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The Overruling of Royal Globe: A "Royal Bonanza" for Insurance Companies, But What Happens Now?

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The Overruling of *Royal Globe*: A "Royal Bonanza" for Insurance Companies, But What Happens Now?†

I. INTRODUCTION

Now that *Royal Globe Insurance Co. v. Superior Court*[1] has been overruled by the California Supreme Court in *Moradi-Shalal v. Fireman's Fund Insurance Cos.*,[2] the inevitable question is: "What happens now?" Several writers have offered their opinions as to the effect of *Moradi-Shalal*,[3] but it has become abundantly clear that, in general, people are not familiar with the status of the law regarding unfair and abusive insurance claims practices.[4]

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† Moradi-Shalal v. Fireman's Insurance Cos., 46 Cal. 3d 287, 313-14, 758 P.2d 58, 75, 250 Cal. Rptr. 116, 133 (1988) (Mosk, J., dissenting) ("The majority have now replaced *Royal Globe* with a "Royal Bonanza" for insurance carriers.").

1. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979), *rev'd*, 46 Cal. 3d 287, 785 P.2d 58, 250 Cal. Rptr. 116 (1988).

2. 46 Cal. 3d 287, 758 P.2d 58, 250 Cal. Rptr. 116 (1988).

3. Bourhis, *Practical Concerns For Civil Litigators in Light of Moradi-Shalal*, 18 CTLA F. 365 (1988); Thomas, *Black Friday—Third Party Remedies Against Insurers After Moradi-Shalal and Blough*, 18 CTLA F. 359 (1988); Hahn, *Insurance Chief Should Answer to Voters*, L.A. Times, Sept. 22, 1988, § 2 (Metro), at 7, col. 3; *Insurance Revolution*, L.A. Times, Aug. 26, 1988, § 2, (Metro), at 6, col. 1; Boles, *Private Bad-Faith Suit Against Insurer Abolished by California Supreme Court*, L.A. Daily J., Aug. 22, 1988, at 1, col. 1; Hager, *Suits Against 'Bad Faith' Insurers Barred by Justices*, L.A. Times, Aug. 19, 1988, § 1, at 1, col. 1; *Insurers Win Ban On 'Bad Faith' Lawsuits*, L.A. Times, Aug. 18, 1988, § 1, at 1, col. 5.

4. Los Angeles City Attorney James Hahn stated that under *Moradi-Shalal*, "a policy holder's *only* remedy is to inform the California Department of Insurance that an insurance company has wrongfully refused to pay a claim and then hope that the department will take action against the company." Hahn, *Insurance Chief Should Answer to Voters*, L.A. Times, Sept. 22, 1988, § 2 (Metro) at 7, col. 3 (emphasis added). This is simply *not* true. Although Hahn mentions *a* remedy, it is certainly not the *only* remedy. *See infra* notes 185-88, 195-211, and accompanying text.

The law regarding unfair and abusive insurance claims practices has developed as the tort of "bad faith," or breach of the covenant of good faith and fair dealing.[5] Although independent tort actions are available for handling abusive insurance claims practices,[6] this article will focus on insurance bad faith. Section I will discuss the historical development of insurance bad faith in California, including both the common law and statutory regulations which existed prior to *Royal Globe*. A foundation will be established using the principle cases involving insurance bad faith. The relevant rulings and facts will be set forth to give the reader an understanding of how this area of the law has evolved, as well as the types of abuses the California courts are trying to prevent.

Section II will discuss the effect *Royal Globe* had on the development of insurance bad faith law, while section III will discuss the *Moradi-Shalal* decision and its impact. Finally, the author concludes that insureds still have bad faith actions against their insurance companies. However, absent assignment of a bad faith claim by an insured, a third-party victim will have to rely on traditional tort theories or future legislative intervention to recover damages for unfair and abusive insurance claims practices.

II. DEVELOPMENT OF INSURANCE BAD FAITH LIABILITY IN CALIFORNIA

The tort of bad faith is a judicially created form of extra-contractual liability[7] which emerged as early as 1899,[8] but did not become fully established until 1931.[9] Historically, breach of contract was the primary cause of action available for broken promises[10] and, there-

5. *See* S. ASHLEY, BAD FAITH LIABILITY, A STATE-BY-STATE REVIEW §§ 1:05, 2:01-02 (1987) [hereinafter ASHLEY]; J. MCCARTHY, PUNITIVE DAMAGES IN BAD FAITH CASES § 1.7 (4th ed. 1987) [hereinafter MCCARTHY].

6. *See, e.g.*, G. KORNBLUM, M. KAUFMAN, H. LEVINE, CALIFORNIA PRACTICE GUIDE, BAD FAITH ¶¶ 3:3-5 (1988) [hereinafter KORNBLUM].

7. KORNBLUM, *supra* note 6, at ¶ 1:2. Extra-contractual liability refers to the tort liability for compensatory and punitive damages recoverable over and above that which is required under the express terms of the contract. *Id.* at ¶ 1:4.

8. ASHLEY, *supra* note 5, § 1:02, at 6 (citing Rumford Falls Paper Co. v. Fidelity & Casualty Co., 92 Me. 574, 43 A. 503 (1899)). Although the Maine Supreme Court rejected plaintiffs' argument that they were entitled to indemnification for an excess judgment in an insurance dispute, Ashley notes that this is "the earliest reported case of what we now think of as insurer bad faith . . . ." *Id.*

9. *Id.* § 2:01, at 55 (citing Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on reh'g*, 204 Wis. 1, 235 N.W. 413 (1931)). The Wisconsin Supreme Court in *Hilker* ruled that although the insurer did not have a duty to settle an action against its insured, it must act in good faith when deciding whether to settle or defend an action. *Hilker*, 204 Wis. at 14-15, 231 N.W. at 258-59.

10. ASHLEY, *supra* note 5, § 1:01. "Parties could first bring an action in assumpsit for breach of a promise given in exchange for a promise [(contract)] at the beginning of the 17th century." *Id.* § 1:01 n.1 (citing T. PLUCKNETT, A CONCISE HISTORY OF THE COMMON LAW 643-46 (5th ed. 1956)).

fore, only contract damages could be recovered. However, in the mid 1900s, courts began to realize that with only contractual remedies available, insurers would, at most, be held liable for the policy limits and could therefore benefit from delaying or refusing settlement of valid claims.[11] In response to this realization, the courts began to award compensatory[12] and eventually punitive damages[13] for breaches of the covenant of good faith and fair dealing, or bad faith.[14] Although not the "true pioneers," the California courts have been at the forefront of this modern revolution in both common law and statutory interpretation.[15]

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11. KORNBLUM, *supra* note 6, ¶ 1:14. *See, e.g.*, Brown v. Guarantee Ins. Co., 155 Cal. App. 2d 679, 682-83, 319 P.2d 69, 71 (1957) (conflict of interest between insurer and insured when settlements approach policy limits).

12. *See, e.g.*, Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967); Comunale v. Traders & General 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).

13. *See, e.g.*, Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); Wetherbee v. United Ins. Co. of Am., 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

14. Bad faith is defined as "a breach of the *covenant of good faith and fair dealing* implied by law in every contract." KORNBLUM, *supra* note 6, ¶ 1:2 (emphasis in original). The breach of this covenant, independent of other tort recoveries, may give rise to tort liability, and therefore to compensatory as well as punitive damages. Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 401-02, 89 Cal. Rptr. 78, 93-94 (1970). Further, " 'bad faith' . . . [is] not meant to connote the absence or presence of positive misconduct of a malicious or immoral nature . . . ." Neal v. Farmers Ins. Exch., 21 Cal. 3d 910, 921-22 n.5, 582 P.2d 980, 986 n.5, 148 Cal. Rptr. 389, 395 n.5 (1978). Instead, it is simply the opposite of "good faith," which "emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party . . . ." *Id.* (quoting RESTATEMENT (SECOND) OF CONTRACTS § 231 comment a (tentative draft Nos. 1-7) (1973)).

15. ASHLEY, *supra* note 5, § 2:01, at 55. For excellent discussions of pre-*Royal Globe* bad faith liability in California, see Allen, *Insurance Bad Faith Law: The Need for Legislative Intervention*, 13 PAC. L.J. 833 (1982); Ashley, *Guidelines for the Insurer in Avoiding Bad Faith Exposure*, 36 FED'N OF INS. & CORP. COUNS. Q. 103 (1986); Damlos, *The Duty of Good Faith—More Than Just a Duty to Defend and Settle Claims*, 14 W. ST. U. L. REV. 209 (1986); Karp, *Avoiding Punitive Damages in Property Insurance Cases: Are We Being Intimidated By Windmills?*, 36 FED'N OF INS. & CORP. COUNS. Q. 369 (1986); Kornblum, *Royal Globe v. Superior Court: Its Impact on Litigation Involving Insurers*, 15 FORUM 967 (1980); Levine, *Demonstrating and Preserving the Deterrent Effect of Punitive Damages in Insurance Bad Faith Actions*, 13 U.S.F. L. REV. 613 (1979); Mayhew, *Bad Faith and the Uninsured Motorist Claim*, 19 FORUM 618 (1984); Rees, *Bad Faith and Unfair Claims Handling Review*, 36 FED'N OF INS. & CORP. COUNS. Q. 389 (1986); Tornehl, *Insurer's Liability for Wrongful Refusal to Honor First Party Claims*, 29 FED'N OF INS. & CORP. COUNS. Q. 397 (1979); Comment, *Damages for Mental Suffering Caused By Insurers: Recent Developments in the Law of Tort and Contract*, 48 NOTRE DAME L. REV. 1303 (1973); Comment, *Bad Faith: A Commentary*, 17 U. WEST L.A. L. REV. 1 (1985).

A. *Pre-Royal Globe Bad Faith Liability: Case Law*

Bad faith was first established in California by the court of appeal in *Brown v. Guarantee Insurance Co.*,[16] wherein the court held that the basis of the insured's cause of action should be bad faith rather than negligence.[17] The court concluded that "when an insurer engages in compromise negotiations of a claim against the insured, it owes the insured a duty to exercise good faith, for the breach of which it is liable in damages."[18] In addition, *Brown* was the first case to set out factors to be considered when deciding whether an insurer's actions constituted bad faith.[19] The court stated:

> In deciding whether the insurer's refusal to settle constitutes a breach of its duty to exercise good faith, the following factors should be considered:
> [-] the strength of the insured claimant's case on the issues of liability and damages;
> [-] attempts by the insurer to induce the insured to contribute to a settlement;
> [-] failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured;
> [-] the insurer's rejection of advice of its own attorney or agent;
> [-] failure of the insurer to inform the insured of a compromise offer;
> [-] the amount of financial risk to which each party is exposed in the event of a refusal to settle;
> [-] the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and
> [-] any other factors tending to establish or negate bad faith on the part of the insurer.[20]

In *Brown*, the insured brought an action for damages resulting from the insurer's alleged bad faith conduct in refusing to settle the claim, within the policy limits, of an injured party against the insured. In the context of this classic third-party claim,[21] the court

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16. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

17. *Id.* at 688-89, 319 P.2d at 75 ("[W]e are convinced that only bad faith should be the basis of the insured's cause of action.").

