The Natural History of the Insurer's Liability for Bad Faith

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As recently as ten years ago, an insurer's liability for bad faith was one of the legal growth stocks of that period. Having come into their own in the 1970s, both first-party and third-party bad faith claims were resulting in multi-million dollar judgments,[1] treatises and law review articles exploring the contours of the law in these fields were being published,[2] and—along with civil liability generally—the field seemed to be expanding without an end in sight.[3]

The current climate is quite different. Although liability for bad faith now has an established place in insurance law, the exciting days of the late 1970s and 1980s have been left behind. My overall impression is that bad faith activity has leveled off and that liability for bad faith is no longer quite the dramatic threat to insurers—nor for most plaintiffs the potential pot of gold at the end of the rainbow—that it may once have seemed to be. I also believe that at present the probability of substantial doctrinal expansion in this field is low. In this Paper, I want to explore some of the reasons that the law of liability for the insurer's bad faith now stands where

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1. *See* Richard G. Mandel, *Extracontract Damages Survey*, 16 FORUM 874, 874-91 (1981) (summarizing the law governing liability for bad faith failure to pay insurance claims in each state).

2. *E.g.*, WILLIAM M. SHERNOFF ET AL., INSURANCE BAD FAITH LITIGATION (1984) [hereinafter SHERNOFF ET AL., BAD FAITH]; Glenn L. Allen, *Insurance Bad Faith Law: The Need for Legislative Intervention*, 13 PAC. L.J. 833 (1982); Steven J. Harman, *An Insurer's Liability for the Tort of Bad Faith*, 42 MONT. L. REV. 67 (1981); Robert D. Myers, *Bad Faith: A Tort Expands to Protect the Insured*, TRIAL, Mar. 1982, at 56; William M. Shernoff, *Insurance Company Bad Faith Law: A Potent Weapon for Consumer Protection*, TRIAL, May 1981, at 22 [hereinafter Shernoff, *A Potent Weapon*]; Janet Amarine & Jan E. Montgomery, Note, *Insurer's Bad Faith: A New Tort for Kansas?*, 19 WASHBURN L.J. 467 (1980); Phyllis Savage, Note, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164 (1976).

3. *See* Allen, *supra* note 2, at 833 ("[T]he scope and use of this tort has expanded dramatieally."); Myers, *supra* note 2, at 59 ("During the last two decades, the judiciary has manifested its dissatisfaction with unfair insurance practices by rapidly expanding the tort of bad faith."); Shernoff, *A Potent Weapon*, *supra* note 2, at 24 (describing the rapidly growing body of insurance bad faith law).

it does and to make some observations about the significance of the present condition of bad faith law for the future of this field.

I. Bad Faith Liability, Past and Present

In order to know where bad faith law stands at present and where this body of law is heading, it is necessary to know where it has been. The ferment of a decade or more ago has now died down; the entire field of bad faith liability is less volatile and has less momentum than might have been expected given the furor of that time. Why is this field now experiencing comparative calm and stability?

A. Maturity

The most general explanation for the current stability of bad faith law is that virtually any field that moves from infancy to maturity is likely to become calmer as major issues are resolved, occasional large judgments come to be understood as outliers rather than as representative results, and general uncertainty about the future of the field gives way to increasing predictability. Thus, in one sense the comparative stability that now prevails in the field of bad faith liability is not surprising, but normal, and should have been anticipated by those analyzing the field a decade ago. Aside from this most general of reasons, however, a number of other forces have been at work, affecting the different categories of bad faith litigation in different ways.

B. The Civil Liability Plateau

The ten-year period running roughly from 1975 to 1985 witnessed an extraordinary degree of instability in tort law and insurance. During this period, a number of mass tort cases were filed,[4] and new doctrines in tort law were discussed[5] and created to deal with new challenges. There were,

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4. *See, e.g.*, A.H. Robins Co. v. Piccinin, 788 F.2d 994 (4th Cir.) (involving A.H. Robins Company's intrauterine contraceptive device known as the Dalkon Shield), *cert. denied*, 479 U.S. 876 (1986); *In re* Bendectin Prods. Liab. Litig., 749 F.2d 300 (6th Cir. 1984) (concerning Merrell Dow Pharmaceutical's morning-sickness drug, Bendectin); *In re* Federal Skywalk Cases, 680 F.2d 1175 (8th Cir.) (involving the collapse of two skywalks at the Hyatt Regency hotel in Kansas City, Missouri), *cert. denied*, 459 U.S. 988 (1982); *In re* MGM Grand Hotel Fire Litig., 570 F. Supp. 913 (D. Nev. 1983) (involving the 1980 fire at the MGM Grand Hotel and Casino in Las Vegas, Nevada); Sindell v. Abbott Lab., 607 P.2d 924 (Cal.) (concerning a class action by daughters of women who took the drug DES during pregnancy), *cert. denied*, 449 U.S. 912 (1980).

