validity of the claim. Thus, the argument runs, the insurer has no reasonable alternative. *Silberg* suggested that when there is

cases where jurors obtain information that the damages as fixed by them will be paid by insurance companies, that the amount thereof is usually greatly enhanced."

104. C. McCORMICK, HANDBOOK ON THE LAW OF EVIDENCE § 201, at 479 (1972).

105. Annot., 4 A.L.R.2d 761, 767 (1949).

106. LA. REV. STAT. ANN. § 22:655 (West 1959) provides: "The injured person . . . at [his or her] option, shall have a right of direct action against the insurer within the terms and limits of the policy. . . . This right of direct action shall exist . . . whether or not such policy contains a provision forbidding such direct action" WIS. STAT. ANN. § 803.04 (West 1977) provides: "In any action for damages caused by negligence, any insurer which has an interest in the outcome of such controversy . . . is by this section made a proper party defendant in any action brought by plaintiff in this state on account of any claim against the insured."

Texas, by judicial decision, permits the insurer to be joined when the policy is a liability policy and, therefore, for the benefit of the injured party. This procedure is permitted on the joinder theory of two transactionally related causes of action. Annot., 4 A.L.R.2d 761, 766-67 (1949).

107. C. McCORMICK, HANDBOOK ON THE LAW OF EVIDENCE § 201, at 482 (1972), suggests that because the parties and the court are entitled to know the identity of all parties to a suit, the jury, as part of the tribunal, has a right to know of the presence of an insurer who is a party in all but name only.

an alternate insurer who may be responsible for paying the claim, the first insurer should pay and put a lien on future payments by the second insurer.¹⁰⁸ This approach seems reasonable when there are competing insurers, each denying liability and each willing to wait until the matter can be litigated. However, it offers no solace to the insurer who doubts the legitimacy of a claim when no alternate insurer exists. If it turns out that the first insurer is not responsible for the payment the insurer cannot count on a second insurer for restitution. Instead, the insurer must turn to his insured for restitution. And there are three obstacles to restitution.

The first problem is that if the insurer knew of a possible defense but paid, the insurer may have waived any claim of "mistake of fact."¹⁰⁹

The second obstacle would be a reasonable change of position by the insured in reliance on the payments. If the insured makes such a change of position, the insurer cannot obtain restitution.¹¹⁰ There exists no effective way to protect the insurer. If the insurer was to inform the insured that there may be a subsequent attempt to recover the payment and that therefore the insured should not spend the payment, it would undermine the purpose of paying now and investigating later. This purpose is, of course, to give the insured the benefit of the policy when he or she needs it the most.

The final difficulty is the financial condition of the insured. Even if the insured's reliance on the payments was unreasonable or the insurer has reserved its rights to the payments, the insurer will still not recover the payment if the insured is judgment proof.

These obstacles force the insurer to make a choice: The insurer must either pay a claim which it believes invalid and attempt to recover years later the monies paid or deny the payment and risk an astronomical award of punitive damages. This may indeed put the insurer in a difficult position. Nevertheless, the potential for abuse by insurers due to the fiduciary and adhesive natures of insurance contracts more than offsets this objection. The insurer has assumed contractual duties and it is usually well paid for the risks it takes. The insurer should absorb the losses which result from its failure to settle a claim,¹¹¹ including punitive damages.

108. 11 Cal. 3d at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

109. *Meeme Mut. Home Protection Fire Ins. Co. v. Lorfeld*, 194 Wis. 322, 216 N.W. 507 (1927).

110. RESTATEMENT OF RESTITUTION § 69(1) (1937).

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

Higher Premiums

The final objection is economic. If insurers must pay huge awards of punitive damages, the public eventually bears the cost through higher premiums. The counter argument is that insurers who are forced to raise their premiums will be forced out of business and, as a result, insurance costs will not increase. This may, however, ignore the economic realities of the insurance industry. The claim is that the insurance market functions more as an oligopoly than as a free market, and, therefore, most insurers will not be driven out of business. Rather, costs will rise and the public will bear the cost.

This argument may have the most merit of all. If in fact higher premiums will result from large awards of punitive damages, then the public—rather than the insurer—bears the cost. Thus, if the insurer is able to maintain its profit margin by passing the cost of punitive damages along to other insureds, the punishment and deterrence functions of punitive damages may be defeated. However, even if the economic nature of the insurance industry is such that insurers will charge similar rates regardless of costs, punitive damages may still serve some function. Those insurers which do not have to pay large awards of punitive damages will have larger profit margins. This will encourage insurers to minimize punitive damages.

CONCLUSION

Punitive damages can be an effective means of combating breach of contracts by insurers. Although several objections to punitive damages have been expressed, only two objections have real merit: (1) there are no reasonable alternatives to withholding payments when an insurer has reasonable doubts as to the validity of a claim, and (2) the public will ultimately bear the cost of punitive damages through higher premiums.

These objections, however, must be weighed against the value of encouraging insurers to make good faith efforts to settle claims. Arguably, the insurer will take its own interests into account whenever it has genuine doubts as to the validity of a claim, regardless of the punitive damages that may be imposed. Therefore, the real value of punitive damages is to encourage insurers to settle fairly with their insureds in the absence of genuine doubt.

As to the argument that the public will pay the costs of large judgments, the impact on the insurance industry of cases awarding

punitive damages must be considered. If the availability of punitive damages has the predicted deterrent effect, there should be fewer punitive damage awards in the future and thus premiums may not rise. Furthermore, these objections to punitive damages carry little weight against the numerous justifications for their imposition, notably their deterrent effect and their potential for combatting the abuses of adhesive contracts and fiduciary relationships.

The recent response of the California courts to bad faith cases such as *Egan v. Mutual of Omaha Insurance Co.* has demonstrated that punitive damages are justified from a theoretical point of view. The responses of the insurance industry, not yet available, will determine the future value of punitive damages as a practical matter.

BRADLEY JAY FISHER