18. *Id.* at 682, 319 P.2d at 71.

19. *Id.* at 689, 319 P.2d at 75.

20. *Id.* To emphasize the long-standing quality of these bad faith factors, it is interesting to note that 30 years after *Brown* the following factors are considered when determining whether the insurer's actions constitute bad faith:

- Failure to investigate claim thoroughly (¶ 4:58);
- Failure to evaluate claim objectively (¶ 4:83);
- Unduly restrictive interpretation of policy or claim forms (¶ 4:95);
- Using improper standards to deny claim (¶ 4:98);
- Purposeful delay in payment of claim (¶ 4:107);
- Dilatory claims handling (¶ 4:102);
- Deceptive practices to avoid payment of claims (¶ 4:116);
- Abusive or coercive practices to compel compromise of claim (¶ 4:120);
- Breakdown in communications with insured (¶ 4:134);
- Unreasonable conduct during litigation (¶ 4:149).

KORNBLUM, *supra* note 6, ¶ 4:57. *See also* MCCARTHY, *supra* note 5, §§ 2.28-2.37.

21. "A 'third party case' is one in which the 'bad faith' cause of action is based on an insurance company's unreasonable handling of or *refusal to settle a third party's claim against the insured* under a liability insurance policy." KORNBLUM, *supra* note 6, 1:8 (emphasis in original). However, it is the insured who has the cause of action for

held that payment by the insured to the injured party of any verdict in excess of the policy limits was not a prerequisite to creating liability in the insurer for the full amount of the judgment.[22] Furthermore, the court held that the cause of action against the insurer for the excess judgment was assignable to the injured party.[23]

The next case in the development of bad faith liability in California was *Comunale v. Trader's & General Insurance Co.*[24] This case is best known for the supreme court's reasoning that "[t]here is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."[25] In addition, the supreme court stated:

> [T]he implied obligation of good faith and fair dealing requires the insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty.
>
> The insurer, in deciding whether a claim should be compromised, must take into account the interest of the insured and give it at least as much consideration as it does to its own interest.[26]

Therefore, not only is the implied covenant of good faith and fair dealing found in every contract, but an insurer may have an affirmative duty to settle in an appropriate case.

Like *Brown, Comunale* involved an insured who brought an action for damages because of the insurer's bad faith in refusing to settle a claim within the policy limits of an injured party against the insured. These excess judgment cases refined bad faith liability.

In *Comunale*, the injured third party sued the insured for personal

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breach of the implied covenant, usually for excess liability actions, because privity of contract exists between the insured and the insurer. Damlos, *supra* note 15, at 224. "A third party claimant does *not* have the right to proceed under a contract of the implied covenant of good faith and fair dealing because there is *no* privity of contract." *Id.* at 223 (emphasis added). When a claim is *against* the insured, it is a third-party claim and the third party is the allegedly injured party. MCCARTHY, *supra* note 5, § 1.7, at 21. A first-party claim occurs when an insured brings *its own claim* against the insurance company for mishandling its claim under coverage providing for direct reimbursements. *Id.; see also* KORNBLUM, *supra* note 6, at ¶ 1:5. Examples of first-party claims include: life, health, and disability insurance, as well as medical, collision, and uninsured motorist coverage under liability insurance coverage. KORNBLUM, *supra* note 6, ¶ 1:6-7. An injured third party may have a first-party claim by becoming an additional insured under the insured's policy (*e.g.*, permissive driver or occupant). *Id.* at ¶ 1:12.1.

22. Brown v. Guarantee Ins. Co., 155 Cal. App. 2d 679, 689-90, 319 P.2d 69, 75-76 (1957).

23. *Id.* at 693-95, 319 P.2d at 78-79.

24. 50 Cal. 2d 654, 328 P.2d 198 (1958).

25. *Id.* at 658, 328 P.2d at 200 (citation omitted).

26. *Id.* at 659, 328 P.2d at 200-01 (citing Ivy v. Pacific Auto. Ins. Co., 156 Cal. App. 2d 652, 659, 320 P.2d 140, 146 (1958)).

injuries resulting from an automobile accident. Although the insured informed his insurer of the pending suit, the insurer refused to defend the action. As a result, the insured was forced to obtain independent counsel to defend the suit. Subsequently, the third party offered to settle the case for $16,000 less than the total policy limits.[27] The insured could not afford to pay but demanded that the insurer pay the claim, thereby settling the suit. The insurer, however, refused to pay the settlement amount and, at trial, the third party recovered a verdict for $15,000 over the policy limits.[28] In a subsequent indemnity action brought by the insured against his insurer, the insured recovered the policy limit and then assigned his rights in a bad faith cause of action to the third party, thus allowing the injured third party to recover the excess judgment.[29]

In holding the insurer liable for the amount in excess of the policy limits, the court established the foundation for future bad faith liability:

> An insurer who denies coverage does so at his own risk, and, although its position may not have been entirely groundless, if the denial is found to be wrongful it is liable for the full amount which will compensate the insured. . . . Certainly an insurer who not only rejected a reasonable offer of settlement but also wrongfully refused to defend should be in no better position than if it had assumed the defense and then declined to settle. The insurer should not be permitted to profit by its own wrong.[30]

The supreme court also noted, in dictum, that breach of the implied covenant of good faith and fair dealing sounded in both tort and contract.[31]

In the 1967 landmark case of *Crisci v. Security Insurance Co.*,[32] the California Supreme Court relied on the dictum in *Comunale* to firmly establish tort liability for insurance bad faith.[33] The court held "that a plaintiff who as a result of a defendant's tortious conduct loses his property and suffers mental distress may recover not only for the pecuniary loss but also for his mental distress."[34] In reaching this conclusion, the court restated its earlier reasoning in

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27. *Id.* at 657, 328 P.2d at 200 (The insured was covered under a policy with limits of $10,000 per person injured and $20,000 per accident. The Comunales had offered to settle the case for $4,000.).

28. *Id.* (Mr. Comunale was awarded a verdict of $25,000 while his wife was awarded $1250.).

29. *Id.* at 662-63, 328 P.2d at 202.

30. *Id.* at 660, 328 P.2d at 202.

31. *Id.* at 663, 328 P.2d at 203.

32. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). For additional analysis of this decision, see Levit, *The Crisci Case—Something Old, Something New*, 12 INS. L.J. 12 (1968); Note, *Insurance—Insurer Liability for Excess Judgment Upon Failure to Accept Reasonable Settlement Demand in Good Faith; Merits of Absolute Liability Given Favorable Consideration: Crisci v. Security Insurance Co.*, 5 SAN DIEGO L. REV. 228 (1967).

33. KORNBLUM, *supra* note 6, § 1:16.

34. *Crisci*, 66 Cal. 2d at 433-34, 426 P.2d at 179, 58 Cal. Rptr. at 19.

Comunale,[35] adding that "[l]iability is imposed not for bad faith breach of the contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing."[36] Furthermore, the court found that a cause of action for bad faith was not dependent upon proof of actual dishonesty, fraud, or concealment.[37]

The court in *Crisci* was able to lay quite a foundation for future bad faith liability and was the first case to allow recovery against an insurer for mental suffering.[38] The extreme facts in this third-party case made it all possible.[39] Mrs. Crisci, an elderly immigrant widow whose primary asset was her apartment building, had a $10,000 liability insurance policy with the defendant insurance company covering her building. One of her tenants fell through a defective step in an outside stairway and was left hanging for some period of time. Although the tenant sustained only minor injuries, she developed a severe psychosis, and subsequently filed a personal injury suit against Mrs. Crisci for $400,000.[40]

The defendant insurance company rejected a settlement demand of $9,000 of which Mrs. Crisci offered to pay $2,500, even though they knew that the tenant could recover a possible verdict of at least $100,000.[41] The insurer offered no more than $3,000. The suit went to trial where the tenant was awarded a jury verdict of $101,000.[42] The verdict was affirmed on appeal, and the insurer paid its $10,000 policy limit, leaving Mrs. Crisci responsible for the excess judgment of $91,000.[43] As a result, Mrs. Crisci lost her property, becoming indigent, which led to her decline in health and subsequent suicide attempts.[44] She eventually brought suit against the insurance company for its wrongful refusal to settle within the policy limits.

In holding Security Insurance Company liable for the excess judg-

35. *Id.* at 429, 426 P.2d at 177, 58 Cal. Rptr. at 16. *See also supra* notes 24-30 and accompanying text.

36. *Crisci*, 66 Cal. 2d at 430, 426 P.2d at 177, 58 Cal. Rptr. at 17.

37. *Id.*

38. Comment, *An Insurance Company's Duty to Settle: Qualified or Absolute?*, 41 S. CAL. L. REV. 120, 134 & n.78 (1968).

39. Callahan, *Some Thoughts on the Avoidance of Extra-Contractual Damages in California Insurance Litigation*, 14 W. ST. U.L. REV. 73, 96, 103 (1986).

40. Crisci v. Security Ins. Co., 66 Cal. 2d 425, 428, 426 P.2d 173, 175, 58 Cal. Rptr. 13, 15 (1967).

41. *Id.* at 428, 426 P.2d at 175-76, 58 Cal. Rptr. at 15-16.

42. $100,000 was for the tenant and $1000 was for her husband. *Id.*

43. *Id.* at 428-29, 426 P.2d at 176, 58 Cal. Rptr. at 16.

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

ment and the resulting mental suffering,[45] the supreme court noted that liability insurance contracts are personal in nature, and not commercial.[46] Therefore, where there exists a special relationship between the parties resulting from an extreme disparity in the parties' bargaining positions and financial situations, insurance companies will be held liable if they do not fulfill their contractual obligations with good faith and fair dealing.[47]

The establishment of the implied covenant of good faith and fair dealing in *Brown, Comunale,* and *Crisci* formed the basis of insurer liability for damages to its insured resulting from a third party's claim against the insured. The next step in the development of bad faith liability in California was the extension of bad faith liability to insureds in first-party claims.[48] One case leading the California courts to award extra-contractual damages to insureds in first-party cases was *Wetherbee v. United Insurance Co. of America.*[49]

In *Wetherbee,* the court of appeal held that an insurer who enters into a disability insurance policy without intending to perform the obligations could be liable for both actual and punitive damages.[50] Despite the insurer's representations to the contrary, its intent not to perform the obligations under the contract could be inferred from its subsequent refusal to pay a valid claim.[51]

The insured in *Wetherbee* had thought about canceling her insurance policy; she decided to retain it after receiving a letter from her insurance company assuring her that should she become sick or injured she would be entitled to lifetime benefits and that the policy could not be terminated if she became permanently disabled.[52]

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

46. *Id.* at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19.