5. *See* Symposium, *Claims Resolution Facilities and the Mass Settlement of Mass Torts*, 53 LAW & CONTEMP. PROBS. 1 (1990) (containing articles "concerning the mechanisms . . . developed to dispense funds to resolve mass tort litigation"); Kenneth S. Abraham, *Individual Action and Collective Responsibility: The Dilemma of Mass Tort Reform*, 73 VA. L. REV. 845, 885-906 (1987) (discussing liability standards and proof of causation as well as administrative compensation funds and the expanded use of first-party insurance to deal with the problems posed by mass tort litigation); John P. Burns et

moreover, two insurance "crises"—the first, at the beginning of the period, related mainly to medical malpractice liability[6] and the second, at the end of the period, related to civil liability for personal injury and property damage across the board.[7] During each of these crises, states enacted statutes restricting tort liability in various ways.[8]

During this period, many observers sensed that the boundaries of civil liability were expanding. Without doubt, that sense of expansion included the insurer's liability for bad faith. Whether or not the expansion was as substantial as some observers believed, the current climate in civil liability is more stable.[9] There is currently no sense of general expansion, no major ongoing change in the doctrinal landscape, no explosion in claim frequency. Indeed, in at least some of the last few years, the incidence of liability in certain fields of tort liability may actually have declined.[10]

I cannot claim that there is automatically a connection between the pace of change in the field of tort liability for personal injury and property damage, on the one hand, and the insurer's liability for bad faith, on the other. It is plausible to suppose, nonetheless, that in recent years some of the same factors have accounted for the decreasing pace of change in both fields. First, certain of the tort-reform statutes of the mid-1980s placed ceilings or limitations on the right to recover punitive damages; in some jurisdictions, these limits apply not only to conventional tort liability but

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al., Special Project, *An Analysis of the Legal, Social, and Political Issues Raised by Asbestos Litigation*, 36 VAND. L. REV. 573, 845-46 (1983) (concluding that a legislative compensation program is necessary to deal with litigation arising from asbestos-related disabilities); David Rosenberg, *The Causal Connection in Mass Exposure Cases: A "Public Law" Vision of the Tort System*, 97 HARV. L. REV. 849, 859-60 (1984) (summarizing a "public law" approach to mass exposure cases that distributes compensation in proportion to the probability of causation).

6. *See generally* Symposium, *The Medical Malpractice Crisis: Managing the Costs*, 36 MD. L. REV. 489 (1977) (analyzing various reform proposals designed to lessen the increasing costs associated with medical malpractice liability); Prentiss E. Feagles et al., Comment, *An Analysis of State Legislative Responses to the Medical Malpractice Crisis*, 1975 DUKE L.J. 1417 (proposing tort law modifications to counter the rising cost of medical malpractice insurance).

7. *See generally* Kenneth S. Abraham, *Making Sense of the Liability Insurance Crisis*, 48 OHIO ST. L.J. 399 (1987) (analyzing the causes of and possible solutions to the liability insurance crisis); George L. Priest, *The Current Insurance Crisis and Modern Tort Law*, 96 YALE L.J. 1521 (1987) (discussing theories that explain the modern insurance crisis and arguing that modern tort law created the crisis).

8. For catalogs of these reforms, see Feagles, *supra* note 6, at 1418-25 (discussing and evaluating tort law modifications proposed or enacted by state legislatures in an attempt to counter the rising cost of medical malpractice insurance); Joseph Sanders & Craig Joyce, *"Off to The Races": The 1980s Torts Crisis and the Law Reform Process*, 27 HOUS. L. REV. 207, 217-23 (1990) (summarizing state legislation passed between 1985 and 1988 attempting to reform tort law).

9. *See* 1 THE AMERICAN LAW INSTITUTE, REPORTERS' STUDY, ENTERPRISE RESPONSIBILITY FOR PERSONAL INJURY 55 (1991) (observing that state legislatures have stopped enacting tort reforms and that premium increases have ceased).