> [P]laintiff did not seek by the contract involved here to obtain a commercial advantage but to protect herself against the risks of accidental losses, including the mental distress which might follow from the losses. Among the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental loss, and recovery of damages for mental suffering has been permitted for breach of contracts which directly concern the comfort, happiness or personal esteem of one of the parties.

Id. (citations omitted).

47. MCCARTHY, *supra* note 5, § 1.8, at 23; *see* Crisci v. Security Ins. Co., 66 Cal. 2d 425, 433-34, 426 P.2d 173, 179, 58 Cal. Rptr. 13, 19 (1967).

48. *See supra* note 21. "Most commentators . . . disagree with this extension of bad faith into first party cases and view it as more of a social policy decision on the part of the courts to deter untoward conduct." Callahan, *supra* note 39, at 103.

49. 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968).

50. *Id.* at 932, 71 Cal. Rptr. at 770. The court found that the insurer's post-claim conduct was sufficient to support their conclusion that the insurer never intended to fulfill the obligations of either the renewed first policy or the subsequently purchased policy. *Id.* at 932, 71 Cal. Rptr. at 770-71.

51. *Id.* at 931-32, 71 Cal. Rptr. at 769-70.

52. *Id.* at 925, 71 Cal. Rptr. at 766.

Shortly after retaining her policy she suffered a stroke which rendered her permanently disabled. After paying benefits for two years, the insurance company discontinued the payments.

Prior to discontinuing the payments, the insurer sent the insured's physician a letter asking how long the disability would last in order to be able to cut off the benefits as soon as possible.[53] In addition to the letter, the insurer conducted its own investigation into the insured's physical capabilities in an effort to stop the payments, but was unable to discover any information to invalidate her claim.[54] However, a later discovery revealed that the insured was able to go to church and make her monthly visits to her physician.[55] As a result, the insurer cut off her disability payments.[56] The appellate court found the insurer's conduct to be unreasonable[57] and fraudulent. It therefore affirmed an award of actual and punitive damages in this first-party suit.[58]

In the 1970 case of *Fletcher v. Western National Life Insurance Co.*,[59] California became the first state to extend bad faith liability to first parties.[60] In addition, *Fletcher* is well-known for being the first case to make use of intentional infliction of emotional distress as it applies to insurance.[61]

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53. *Id.* at 932, 71 Cal. Rptr. at 770. "The [insurer] sent [the insured's] physician an artfully worded letter which indicated its desire to assure [the insured] uninterrupted coverage and added, apparently as an afterthought, a postscript inquiring whether [the insured] was continously confined within her home." *Id.*

54. *Id.* at 925, 71 Cal. Rptr. at 770.

55. *Id.* at 926, 71 Cal. Rptr. at 776. This discovery was supported by the insured's physician's response to the insurer's letter. The physician had responded that the insured was *not* confined to her home, as she was capable of making her appointments with the aid of a crutch, a footbrace, and another person. *Id.*

56. *Id.* at 932, 71 Cal. Rptr. at 770.

57. For a list of the types of conduct modern courts consider "unreasonable" in bad faith actions, see KORNBLUM, *supra* note 6 ¶ 4:57.

58. Wetherbee v. United Ins. Co. of Am., 265 Cal. App. 2d 921, 931-32, 71 Cal. Rptr. 764, 770 (1968).

59. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

60. ASHLEY, *supra* note 5, §§ 2:03-2:04.

61. *Id.* at 397, 89 Cal. Rptr. at 90. *See also* Note, *The Widening Scope of Damages for the Disability Insurer: Fletcher v. National Life Insurance Co.*, 7 CAL. W.L. REV. 496, 501-502 (1971); Note, *Damages For Mental Suffering Caused by Insurers: Recent Developments in the Law of Tort and Contract*, 48 NOTRE DAME L. REV. 1303, 1307 (1973); Note, *Insurance-Disability Insurer's Refusal to Pay Gives Rise to Action in Tort—Fletcher v. Western National Life Insurance Co.*, 47 WASH. L. REV. 489, 492 (1972). For a discussion on the tort of intentional infliction of emotional distress and its application to insurance, see Keenan & Gillespie, *The Insurer and The Tort of the International [sic] Infliction of Mental Distress: Fletcher v. Western National Life Insurance Co.*, 39 INS. COUN. J. 335 (1972).

Although the court of appeal in *Fletcher* expressed liability in terms of intentional infliction of emotional distress,[62] it opened the door for first-party bad faith actions by noting:

> An insurer owes to its insured an implied-in-law duty of good faith and fair dealing that it will do *nothing* to deprive the insured of the benefits of the policy. Included within this duty in the case of a liability insurance policy is the duty to act reasonably and in good faith to settle claims against the insured by a third person. . . . We think that, similarly, the implied-in-law duty of good faith and fair dealing imposes upon a disability insurer *a duty not to threaten to withhold or actually withhold payments*, maliciously and without probable cause, for the purpose of injuring its insured by depriving him of the benefits of the policy. We think that . . . the violation of that duty sounds in tort notwithstanding that it also constitutes a breach of contract.[63]

The court also held that "independent of the tort of intentional infliction of emotional distress, such conduct on the part of a disability insurer constitutes tortious interference with a protected property interest of its insured for which damages may be recovered for . . . economic loss as well as emotional distress . . . and, in a proper case, punitive damages."[64]

Just as the facts in *Crisci* and *Wetherbee* led the courts to compensate the victims for the insurers' claims-handling abuses, the facts in *Fletcher* also illustrate the types of abuses the courts have been attempting to eliminate. The insured in *Fletcher*, a forty-one-year-old manual laborer and father of eight children, had purchased disability insurance from the insurer to provide disability payments in the event of his becoming totally disabled. While insured, Fletcher sustained a back injury, the result of a lifting accident at work. The insurer began paying disability benefits but one of its claims supervisors immediately set out to find some way to characterize the insured's injury as a "sickness," thereby allowing the insurer to cut off payments after two years, as provided by the terms of the policy.[65]

Although the doctors involved unanimously agreed that the insured was injured as a result of the lifting accident, the claims supervisor seized upon every opportunity to classify it as a sickness.[66] At one point, the supervisor interpreted a medical diagnosis which stated that the insured's back injury involved an "irritation of the cauda equina," a collection of spinal roots resembling the tail of a

62. Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 385, 89 Cal. Rptr. 78, 92 (1970).

63. *Id.* at 401, 89 Cal. Rptr. at 93 (citations omitted) (emphasis added).

64. *Id.* at 401-02, 89 Cal. Rptr at 93-94.

65. *Id.* at 388, 89 Cal. Rptr. at 84. The policy provided that if the disability was due to "sickness," the payments of $150.00 per month would be limited to two years, but if the disability were caused by an "injury" they could continue for up to 30 years. *Id.* at 386, 89 Cal. Rptr. at 83.

66. *Id.* at 388-89, 89 Cal. Rptr. at 84-85.

horse,[67] to mean that the insured had contracted a sickness from a horse.[68] Later, the claims supervisor discovered a suggestion in one of the medical reports that the insured's injury may have been contributed to by a "congenital back ailment." Because the insured had not disclosed this congenital back ailment on his application the insurer accused him of fraudulently concealing the information, terminated the payments, and demanded the return of all previously paid benefits.[69] Knowing that the insured was completely unaware of the congenital back ailment at the time he applied for the insurance, and that his family was in a difficult financial situation,[70] the claims supervisor tendered a settlement offer for the release of the policy and threatened to sue if it was not accepted.[71] In the subsequent trial, the claims supervisor admitted that he would use the same tactics again if a similar situation arose.[72]

After reviewing the outrageous[73] claims practices of the insurer, the appellate court affirmed the award from the lower court[74] and held that:

> [D]efendants' threatened and actual bad faith refusals to make payments under the policy, maliciously employed by defendants in concert with false and threatening communications directed to plaintiff for the purpose of causing him to surrender his policy or disadvantageously settle a nonexistent dispute is essentially tortious in nature and is conduct that may legally be the basis for an action for damages for intentional infliction of emotional distress.[75]

By allowing recovery of tort damages in an insurance breach of contract case, the appellate court recognized a possible independent tort cause of action for an insurer's breach of the implied covenant of

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67. *Id.* at 388 n.3, 89 Cal. Rptr. at 84 n.3.

68. *Id.* at 388, 89 Cal. Rptr. at 84.

69. *Id.* at 389-90, 89 Cal. Rptr. at 85.

70. *Id.* at 389, 89 Cal. Rptr. at 85. As a result of the payments being withheld, the insured's family lived on macaroni, beans, and potatoes (causing the insured's subsequent 47 pound weight gain). They lacked clothing, lost some land, had their utilities shut off, and the house payments became delinquent. A daughter had to leave school, his wife had to go to work, and he was forced to beg money from his friends and neighbors to make ends meet. *Id.* at 394, 398, 89 Cal. Rptr. at 88, 91.

71. *Id.* at 390, 89 Cal. Rptr. at 85.

72. Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 392, 89 Cal. Rptr. 78, 87 (1970).

73. *Id.*

74. The jury returned a verdict of $710,000 in damages; $60,000 compensatory and $650,000 punitive. *Id.* at 408, 89 Cal. Rptr. at 98. However, the insured later accepted a final award of $60,000 in compensatory and $180,000 in punitive damages. *Id.* at 409, 89 Cal. Rptr. at 99.

75. *Id.* at 401, 89 Cal. Rptr. at 92.

good faith and fair dealing in a first-party case.[76]

The appellate court in *Fletcher* took a step forward in first-party bad faith cases, but in 1973, the California Supreme Court picked up the pace in *Gruenberg v. Aetna Insurance Co.*[77] The court firmly held that, as in third-party cases, if the insurer acts in bad faith, it will be liable for tort damages.[78] Using the foundation set by earlier decisions, the court stated:

> [I]n every insurance contract there is an implied covenant of good faith and fair dealing. The duty to so act is immanent (sic) in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself. Accordingly, when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to liability in tort.[79]

It also noted that the implied covenant is an obligation imposed by law and, therefore, breach of the covenant would give rise to a tort measure of damages, as opposed to only what is due under the terms of the contract.[80] Furthermore, the court made it clear that because the insured was basing his claim solely on breach of the implied covenant of good faith and fair dealing, the insurer's conduct did not have to be "outrageous," "severe," or display an intent to inflict emotional distress, all of which are prerequisites of a cause of action for intentional infliction of emotional distress.[81] The court stated that "since plaintiff has alleged substantial damages for loss of property apart from damages for mental distress, the complaint is sufficiently pleaded with respect to the latter element of damages."[82] Bad faith was now a separate and distinct tort theory with recoverable emotional distress damages.

The facts in *Gruenberg* leading the court to this landmark decision were not as egregious as those in *Crisci* or *Fletcher*, but they were indicative of the types of insurer conduct the courts were apparently trying to curtail.[83] Mr. Gruenberg's restaurant, which was insured

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76. MCCARTHY, *supra* note 5, § 1.8, at 24.

77. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

78. *Id.* at 581, 510 P.2d at 1042, 108 Cal. Rptr. at 490. *See also* Parks & Heil, *Insurers Beware: "Bad Faith" is in Full Bloom*, 9 FORUM 63, 71 (1973); Comment, *An Independent Duty of Good Faith and Fair Dealing in Insurance Contracts—Gruenberg v. Aetna Insurance Co.*, 11 SAN DIEGO L. REV. 492, 498 (1974); Note, *Good Faith and Fair Dealing in Insurance Contracts: Gruenberg v. Aetna Insurance Co.*, 25 HASTINGS L.J. 699, 701 (1974).

79. *Gruenberg*, 9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.

80. *Id.* at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485.

81. *Id.* at 579-81, 510 P.2d at 1041-42, 108 Cal. Rptr. at 489-90.

82. *Id.* at 580, 510 P.2d at 1042, 108 Cal. Rptr. at 490.

83. *See* MCCARTHY, *supra* note 5, § 1.8, at 27. By removing the standards of "outrageous" and "severe" from the requirements of a bad faith action, the court in *Gruenberg* "released the insured from the necessity of grafting the essential elements of a cause of action for the independent action [for bad faith]." *Id.* As a result, "when the terms and conditions for payment have been fulfilled, refusal to pay is a clear exercise of bad faith." *Id.* § 1.9, at 39. *Compare Gruenberg*, 9 Cal. 3d 566, 510 P.2d 1032,

for a total of $35,000 by three insurance companies, was destroyed by fire. While he was at the fire scene Gruenberg got into an argument with a fire department arson investigator and was arrested. The insurer's claims adjustor later informed the arson investigator that Gruenberg had excess coverage and, as a result, Gruenberg was also charged with insurance fraud.

While charges were pending against Gruenberg, the insurers' lawyer demanded an examination under oath pursuant to the "cooperation and notice" clause of the policy. Gruenberg refused to appear for the examination while the criminal charges were still pending. At the preliminary hearing on the charges of arson and fraud, the insurers' adjustor testified as to Gruenberg's excess coverage. The criminal charges were subsequently dismissed due to lack of probable cause. Gruenberg notified the claims adjustor that he would agree to appear for the examination. The adjustor then took the position that Gruenberg's claim was void and denied liability because of his earlier refusal to submit to the examination.[84] Gruenberg then brought a cause of action against the insurers for breach of the implied covenant of good faith and fair dealing, alleging that the defendants "willfully and maliciously entered into a scheme to deprive him of the benefits" due under his insurance policy.[85] In allowing Gruenberg to recover for breach of the implied covenant of good faith and fair dealing, the court noted: "While it might be argued that defendants would be excused from their contractual duties (*e.g.*, obligation to indemnify) if plaintiff breached his obligations under the policies, we do not think that plaintiff's alleged breach excuses defendants from their duty, implied by law, of good faith and fair dealing."[86] Therefore, an insurer's duty of good faith and fair dealing in a first-party claim is independent of the insured's obligation under the contract.

In the evolution of bad faith tort liability in California, *Gruenberg* exemplified the emerging trend in the 1970's of allowing more bad faith claims to succeed in cases involving substantially less egregious

108 Cal. Rptr. 480 (1973) and Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974) with Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1973) and Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1967). (The former involved substanially less egregious conduct and more of a "taking a stand on the policy" approach, while the latter involved assertive misconduct and substantially more outrageous behavior.).

84. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 571, 510 P.2d 1032, 1035, 108 Cal. Rptr. 480, 483 (1973).

85. *Id.* at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.

86. *Id.* at 578, 510 P.2d at 1040, 106 Cal. Rptr. at 488.

conduct by the insurer.[87] *Silberg v. California Life Insurance Co.*,[88] decided shortly after *Gruenberg*, further exemplified this emerging trend. In *Silberg*, Silberg was insured for hospital and surgical benefits under a policy which protected him against ruinous medical bills.[89] He was injured when he stepped on the top of a glass lid washing machine, while attempting to locate the source of smoke coming from a laundromat adjacent to his own business. The glass top broke and Silberg's foot fell into the rapidly spinning machine, severing it at the ankle. His foot was later repaired, but he was hospitalized five times for surgery.

Silberg subsequently made claims for medical benefits under both worker's compensation and his policy with California Life, both of which were denied. His insurer refused to pay any benefits because the policy excluded injuries covered by worker's compensation.[90] Therefore, it took a "wait-and-see" approach until after the outcome of the worker's compensation claim.[91] After two years of litigation, the worker's compensation claim was finally settled for a nominal amount.[92] The insurer then refused any payment under the policy, claiming that the settlement under worker's compensation precluded further claims on their policy.[93] Finally, the insurer offered Silberg a minimal amount to avoid litigation, but Silberg refused[94] and sued the insurer for the policy benefits as well as both compensatory and punitive damages.[95]

The supreme court in *Silberg* held that the insurer had violated its tort duty of good faith and fair dealing as a matter of law.[96] The conduct which led to the court's decision was (1) the insurer's interpretation of an ambiguous policy provision to its own advantage; (2) the insurer's failure to explain why it had not paid the benefits and then filed a lien against the workers' compensation claim; and (3) the insurer's refusal to pay the benefits, knowing the financial condition of

87. *See supra* note 83.

88. 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

89. *Id.* at 461, 521 P.2d at 1109, 113 Cal. Rptr. at 717. "[T]he company's policy application declared in large, heavy type, 'Protect Yourself Against the Medical Bills That Can Ruin You'." *Id.* The policy covered hospital expenses, including fees for surgery, but excluded "losses caused by injuries for which compensation was payable under any workmen's compensation law." *Id.* at 456, 521 P.2d at 1105, 113 Cal. Rptr. at 713.

90. *Id.*

91. *Id.* at 459, 521 P.2d at 1108, 113 Cal. Rptr. at 716.

92. *Id.* at 456, 521 P.2d at 1105, 113 Cal. Rptr. at 713. The Worker's Compensation Appeals Board settled Silberg's claim for $3700. *Id.* He had already incurred $6900 in medical bills, of which only $1100 was included in the worker's compensation settlement. *Id.*

93. *Id.*

94. *Id.* at 458, 521 P.2d at 1107, 113 Cal. Rptr. at 715.

95. *Id.* at 456, 521 P.2d at 1106, 113 Cal. Rptr. at 714.

96. *Id.* at 462, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

Silberg.[97] The court further noted that "[t]he scope of the duty of an insurer to deal fairly with its insured is prescribed by law and cannot be delineated entirely by the customs of the insurance industry."[98] In addition, the court held that a finding of bad faith "alone does not necessarily establish that [the insurer] acted with the requisite intent to injure [the insured]."[99] Therefore, an insurer must be guilty of "oppression, fraud, or malice"[100] before an award of punitive damages can be justified under section 3294(a) of the California Civil Code.[101]

Thus far in the evolution of common law tort liability of bad faith, unreasonable insurer conduct had been delineated and a cause of action had emerged for the insured against its insurer in both first-party and third-party claims. The inevitable question in this development, however, was to what extent a third-party victim, who is not a party to the insurance contract, may have a cause of action against the tortfeasor's insurer for bad faith conduct. Although some appellate court decisions had discussed a third party's cause of action,[102] the arguments and decisions in this regard are best exemplified by the California Supreme Court's decision in *Murphy v. Allstate Insurance Co.*[103]

In *Murphy*, the plaintiff alleged that the defendant, who was insured by Allstate, had caused the wrongful death of her nine-year-old son. Allstate rejected a settlement offer within the policy limits ($25,000) and the plaintiff was awarded a verdict of $85,000.[104] All-

97. *Id.* at 461-62, 521 P.2d at 1109, 113 Cal. Rptr. at 717. The insurer had knowledge of the extreme financial problems that Silberg was having as a result of their nonpayment of benefits, including his substantial medical bills from his multiple hospitalizations, offset by only his modest ($500 per month) income, and the failure of his business, his nonpayment of rent, his loss of utilities, and his two nervous breakdowns. *Id.*

98. *Id.* at 462, 521 P.2d at 1109, 113 Cal. Rptr. at 717.

99. *Id.* at 462-63, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

100. *Id.* at 462, 521 P.2d at 1110, 113 Cal. Rptr. at 718.

101. CAL. CIV. CODE § 3294(a) (West Supp. 1989).

102. *See* Austero v. Nat'l Casualty Co., 62 Cal. App. 3d 511, 133 Cal. Rptr. 107 (1976) (no cause of action by insured's wife against insurer because she was not a party to the insurance contract); Zahn v. Canadian Indem. Co., 57 Cal. App. 3d 509, 129 Cal. Rptr. 286 (1976) (insurer's duty to accept reasonable settlement offer is one owed to the insured and not the injured third party); Shapero v. Allstate Ins. Co., 14 Cal. App. 3d 433, 92 Cal. Rptr. 244 (1971) (no duty on part of insurer to settle with third party claimant where no risk of excess verdict to the insured's estate existed).

103. 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976), *rev'd*, 46 Cal. 3d 287, 785 P.2d 58, 250 Cal. Rptr. 116 (1988).