10. *See* James A. Henderson, Jr. & Theodore Eisenberg, *The Quiet Revolution in Products Liability: An Empirical Study of Legal Change*, 37 UCLA L. REV. 479, 522-30 (1990) (observing both a declining success rate and declining expected returns for plaintiffs in products-liability actions).

also to recovery for bad faith.[11] Because a good deal of the action in first-party bad faith claims involves potential liability for punitive damages, these statutes may have slowed the pace of expansion. Second, I suspect—though I cannot prove—that expansions of civil liability are influenced by, among other things, intangible cultural factors, and that there have been a variety of changes in this regard. It would be too simple merely to say that the courts read the election returns and that the enactment of the tort-reform statutes of the mid-1980s operated as a shot across the expansionist judicial "bow," even apart from the precise terms of these statutes. But that is probably part of what has occurred.[12] Jury attitudes toward liability also may have evolved in subtle ways, especially as the national economy entered a recession and jurors probably became less prone to assume the economic health, and therefore the sufficiently deep pockets, of the large enterprises that are so frequently defendants in tort and bad faith suits. Finally, doctrinal expansion of civil liability may well have a life cycle of its own, in which the inner logic of a change of direction is worked through and rapid expansion occurs at first, with the limits of the new principles governing liability eventually emerging. In short, the confluence of the several factors that have created a general civil liability plateau have probably affected bad faith litigation as well.

C. *The Effect of ERISA*

Two features of the Employment Retirement Income Security Act of 1974 (ERISA)[13] also have almost certainly affected the level of bad faith litigation. The first is the effect of ERISA's preemption of major portions of state regulation of employee-benefit plans. The second is the incentive that this preemption and certain related ERISA provisions create for employers to self-insure employee benefits.

1. The ERISA Preemption.—In its 1987 decision in *Pilot Life Insurance Co. v. Dedeaux*,[14] the Supreme Court held that ERISA preempts certain common-law tort and contract actions used to claim damages for the improper processing of claim benefits under an insured employee benefit

11. *See, e.g.*, ALA. CODE § 6-11-21 (1993) (limiting punitive damages to $250,000); COLO. REV. STAT. ANN. § 13-21-102.5 (West 1989) (placing monetary limitations on noneconomic loss or injury); KAN. STAT. ANN. § 60-3701 (Supp. 1992) (establishing a formula limiting punitive and exemplary damages). For a compilation of the tort reform statutes enacted during this period, see Sanders & Joyce, *supra* note 8, at 220-22.

12. *See* Kenneth S. Abraham, *The Causes of the Insurance Crisis*, *in* NEW DIRECTIONS IN LIABILITY LAW 54, 63 (Walter Olson ed., 1988) ("The most that can be expected from typical state tort reforms . . . is that they will serve as a warning [to judges and juries].").

13. Pub. L. No. 93-406, 88 Stat. 832 (codified as amended in scattered sections of 29 U.S.C. and 26 U.S.C.).

14. 481 U.S. 41 (1987).

plan.[15] Although the full reach of that decision is not clear, at the least *Dedeaux* precludes first-party bad faith claims involving employment-based health and disability insurance in jurisdictions in which bad faith claims may be brought not only against insurers, but also for bad faith breach of contract generally.[16] Because the vast majority of health and disability insurance in this country is provided as a fringe benefit of employment,[17] it seems likely that *Dedeaux* precluded a considerable portion of the first-party bad faith litigation that might otherwise have occurred in recent years. Instead, many insurance beneficiaries have recourse only to the remedies afforded them under ERISA. For most practical purposes, only individual purchasers of health and disability insurance may bring bad faith claims against their insurers. Of course, because most homeowner's and commercial property insurance is not governed by ERISA because it is not sold as an employee benefit,[18] bad faith claims arising out of these forms of coverage fall outside the rule in *Dedeaux*. In my estimation, however, these forms of coverage probably were a source of only a minority of the first-party bad faith claims that were brought prior to the decision in *Dedeaux*.

2. *Incentives Created by the ERISA Regulatory Exception.*—Although ERISA preempts and supersedes "any and all State laws" relating to any employee-benefit plan,[19] it makes an exception for "any law of any State which regulates insurance, banking, or securities."[20] As a consequence, state regulation of insurer-provided health and disability plans may continue. Such regulation, of course, directly affects the insurers that provide employment-based insurance, but it also indirectly affects the employers that purchase this coverage. For example, in a number of states, health insurance provided by insurance companies must include certain bene-

15. *Id.* at 48.