104. *Id.* at 940, 553 P.2d at 586, 132 Cal. Rptr. at 426. On motion for a new trial the verdict was reduced to $42,000. *Id.*

state then advised that it would pay only the policy limits and subsequently denied any obligation owing to either its insured or the plaintiff. The plaintiff then brought an action against Allstate, alleging that it breached its duty of good faith and fair dealing with its insured by refusing to settle the plaintiff's claim within the policy limits.[105]

Instead of alleging that the insured had assigned the cause of action to her, the plaintiff argued that the duty of good faith and fair dealing should be extended to third party claimants. First, plaintiff argued that section 11580(b)(2) of the California Insurance Code authorized her to proceed directly against the insurer.[106] However, the court noted that "section 11580 must be read in light of the Financial Responsibility Law"[107] and that "neither [the] third party beneficiary doctrine nor the Financial Responsibility Law warrant granting the injured claimant the right to recover from the insurer for breach of the [duty to settle]."[108] Furthermore, the court held:

> A third party should not be permitted to enforce covenants made not for his benefit, but rather for others. He is not a contracting party; his right to performance is predicated on the contracting parties intent to benefit him. As to any provision made not for his benefit but for the benefit of the contracting parties . . . he becomes an intermeddler. Permitting a third party to enforce a covenant made solely to benefit others would lead to the anomaly of granting him a bonus after his receiving all intended benefit. Because . . . the duty to settle is intended to benefit the insured and not the injured claimant, third party beneficiary doctrine does not furnish a basis for the latter to recover.[109]

The plaintiff then asserted that a direct action was permitted by a creditor's suit under section 720 of the California Code of Civil Procedure.[110] However, the court reasoned:

> Because causes of action for tort committed to property are assignable, they

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105. *Id.*

106. *Id.* Section 11580, subdivision (b) of the Insurance Code states:

> Such policy shall not be thus issued . . . unless it contains all the following provisions:
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> . . .
>
> (2) A provision that whenever judgment is secured against the insured or the executor or administrator of a deceased insured in an action based upon bodily injury, death, or property damage, then an action may be brought against the insurer on the policy and subject to its terms and limitations, by such judgment creditor to recover on the judgment.

CAL. INS. CODE § 11580(b) (West 1972).

107. Murphy v. Allstate Ins. Co., 17 Cal. 3d 937, at 943-44, 553 P.2d 584, 588, 132 Cal. Rptr. 424, 428 (citing Barrera v. State Farm Mut. Auto. Ins. Co., 71 Cal. 2d 659, 670, 456 P.2d 674, 682, 79 Cal. Rptr. 106, 114 (1969)).

108. *Id.* at 944, 553 P.2d at 588, 132 Cal. Rptr. at 428.

109. *Id.* (citations omitted).

110. *Id.* at 940, 553 P.2d at 586, 132 Cal. Rptr. at 426. Section 720 of the Code of Civil Procedure provided:

> If it appears that a person or corporation, alleged to have property of the judgment debtor, or to be indebted to him, claims an interest in the property adverse to him, or denies the debt, the judgment creditor may maintain an action against such person or corporation for the recovery of such interest or debt . . . .

> may be reached by proceedings under section 720. On the other hand, section 720 should not be applied so as to render the nonassignable assignable. And nonassignable tort actions [for punitive, emotional, and personal injury damage] may not be reached in proceedings pursuant to section 720.[111]

In addition, because a cause of action for bad faith was considered a hybrid of assignable (excess judgment) and potentially nonassignable (punitive, emotional, and personal injury) damages, and due to the potential conflicts between the injured, the insured, and the insurer, recovery under section 720 was held unavailable.[112]

However, the court did hold that insureds could partially assign and then join in the claimant's action, thereby permitting the insured to be covered from personal liability, allowing the judgment creditor to gain control of its cause of action, and protecting the insured's "right to nonassignable claims for punitive, emotional and personal injury damage."[113] Furthermore, an "insured may assign his cause of action for breach of the duty to settle without consent of the insurance carrier, even when the policy provisions provide the contrary."[114]

By unanimously holding that the insurer's duty of good faith and fair dealing runs only to its insured, the supreme court in *Murphy* answered one of the key questions remaining in the development of pre-*Royal Globe* bad faith tort liability. As one commentator noted:

> The remedy of the injured party was clear: a suit against the insured. The insured, in turn, had standing to sue the carrier directly for a breach of the implied covenant of fair dealing and good faith if the insured [sic] had wrongfully refused to settle and a judgment exceeding the policy limits was rendered. The injured claimant could obtain an assignment of this cause of action to proceed against the insurance company.[115]

Subsequent cases further refined the tort duty of good faith and fair dealing as it related to the insurance industry,[116] culminating in the

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CAL. CIV. PROC. CODE § 720 (West 1987) (repealed 1982 Cal. Stat. ch. 1364, § 1, p. 507-0). *See* CAL. CIV. PROC. CODE § 7-08.180 (West 1988) (current provision).

111. Murphy v. Allstate Ins. Co., 17 Cal. 3d 937, 946, 553 P.2d 584, 589-90, 132 Cal. Rptr. 424, 429-30 (citations omitted).

112. *Id.* at 946, 553 P.2d at 590, 132 Cal. Rptr. at 430.

113. *Id.* at 946-7, 553 P.2d at 590, 132 Cal. Rptr. at 429-30.

114. *Id.*

115. Note, *Royal Globe Insurance Co. v. Superior Court: Right to Direct Suit Against an Insurer by a Third Party Claimant*, 31 HASTINGS L.J. 1161, 1166-67 (1980).

116. *See, e.g.*, Neal v. Farmers Ins. Exch., 21 Cal. 3d 910, 922-23, 582 P.2d 980, 986-87, 148 Cal. Rptr. 389, 395-96 (1978) (court affirmed award of punitive damages based on showing of oppression, fraud, and malice in insurer's attempt to coerce an uninsured motorist settlement); Cancino v. Farmers Ins. Group, 80 Cal. App. 3d 335, 344-45, 145 Cal. Rptr. 503, 508-09 (1978) (person loading vehicle held to be additional insured under policy and, therefore, had standing to sue for wrongfully withheld benefits).

landmark case of *Royal Globe Insurance Co. v. Superior Court.*[117] Because "statutory law proved to be the springboard for imposing a duty toward third party claimants,"[118] and because *Royal Globe* was based upon the existing statutory law and its interpretation, a brief overview of the pre-*Royal Globe* statutory law is required.

B. Pre-Royal Globe Bad Faith Liability: Statutory Law

Consumers of insurance in California are protected not only by common law actions under traditional theories, such as bad faith, but they are also protected by statutory regulation under the Unfair Practices Act.[119] The Unfair Practices Act was enacted in 1959 by the California Legislature in order to regulate unfair trade practices in the insurance industry.[120] It was modeled after the National Association of Insurance Commissioners model act which was drafted in 1947.[121] By 1971, most states had adopted similar statutes.[122]

The unfair and deceptive acts prohibited under the Unfair Practices Act are enumerated in section 790.03 of the California Insurance Code.[123] Section 790.03(h) lists fifteen unfair claims practices prohibited in settlement negotiations.[124] According to one author, "the

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117. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

118. Comment, *Rodriguez v. Fireman's Fund Insurance Companies, Inc.: An Illustration of the Problems Inherent in the Royal Globe Doctrine*, 15 SW. U.L. REV. 371, 379 (1985).

119. 1959 Cal. Stat. ch. 1737, § 1, at 4187 (codified at CAL. INS. CODE §§ 790-790.10 (West 1972 & Supp. 1989)). *See also* Note, *supra* note 115, at 1167-72 (author gives a brief, yet detailed history of regulation of the insurance industry).

120. CAL. INS. CODE § 790 (West 1972).

121. Note, *supra* note 115, at 1167-68 & nn.47-51.

122. Shernoff, *Insurance Company Bad Faith Law, A Potent Weapon for Consumer Protection*, 17 TRIAL 22, 24 (May 1981). For a list of jurisdictions with Unfair Claims Practices Statutes, see MCCARTHY, *supra* note 5, at 591-93 (Appendix I).

123. CAL. INS. CODE § 790.03 (West Supp. 1989).

124. *Id.* § 790.03(h). Section 790.3 provides in pertinent part:

> The following are hereby defined as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance.
>
> . . . .
>
> (h) Knowingly committing or performing with such frequency as to indicate a general business practice any of the following unfair claims settlement practices:
>
> (1) Misrepresenting to claimants pertinent facts or insurance policy provisions relating to any coverages at issue.
>
> (2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
>
> (3) Failing to adopt and implement reasonable standards for the prompt investigation and processing of claims arising under insurance policies.
>
> (4) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss requirements have been completed and submitted by the insured.
>
> (5) Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.
>
> (6) Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ulti-

types of insurer misconduct constituting common law bad faith with respect to the handling of claims are generally the same type of misconduct addressed by [the Unfair Practices Act]."[125]

Enforcement under the Unfair Practices Act is primarily through the Insurance Commissioner who is given the authority to examine and investigate business affairs,[126] issue orders to show cause,[127] conduct hearings,[128] issue injunctive orders,[129] levy fines and penalties,[130] suspend or revoke licenses,[131] and promulgate rules and regulations necessary for the administration of the Act.[132] However, as one commentator noted:

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mately recovered in actions brought by such insureds, when such insureds have made claims for amounts reasonably similar to the amounts ultimately recovered.

(7) Attempting to settle a claim by an insured for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.

(8) Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured, his representative, agent, or broker.

(9) Failing, after payment of a claim, to inform insureds or beneficiaries, upon request by them, of the coverage under which payment has been made.

(10) Making known to insureds or claimants a practice of the insurer of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.

(11) Delaying the investigation or payment of claims by requiring an insured, claimant, or the physician of either, to submit a preliminary claim report, and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

(12) Failing to settle claims promptly, where liability has become apparent, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

(13) Failing to provide promptly a reasonable explanation of the basis relied on in the insurance policy, in relation to the facts or applicable law, for the denial of a claim or for the offer of a compromise settlement.

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

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

Id.

125. MCCARTHY, *supra* note 5, § 1.11, at 43. In addition, McCarthy notes:

Three recent cases have emphasized that a statutory bad faith action as provided for by the California Unfair Practices Act (Cal. Ins. Code § 790.03) is merely a codification of, and is coextensive with, a common-law bad faith action against an insurer, having identical elements, standards, and remedies.

Id. § 2.21, at 250-51 (citations omitted).

126. CAL. INS. CODE § 790.04 (West 1972).

127. *Id.* §§ 790.05, 790.06(a).

128. *Id.* § 790.06.

129. *Id.* § 790.06(d).

130. CAL. INS. CODE § 790.07 (West Supp. 1989).

131. *Id.*

132. CAL. INS. CODE § 790.10 (West 1972).

> [A]lthough there has been significant consumer protection legislation directed at unfair claims practices on the books since the early 1970s, insurance commissioners . . . have rarely sought to enforce these important statutes. Even when an insurance commissioner has attempted enforcement, the only remedy—and it is not really an effective remedy—has been a cease and desist order and a penalty of $50 for violation of such an order, or $500 for a willful violation.[133]

The enforcement problem came to an abrupt halt when the California Supreme Court, in *Royal Globe*[134] "held that no longer were the statutory remedies the private domain of insurance commissioners, but now, for the first time, the commissioner could receive the unwanted help of trial lawyers who could bring bad faith actions based upon violations of these statutes."[135]

III. THE IMPACT OF *ROYAL GLOBE* ON THE DEVELOPMENT OF BAD FAITH LIABILITY

As the preceding section indicates, by 1979 the tort of bad faith, or breach of the covenant of good faith and fair dealing, was firmly established as a common law cause of action which would address the unfair practices of insurance companies in California. Insureds had common law causes of action for insurer's bad faith conduct in both third-party claims[136] and first-party cases,[137]while third-party victims

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133. Shernoff, *supra* note 122, at 24. The enforcement problem and the "apathy, ineffectiveness, and failure of administrative agencies to adequately regulate insurance companies" was explained in Levine, *supra* note 18, at 626, wherein the author quotes an excerpt from the JOINT LEGISLATIVE AUDIT COMMITTEE, REPORT TO THE CALIFORNIA LEGISLATURE: REVIEW OF THE DISCIPLINARY FUNCTION OF THE DEPARTMENT OF INSURANCE, SUMMARY 1 (1977):

> The Department of Insurance's organization and procedures for investigating and resolving public complaints against insurance companies and agents are seriously deficient. Little effort is made to investigate overall patterns of complaints about insurers' business practices upon which serious discipline might be based. Although the Department more effectively addresses public complaints against insurance agents, inadequate management of the investigation of these complaints has resulted in insufficient investigations and an unnecessary backlog of work. The Department's fragmented organization of investigative and disciplinary functions and a lack of uniform procedures compound these problems.
>
> In its disciplinary actions, the Department's Legal Division has given preferential treatment to selected licensees, notably insurance companies and those insurance agents whose attorneys are former key Department officials. Such licensees have been permitted to negotiate and reduce proposed discipline in a manner inconsistent with normal Department procedure.
>
> The Department's inability to enforce the Unfair Practices Act was further commented upon by Los Angeles city attorney James Hahn when he stated that the Department's lack of resources ($30 million budget compared to $30 billion of insurance written in California) and the appointment, rather than the election, of the Insurance Commissioner are the keys to the Department's ineffectiveness. Hahn, *supra* note 3, at 7.

134. 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979). For a discussion of how the courts interpreted the Act prior to *Royal Globe*, see Houser, *Unfair Claims Settlement Practices Act—How the Courts Have Interpreted the Act*, 15 FORUM 336 (1979).

135. Shernoff, *supra* note 122, at 24.

136. *See supra* text accompanying notes 21-47.

could recover for some violations by obtaining an assignment from the insured.[138] In addition, insurer's bad faith conduct was regulated statutorily under the Unfair Practices Act.[139] Bad faith, and the punitive damages associated with it, had begun "to acquire the characteristics of a strong, silent consumer public advocate."[140]

In 1979, bad faith via *Royal Globe* became a strong consumer advocate by adding "a new weapon to the arsenal of trial lawyers in protecting the rights of insurance consumers."[141] "[F]or the first time, third party claimants could sue the insurer directly for certain unfair practices after conclusion of the liability action against the insured."[142]

In *Royal Globe*, the "sole issue . . . [was] whether an individual who is injured by the alleged negligence of an insured may sue the negligent party's insurer for violation of [subdivision (h) of section 790.03]."[143] The court allowed a third party claimant to bring a cause of action against an insurer based upon violations of subdivision (h), provided that any suit the injured party may have had against the insured had been concluded.[144]

The facts which led the supreme court to this decision were certainly not as egregious as those in earlier landmark decisions involving bad faith. The plaintiff, in *Royal Globe*, filed an action for personal injuries sustained in a slip-and-fall accident in a food market. She subsequently joined defendants Royal Globe Insurance Company, who insured the market, and an independent adjusting company which was alleged to be an agent of Royal Globe. She alleged that defendants had violated subdivision (h)(5)[145] and subdivi-

137. *See supra* text accompanying notes 48-101.

138. *See supra* text accompanying notes 102-18.

139. *See supra* text accompanying notes 119-35.

140. Levine, *supra* note 15, at 615.

141. Shernoff, *supra* note 122, at 25. For a thorough survey of the impact of *Royal Globe* on insurance bad faith practices, see Callahan, *supra* note 39; Ailkin & Abeltin, *When Does "The Fat Lady Sing" for Purposes of a Royal Globe Action? Endless Litigation Over What Does or Should Constitute the Resolution of a Claim*, 14 W. ST.U. L. REV. 56 (1986); Comment, *A Statutory Action for Insurer Bad Faith—Reasonably Clear Remedy for the Third Party Claimant*, 11 PAC. L.J. (1980); Comment, *The Permissibly Self-Insured: An Argument For Extension of the Unfair Claims Practices Act*, 14 W. ST. U.L. REV. 251 (1986).

142. KORNBLUM, *supra* note 6, at ¶ 1:24.

143. Royal Globe Ins. Co. v. Superior Court, 23 Cal. 3d 880, 884, 592 P.2d 329, 331, 153 Cal. Rptr. at 842, 844 (1979). *See supra* note 124 for text of section 790.03(h).

144. *Royal Globe*, 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.

145. Subdivision (h)(5) directs insurers to attempt to "effectuate prompt, fair, and equitable settlements." CAL. INS. CODE § 790.03(h)(5) (West Supp. 1989).

sion (h)(14).[146] Plaintiff sought physical and emotional damages, as well as punitive damages for these violations.[147]

Royal Globe demurred and filed a motion for judgment on the pleadings claiming: (1) that the exclusive power to enforce subdivision (h) rested with the Insurance Commissioner; (2) that the legislative intent of subdivision (h) was to protect only the insured and, therefore, a third-party claimant lacked standing to bring such an action; and (3) that the plaintiff must bring separate suits against the insured and the insurer. After the trial court overruled the demurrer and denied the motion, Royal Globe sought a writ of mandate from the California Supreme Court in an effort to vacate the trial court's orders.[148] The supreme court, in a 4-3 decision, allowed the writ to issue, but also held that a third-party claimant could bring an action against an insurer for violating the subdivisions of section 790.03(h).[149]

The first step in the court's analysis was whether a private litigant may bring an action against an insurer for violation of section 790.03 of the Insurance Code, or whether section 790.03 grants the sole authority of enforcement to the insurance commissioner.[150] The court reasoned that section 790.09 provided private litigants with a cause of action against insurers who violate the provisions of subsection (h).[151]

The second step in the court's analysis was whether third-party claimants are precluded from relying on section 790.03 for a private cause of action because of the contention that section 790.03 is only meant to protect insureds.[152] The court concluded that since section 790.03 refers to claimants, and since the legislative history indicates that the legislature failed to exercise their opportunity to change the language of the Act in order to clarify its application, third parties were to be protected by section 790.03.[153] Royal Globe argued that the supreme court's unanimous decision in *Murphy v. Allstate Insur-*

146. Subdivision (h)(14) prohibits "[d]irectly advising a claimant not to obtain the services of an attorney." *Id.* § 790.03(h)(14).

147. *Royal Globe*, 23 Cal. 3d at 884, 592 P.2d at 332, 153 Cal. Rptr. at 845.

148. *Id.*

149. *Id.* at 884, 892, 592 P.2d at 332, 337, 153 Cal. Rptr. at 845, 850.

150. *Id.* at 885, 592 P.2d at 332, 153 Cal. Rptr. at 845. The commission is granted the authority to conduct investigations, CAL. INS. CODE § 790.04 (West 1972), issue cease and desist orders, *Id.* § 790.05, and enforce penalties for unfair business practices. *Id.* § 790.08. In addition, section 790.09 provides in pertinent part:

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

CAL. INS. CODE § 790.09 (West 1986) (emphasis added).

151. *Royal Globe*, 23 Cal. 3d at 885, 592 P.2d at 332, 153 Cal. Rptr. at 845.

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

153. *Id.* at 888-89, 592 P.2d at 334-35, 153 Cal. Rptr. at 847-48.

ance Co.,[154] wherein the court held that a third party could not sue for breach of the duty to settle,[155] should apply to the court's interpretation of section 790.03.[156] However, the court distinguished *Murphy* by reasoning that the plaintiff in *Murphy* had asserted a right to sue for breach of the insurer's duty to the insured under the contract, whereas the plaintiff in *Royal Globe* was suing the insured based upon its duty created under section 790.03.[157]

The final step in the court's analysis was whether a third-party claimant could sue the insurer and the insured in a single lawsuit.[158] The court held that damages suffered by the injured party as a result of violations of section 790.03(h) are to be determined after the third party's action against the insured is concluded.[159] In reaching this decision, the court relied heavily on section 1155 of the Evidence Code which prohibits the admission of insurance, due to its prejudicial nature, in certain tort actions.[160] Therefore, because the plaintiff's claim was not concluded, the supreme court allowed the writ of mandate to issue.[161]

The three-judge dissent in *Royal Globe* blasted the majority for its disregard of the unanimous *Murphy* decision only three years earlier, and its erroneous, labored, and strained interpretation of section 790.03.[162] The dissent concluded that "neither statutory nor decisional law supports the majority's holding. . . . It seems predictable that in almost every case in which an insurer hereinafter declines a settlement offer the injured third party claimant will be tempted to file an independent action [for statutory bad faith] against the [insurance company]."[163]

Royal Globe's impact on the insurance industry was unprecedented.

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154. 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976).

155. *Id.* at 944, 553 P.2d at 428-29, 132 Cal. Rptr. at 588-89. *See also supra* text accompanying notes 102-14.

156. Royal Globe Ins. Co. v. Superior Court, 23 Cal. 3d 880, 889, 592 P.2d 329, 335, 153 Cal. Rptr. 842, 848 (1979).

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

158. *Id.* at 891-92, 592 P.2d at 336-37, 153 Cal. Rptr. at 849-50.

159. *Id.*

160. *Id. See also* CAL. EVID. CODE § 1155 (West 1966). Section 1155 provides: "Evidence that a person was, at the time a harm was suffered by another, insured wholly or partially against loss arising from liability for that harm is inadmissible to prove negligence or other wrongdoing." *Id.*

161. *Royal Globe*, 23 Cal. 3d at 892, 592 P.2d at 338, 153 Cal. Rptr. at 851.

162. *Id.* at 892-94, 592 P.2d at 337, 153 Cal. Rptr. at 850 (Richardson, J., concurring and dissenting).

163. *Id.* at 898, 592 P.2d at 344, 153 Cal. Rptr. at 857 (Richardson, J., concurring and dissenting).