16. The Court based its decision in part on its conclusion that the Mississippi cause of action for bad faith, which could be brought not only against an insurance company but also against other parties who breach contracts, could not be characterized as a law that "regulates insurance" within the meaning of ERISA § 514(b)(2)(A). *Id.* at 48 (construing ERISA § 514(b)(2)(A), 29 U.S.C. § 1144(b)(2)(A) (1988)). Whether a cause of action available against only insurers would be preempted by ERISA is therefore not entirely clear, although other features of the *Dedeaux* decision suggest that even causes of action so limited would be preempted. *See id.* at 44-57 (summarizing additional factors that weighed against "saving" the state bad faith cause of action from preemption, particularly congressional intent that the ERISA civil enforcement scheme be exclusive).

17. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES 105 (112th ed. 1992) (Table: No. 153, Health Insurance Coverage Status, by Selected Characteristics: 1985 to 1990) (showing that of the 212.6 million people who had insurance in 1990, 150.5 million had employment-related insurance).

18. ERISA applies only to employee benefit plans. 29 U.S.C. § 1003(a) (1988).

19. *Id.* § 1144(a).

20. *Id.* § 1144(b)(2)(A).

fits,[21] and in many states, insurers are prohibited from canceling or restricting coverage of existing policyholders or beneficiaries except under limited conditions.[22]

To avoid the effect of these state-imposed regulatory mandates and restrictions on the scope of the health insurance that they may purchase, employers with large numbers of employees frequently self-insure their health benefits.[23] Because in some states bad faith claims may only be brought against insurers,[24] and for practical purposes insurers appear to be the principal object of bad faith suits in most states, this self-insuring removes many employees from the universe of potential bad faith claimants. Along with the ERISA preemption, then, the incentives for self-insuring created by the ERISA regulatory exception probably have reduced the level of bad faith litigation.

D. *Third-Party Bad Faith: The Decline of California's Influence*

California led the way in creating both first-party and third-party bad faith liability. At the same time, the state took innovative approaches in related fields of civil liability. For example, California was the first state

21. *See, e.g.*, COLO. REV. STAT. ANN. § 10-16-104 (West Supp. 1993) (mandating coverage for newborn children, complications due to pregnancy, maternity care, mammography testing, and mental illness); MASS. GEN. LAWS ANN. ch. 175, § 110 (West 1987 & Supp. 1993) (requiring coverage for the treatment of alcoholism and expenses of cytologic screening and mammographic examinations); N.J. STAT. ANN. § 17B:27A-19 (West Supp. 1993) (requiring small-employer carriers to provide basic inpatient and outpatient hospital care, basic and extended surgical benefits, diagnostic testing, maternity benefits, and preventative medicine).

22. *See, e.g.*, LA. REV. STAT. ANN. § 40:1299.166 (West 1992) (prohibiting the cancellation or nonrenewal of a health-care provider's malpractice insurance except in limited circumstances); N.J. STAT. ANN. § 17B:27A-23 (West Supp. 1993) (prohibiting the nonrenewal of small-employer policies except in limited circumstances such as nonpayment of premiums or policyholder fraud).

23. For example, 67% of the 2448 U.S. employers that responded to a survey said they self-insured their group medical plans in 1992. Seventy-four percent of firms with 1000 to 2499 workers self-insured in 1992, as did 83% of companies with more than 5000 employees. Michael Schachner. *Growth in Health Care Self-Funding Slows*, BUS. INS., Jan. 25, 1993, at 3, 6.

24. *See, e.g.*, Jack Walters & Sons Corp. v. Morton Bldg., Inc., 737 F.2d 698, 711 (7th Cir.) (noting that in Wisconsin the tort of bad faith has not been extended beyond the insurance setting), *cert. denied*, 469 U.S. 1018 (1984); Battista v. Lebanon Trotting Ass'n, 538 F.2d 111, 117-18 (6th Cir. 1976) (holding that under Ohio law an insurer may be subject to tort liability for breach of its implied duty of good faith and fair dealing with respect to its insured, but that tort liability does not extend to ordinary contracts between business persons because "the special considerations existent in a consumer-held insurance contract do not apply"); Ford Motor Credit Co. v. Garner, 688 F. Supp. 435, 442-43 (N.D. Ind. 1988) (concluding that Indiana law does not "impose . . . [the] duty of good faith and fair dealing [applicable in insurance cases] in the performance and enforcement of a guaranty"); Peninsular Life Ins. Co. v. Blackmon, 476 So. 2d 87, 89 (Ala. 1985) (refusing to extend the "tort of bad faith refusal to pay a claim" from the narrow confines of the "typical insurer/insured relationship" to cover an employment contract); Mortgage Fin., Inc. v. Podleski, 742 P.2d 900, 903 (Colo. 1987) (holding that the bad faith tort doctrine developed in the insurance context does not apply to a contract dispute between parties of equal bargaining power).