Suddenly, third-party claimants had "a more equal bargaining position" in settlement negotiations and were allowed to sue the insurer directly for bad faith practices, thus deterring violations of the Unfair Practices Act.[164] In addition, the main advantage to both insureds and third-party claimants was the ability to bring a statutory cause of action.[165] As one author notes:

> [T]he lawyer can argue that the defendant not only broke an implied promise in the insurance policy, but also violated the law. This argument has greater force with unsophisticated jurors who may stumble over the concept of an implied promise but can easily comprehend and condemn the insurer's violation of the law.[166]

Furthermore, after *Royal Globe* there was a tremendous surge of suggested guidelines for insurers to avoid bad faith damages.[167] The authors did not condemn past practices, nor did they advocate public policy reasons for suggesting new behavior.[168] Instead, they were concerned with the enormous punitive damage verdicts and their increasing frequency after *Royal Globe*,[169] which indicated that "absent the development of the tort theory of recovery and the incidental punitive damages verdicts, it is doubtful that the claims practices of insurers would be any less unconscionable . . . ."[170]

IV. *MORADI-SHALAL*: ITS IMPACT ON BAD FAITH LIABILITY IN CALIFORNIA

Now that a complete foundation of the applicable common law and statutory provisions has been set, the true impact of *Moradi-Shalal v. Fireman's Fund Insurance Cos.*[171] overruling of *Royal Globe* can be understood and appreciated. The bottom line in *Moradi-Shalal* is that (1) the majority in *Royal Globe* "incorrectly evaluated the legislative intent underlying the passage of section 790.03, subdivision (h),"[172] and (2) "[n]either section 790.03 nor section 790.09 was intended to create a private civil cause of action against an insurer that commits one of the various acts listed in [790.03(h)]."[173] Therefore, *Moradi-Shalal* represents the end of statutory bad faith liability in California.[174]

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164. Note, *Extending the Liability of Insurers for Bad Faith Acts: Royal Globe Insurance Company v. Superior Court*, 7 PEPPERDINE L. REV. 777, 789-90 (1980).

165. Callahan, *supra* note 39, at 116-17.

166. *Id.* (citing ASHLEY, BAD FAITH ACTIONS—LIABILITY AND DAMAGES § 9:06 (1986)).

167. *See, e.g.*, Karp, *supra* note 15, at 378-81; Rees, *supra* note 15, at 405-06.

168. *Id. See also* Levine, *supra* note 15, at 625-26.

169. Levine, *supra* note 15, at 626.

170. *Id.*

171. 46 Cal. 3d 287, 758 P.2d 58, 250 Cal. Rptr. 116 (1988).

172. *Id.* at 292, 758 P.2d at 60, 250 Cal. Rptr. at 118.

173. *Id.* at 304, 758 P.2d at 68, 250 Cal. Rptr. at 126.

174. *See* Thomas, *supra* note 3, at 359; *see generally* Bourhis, *supra* note 3 (discussion of bad faith liability after *Moradi-Shalal*).

A. Moradi-Shalal: The Decision

In *Moradi-Shalal*, the plaintiff had been injured in an auto accident. She subsequently brought suit against the insured for personal injury damages, but the suit was dismissed with prejudice upon settlement. Plaintiff then sued the defendant insurance company for its alleged refusal to promptly and fairly settle her claim, in violation of section 790.03(h)(2), (3), and (5).[175] The trial court sustained the insurer's general demurrer since a final judgment in the underlying action had not been reached as required under *Royal Globe*.[176] The court of appeal reversed and the defendant insurer brought the action to the California Supreme Court.

The court first reviewed the majority and dissenting opinions in *Royal Globe*, paying special attention to the reasoning in the dissent. After discussing the court's ability to reexamine and reconsider prior decisions, the court discussed the subsequent developments relating to the *Royal Globe* doctrine. The court began its discussion of the subsequent developments by noting that although similar unfair practices acts have been adopted by forty-eight states, "the courts of other states have largely declined to follow our *Royal Globe* analysis."[177] While noting that the opinions of other states are not controlling, the court stated that "the clear consensus of these out-of-state cases strongly calls into question the validity of our statutory analysis in *Royal Globe*."[178]

The majority then discussed the subsequent criticism of the *Royal Globe* decision found in scholarly journals, noting that most "emphasize both the erroneous nature of our holding . . . and the undesirable social and economic effects of the decision . . . ."[179] Commentators generally anticipated a rash of unwarranted claims, conflicting interest between insurers and insureds, distorted bargaining strengths, and insurers eventually passing the resulting increased costs onto consumers.[180] In addition, *Royal Globe* was criticized by the court for leaving many unanswered practical questions such as what constitutes bad faith refusal, when an insurer's duty arises, what is the scope of a *Royal Globe* action, and what are the definitions of "con-

175. Moradi-Shalal v. Fireman's Fund Ins. Co., 46 Cal. 3d 287, 293, 758 P.2d 58, 60, 250 Cal. Rptr. 116, 118 (1988).
176. *Id.* at 293, 758 P.2d at 60-61, 250 Cal. Rptr. at 119.
177. *Id.* at 297, 758 P.2d at 63, 250 Cal. Rptr. at 121.
178. *Id.* at 298, 758 P.2d at 64, 250 Cal. Rptr. at 122.
179. *Id.* at 299, 758 P.2d at 64, 250 Cal. Rptr. at 123.
180. *See, e.g.*, Note, *supra* note 164, at 791-93.

clusion" and "pattern."[181] The majority concluded that with all of the criticism, unanswered questions, and competing policies, the resolution of these issues would be best made by the legislature.[182] The majority then held that because of the points raised in the dissent in *Royal Globe*, as well as the subsequent developments, *Royal Globe* should be overruled.[183]

Once the majority overruled *Royal Globe*, they encouraged the insurance commissioner to administratively enforce the Unfair Practices Act, leaving available the imposition of sanctions including cease and desist orders and fines.[184] Furthermore, the majority held that courts would retain jurisdiction over traditional common law actions such as fraud, infliction of emotional distress, breach of contract, and breach of the implied covenant of good faith and fair dealing.[185] In addition, punitive damages and prejudgment interest would be available in appropriate circumstances.[186] The court held that *Moradi-Shalal* would not apply to cases filed before the *Moradi-Shalal* decision became final.[187]

The final analysis in the majority opinion focused upon the meaning of the "conclusion of an action" for those cases pending which were not affected by *Moradi-Shalal*.[188] The court held that: "for surviving *Royal Globe* actions, a final judicial determination of the insured's liability is a condition precedent to a section 790.03 action against the insurer."[189]

Justice Mosk's dissent attacked the majority opinion for creating a "Royal Bonanza" for insurance companies.[190] He further condemned the majority for its judicial activism in "totally destroying a cause of action authorized by statute, approved by decisions of this court and of Courts of Appeal, and acquiesced in by the Legislature for nearly a decade."[191] Next, he reiterated his analysis of the statutory cause of action under section 790.03 which he presented when he wrote the

181. *Moradi-Shalal*, 46 Cal. 3d at 302-04, 758 P.2d at 68-69, 250 Cal. Rptr. at 125-26.

182. *Id.* at 303-04, 758 P.2d at 68, 250 Cal. Rptr. at 126.

183. *Id.* at 304, 758 P.2d at 68, 250 Cal. Rptr. at 126.

184. *Id.* ("We caution, however, that our decision is not an invitation to the insurance industry to commit the unfair practices proscribed by the Insurance Code. We urge the Insurance Commissioner and the courts to continue to enforce the laws forbidding such practices to the full extent consistent with our opinion.") *Id.*

185. *Id.* at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 127.

186. *Id.* at 305, 758 P.2d at 69, 250 Cal. Rptr. at 127.

187. *Id.*

188. *Id.* at 305-06, 758 P.2d at 69, 250 Cal. Rptr. at 127. Recall that *Royal Globe* required a suit between an injured party and the insured be concluded before the injured party could file a cause of action against the insurance company for violations of section 790.03. *See supra* note 144 and accompanying text.

189. Moradi-Shalal v. Fireman's Fund Ins. Co., 46 Cal. 3d 287, 313, 758 P.2d 58, 75, 250 Cal. Rptr. 116, 133 (1988).

190. *Id.* at 313-14, 758 P.2d at 75, 250 Cal. Rptr. at 133 (Mosk, J., dissenting).

191. *Id.* at 314, 758 P.2d at 75, 250 Cal. Rptr. at 133-34 (Mosk, J., dissenting).

majority opinion in *Royal Globe*.[192] Mosk further noted that in the twenty-nine years since the Unfair Practices Act was adopted, "[o]n not one page of one volume is a single case reported in which the Insurance Commissioner has taken disciplinary action against [an insurer] for 'unfair and deceptive acts or practices' . . . involving a claimant."[193]

B. Moradi-Shalal: The Future

By overruling *Royal Globe*, *Moradi-Shalal* eliminated a statutory cause of action for unfair and deceptive insurance practices under section 790.03 of the Insurance Code. However, the court did allow victims of insurance abuse to recover under traditional tort theories such as fraud and intentional infliction of emotional distress, while insureds can additionally recover for breach of contract and breach of the implied covenant of good faith and fair dealing.[194] Therefore, aside from the loss of the trial tactic and ease of pursuing a statutory violation,[195] insureds who are able to bring a common law action for breach of the implied covenant of good faith and fair dealing will not be as seriously affected as third-party victims. Insureds in both first-party and third-party bad faith claims will still be able to rely on the firmly established common law tort of bad faith.[196] In addition, post-*Royal Globe* decisions, which have further refined common law bad faith standards, should still be effective in defining bad faith conduct.[197] Furthermore, even though *Moradi-Shalal* held that section 790.03 does not state a private cause of action,[198] it should still be used in common law bad faith actions to define unfair and deceptive practices, as section 790.03 is "merely a codification of . . . a common-

192. *Id.* at 314-21, 758 P.2d at 75-80, 250 Cal. Rptr. 133-38 (Mosk, J., dissenting). *See also* Royal Globe Ins. Co. v. Superior Court, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979).

193. *Moradi-Shalal*, 46 Cal. 3d at 317, 758 P.2d at 77, 250 Cal. Rptr. at 135. *See also supra* note 133 and accompanying text.

194. *Moradi-Shalal*, 46 Cal. 3d at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 127.

195. *See supra* note 166 and accompanying text.

196. *Moradi-Shalal*, 46 Cal. 3d at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 127.

197. *See, e.g.*, Congleton v. National Union Fire Ins. Co., 189 Cal. App. 3d 51, 234 Cal. Rptr. 222 (1987) (interpretation of ambiguous policy and relation to bad faith); Cal. Shoppers, Inc. v. Royal Globe Ins. Co., 175 Cal. App. 3d 1, 221 Cal. Rptr. 171 (1985) (failure to defend and relation to tort of bad faith); Delgado v. Heritage Life Ins. Co., 157 Cal. App. 3d 262, 203 Cal. Rptr. 672 (1984) (possibility of punitive damages and bad faith).

198. Moradi-Shalal v. Fireman's Fund Insurance Co., 46 Cal. 3d 287, 304, 758 P.2d 58, 68, 250 Cal. Rptr. 116, 126 (1988).

law bad faith action against an insurer . . . ."[199]

The *Moradi-Shalal* decision primarily will affect third-party claimants by denying them a private cause of action under section 790.03. The elimination of the statutory cause of action for bad faith leaves third parties with their pre-*Royal Globe* status under *Murphy v. Allstate Insurance Co.*[200] Therefore, because they are not parties to the insurance contract, third parties will not be able to sue the insurer directly for breach of the implied covenant of good faith and fair dealing.[201] However, under *Murphy*, the third party may proceed against the insurer on an assignment of the insured's rights under the contract.[202] This would enable an insured who has had a judgment brought against her in excess of her policy limits to assign her cause of action against the insurance company to the third-party judgment creditor. Unfortunately, *Murphy* also provides that personal claims such as personal injury and emotional damages, as well as punitive damages, are not assignable.[203] Therefore, in a typical excess judgment action, where the insured has suffered emotional distress as a result of the insurance company's conduct, the insured and the third-party judgment creditor may have difficulty structuring a proper assignment. Because some rights are assignable and others are not, both the insured and the third party need to be careful "not to inadvertently extinguish any rights by improperly splitting a cause of action."[204] "[A]ssignments must be carefully worded to preserve general and punitive damage rights in the insured. He or she must then actively pursue the action, along with the third party, pursuant to a negotiated agreement with the original plaintiff concerning disposition of the proceeds of any settlement or judgment."[205]

Finally, when considering appropriate remedies for third-party claimants seeking redress from the unfair and abusive practices of an insurer, the following four remedies should be considered:

1. After *judgment*, a third party bodily injury or property damage claimant still has a statutory right to collect an unsatisfied judgment, up to the policy limits, directly from the liability insurer of the judgment debtor;
2. After *judgment*, a third party claimant may take an assignment of some, but not all, of the insured's rights against the liability insurer;
3. After *judgment*, a third party claimant may take a lien interest against the proceeds of the insured's suit against the defendant's liability insurer; and,
4. After an insurer's wrongful *failure to defend*, the insured and the claimant *may* enter into a non-collusive *settlement* and enforce that settlement

199. MCCARTHY, *supra* note 5, § 2.21, at 250-51. *See supra* note 125 and accompanying text.

200. 17 Cal. 3d 937, 553 P.2d 584, 132 Cal. Rptr. 424 (1976). *See also* text accompanying notes 102-114; Thomas, *supra* note 3, at 359-60.

201. *Murphy*, 17 Cal. 3d at 942-44, 553 P.2d at 587-88, 132 Cal. Rptr. at 427-28.

202. *Id.* at 946, 553 P.2d at 590, 132 Cal. Rptr. at 430.

203. *Id.*

204. Thomas, *supra* note 3, at 362.

205. Bourhis, *supra* note 3, at 367.

against the defaulting insurer.[206]

In addition, a third party may attempt to separately sue under tort theories such as intentional infliction of emotional distress, conspiracy, invasion of privacy, fraud, or malicious prosecution.[207]

V. CONCLUSION

By overruling *Royal Globe*, the multi-million dollar verdict in *Moradi-Shalal* ended the statutory cause of action for bad faith liability under section 790.03 of the Insurance Code. However, the common law doctrine of bad faith is still firmly established in California.[208] Insured parties are still protected from insurer bad faith conduct as a party to the insurance contract and can bring a cause of action against the insurance company for breach of the covenant of good faith and fair dealing, or bad faith.[209] Unfortunately, third-party claimants, because they are not a party to the insurance contract, may now recover for insurer bad faith conduct only by obtaining an assignment from the insured; if the conduct is egregious enough, the third party may sue under traditional tort theories.[210]

The court in *Moradi-Shalal* encouraged the insurance commissioner to enforce the provisions of section 790.03. However, as commentators and the dissent in *Moradi-Shalal* have pointed out, enforcement will be unlikely. This lack of enforcement and loss of a statutory bad faith cause of action were partially responsible for the "insurance-reform stampede" in the fall of 1988.[211] Both Propositions 100 and 103 would have directly affected the *Moradi-Shalal* opinion. Proposition 100, if passed, would have added section 790.031 to the Insurance Code, which would have statutorily reinstated a private cause of action under section 790.03.[212] Proposition 103, which passed but is still undergoing constitutional attacks, adds an elected insurance commissioner to enforce the Unfair Practices Act,[213] and prohibits unfair insurance business practices under the Business and

206. Thomas, *supra* note 3, at 359 (emphasis added).

207. KORNBLUM, *supra* note 6, ¶¶ 3:3-4.

208. *See Moradi-Shalal*, 46 Cal. 3d at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 127.

209. *Id.* at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 127.

210. Bhouris, *supra* note 3, at 365-66; *see also supra* notes 103-15.

211. Kushman, *The Insurance-Reform Stampede*, 19 CAL. J. 417 (Oct. 1988).

212. Proposition 100, § 13 "Fair Insurance Claims and Underwriting Practices."

213. Proposition 103, § 4. Elected Commissioner. "Section 12900 is added to the Insurance Code to read: *"12900.(a) The commissioner shall be elected by the People in the same time, place and manner and for the same term as the Governor."* *Id.*

Professions Code.[214] Unfortunately, Proposition 103 does not renew a private cause of action for bad faith insurance practices under section 790.03.[215]

Independently, *Moradi-Shalal's* encouragement of the insurance commissioner to enforce section 790.03 may not have generated any pressure for the insurance commissioner to actively protect consumers. However, the additional pressure surrounding the passage of Proposition 103 and its resultant elected commissioner seems to have put some fire under the insurance commissioner to publicly apply pressure on the insurance companies in protecting consumers.[216] It appears that the political pressure on the insurance commissioner may decrease the lack of enforcement problems which occurred before *Royal Globe*.[217] With an effective insurance commissioner seeking to maintain a political career, the need for a private cause of action under sectin 790.03 may be diminished.

However, even with an elected commissioner awakening to the needs of insurance consumers, the State of California needs insurance reform.[218] This became clear in the 1988 elections when mil-

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214. Proposition 103, § 3: Reduction and Control of Insurance Rates.

> Article 10, commencing with Section 1861.01 is added to Chapter 9 of Part 2 of Division 1 of the Insurance Code to read: Prohibition of Unfair Insurance Practices: 1861.03(a) The business of insurance shall be subject to the laws of California applicable to any other business, including, but not limited to, the Unruh Civil Rights Act Civil Code Sections 51 through 53, and the antitrust and unfair business practices laws (Parts 2 and 3, commencing with section 16600 of Division 7, of the Business and Professions Code). . . .

Id.

215. *See id.* If Proposition 103 withstands the constitutional attack being brought by the insurance industry, arguments may be made that, because the new act is to be "liberally construed and applied in order to fully promote its underlying purposes," the Unfair Insurance Practices section should include a private cause of action under Insurance Code section 790.03. *Id.* § 8. However, this argument will probably fail because section 1861.03 seems to be concerned only with violations of the Business and Professions Code. *Id.* It follows that if the writers of Proposition 103 had intended the new act to include a private cause of action under Insurance Code section 790.03, they would have done so expressly, as did the writers of Proposition 100:

> Section 13. Fair Insurance Claims and Underwriting Practices. Section 790.031 is added to article 6.5 of Chapter 1 of Part 2 of Division 1 of the Insurance Code to read as follows:
> *790.031 Any person engaged in the business of insurance in the State of California is required to act in good faith toward, and to deal fairly with, current and prospective policy holders and other persons intended to be protected by any policy of insurance. A policyholder or a third-party may bring an action against an insurer or licensee for violation of the provisions of this article, including but not limited to subdivision (h) of Section 790.03.*

Proposition 100, § 13.

216. Reich, *State Farm to Refund New-Customer Boosts*, L.A. Times, Mar. 9, 1989, § 1, at 1, col. 2 ("the State's largest seller of auto insurance, yielded to pressure from Insurance Commissioner Roxani Gillespie . . . .").

217. *See supra* note 133 and accompanying text.

218. *The Insurance Mess: What Now?*, L.A. Times, Nov. 10, 1988, § 2 (Metro), at 6, col 1. The editorial indicated that unfortunately "[t]he future of auto insurance in this state depends on several officials who opposed Proposition 103, including . . . [Insur-

lions of dollars were spent trying to pass insurance-related initiatives.[219] The legislature needs to address the problem with renewed vigor, or consumers will continue to be at the mercy of the insurance industry. One suggestion might be the allowance of treble damages for unfair trade practices which violate consumer protection statutes such as section 790.03, as seen in Massachusetts, Texas, and Washington.[220] As Proposition 100 suggested, and states such as Florida have already adopted, the legislature could expressly authorize a private cause of action for damages against an insurer who acts in bad faith.[221] Unfortunately, as one commentator has noted: "[L]awmakers [have been] co-opted as effective peacemakers [between lawyers and insurance companies] by massive infusions of campaign contributions from both sides; years of legislative skirmishing between lawyers and insurers have been lucrative for members of the Senate and Assembly, and a real solution would likely [anger] both sides."[222]

Therefore, because of the continual leverage being applied on California lawmakers by the insurance industry and lawyers, a solution to the insurance unfair practices problem does not appear to be forthcoming. A solution would require "legislative action," a phrase that is almost a contradiction of terms in California and, therefore, is unlikely.

MICHAEL J. GAINER*

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ance Commissioner] Gillespie." *Id. See also*, Dresslar, *Legislature Held at Fault for Crisis in Auto Insurance*, L.A. Daily J., Oct. 17, 1988, at 1, col. 6 (In discussing why so many initiatives were on the November ballot, one commentator stated: "The record shows [the legislature] failed to act on a number of insurance reform measures, at least in part because they feared to lose the support (and considerable campaign contributions) of either trial lawyers or insurers.") *Id.*

219. Reich and Shuit, *Insurance Initative Spending Climbs to Record $61 Million*, L.A. Times, Oct. 29, 1988, § 1 at 29, col. 1. Two weeks before the election $61,182,505 had been spent in campaigning on the insurance initiatives. After the elections, it was determined that over $81 million was spent campaigning on the insurance initiatives, of which more than $60 million was spent on the insurance companies' side. Reich, *Voters Splitting Evenly on Nader's Prop. 103*, L.A. Times, Nov. 9, 1988, § 1, at 1, 15, col. 2.

220. *See* MCCARTHY, supra note 5, at § 1.33.

221. FLA. STAT. § 624.155 (1988).

222. Kushman, *supra* note 211, at 417.

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