squarely to adopt strict products liability;[25] it also abolished the ancient distinction among the duties owed by landowners to different categories of entrants on land[26] and was the first state to adopt market-share liability.[27] The state's innovative decisions from roughly 1960 to 1980 were taken seriously, and they spread. So there was good reason, a decade or more ago, to anticipate that the expansive California rules governing the third-party insurer's liability for bad faith would spread as well. In the field of third-party liability, however, the doctrinal twists developed in California have never taken hold strongly in the remainder of the country, and some of the apparent trends of the 1970s have not grown to maturity even in California. Instead, liability for bad faith breach of a liability insurance policy has evolved into a relatively conventional and stable field of law. This stability is evidenced by three different features of the field: the kinds of damages that are recoverable for breach of the duty to settle, the factors that trigger liability for breach of the duty to settle, and the virtually complete abolition of a cause of action by nonpolicyholders against liability insurers.

1. Liability for Noneconomic Loss.—Perhaps the most conventional of the various bad faith causes of action involves an insurer's liability for its failure to accept a reasonable offer to settle a claim against its policyholder for an amount within the policy limits. If an insurer rejects such an offer and that rejection results in a judgment against the policyholder in excess of the policy limits, then the insurer is liable not only for its policy limits but also for the amount of the judgment exceeding the limits.[28] In one of the early California cases, the court not only permitted the imposition of liability for these "economic" losses in excess of the policy limits, but also affirmed an award to the policyholder of $25,000 for mental suffering resulting from the insurer's breach of its duty to settle.[29]

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25. *See* Greenman v. Yuba Power Prods., Inc. 377 P.2d 897, 900 (Cal. 1963) (holding that "a manufacturer is strictly liable in tort when an article he places on the market . . . proves to have a defect that causes injury to a human being").

26. *See* Rowland v. Christian, 443 P.2d 561, 565 (Cal. 1968).

27. *See* Sindell v. Abbott Lab., 607 P.2d 924, 927, 937 (Cal.) (allowing the plaintiffs to use a theory of market-share liability, but noting that no other state had adopted the theory), *cert. denied*, 449 U.S. 912 (1980).

28. The leading cases establishing and confirming this cause of action were decided in California. *See, e.g.*, Crisci v. Security Ins. Co., 426 P.2d 173, 177 (Cal. 1967) (holding that "[l]iability is imposed [on an insurer] 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"); Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 202 (Cal. 1958) (holding that "an insurer, who wrongfully declines to defend and who refuses to accept a reasonable settlement within the policy limits in violation of its duty to consider in good faith the interest of the insured in the settlement, is liable for the entire judgment against the insured even if it exceeds the policy limits").

29. *Crisci*, 426 P.2d at 178-79.

The prospect of easily available damages for mental suffering resulting from a liability insurer's breach of the duty to settle could have destabilized this area of law and substantially increased litigation of duty-to-settle claims. Because the reasonableness of a settlement offer may be in doubt, an insurer sued for the economic losses suffered by its policyholder as a result of an alleged breach of the duty to settle may not be certain whether it has in fact breached the duty. The insurer can be certain, however, of the amount of damages that will be awarded if it is found to have breached its duty: the economic loss resulting from any breach is the amount of any above-the-policy-limits judgment. In contrast, the amount that will be awarded for noneconomic loss in the form of mental suffering is a "wild-card." The likelihood that breach of the duty-to-settle cases will be brought, and that such cases will not be settled, is therefore increased by the availability of such damages.

The prospect that liability for noneconomic loss would routinely be imposed in duty-to-settle cases, however, has not materialized. There are only a handful of reported cases in which such liability has been imposed, both around the country and in California itself.[30] The norm in duty-to-settle cases has tended to be an award of economic loss only, measured by the amount of the judgment in excess of policy limits rendered against the policyholder.

2. *Factors Triggering the Duty to Settle.*—More than a decade ago, two other developments in California also threatened to expand the scope of the bad faith cause of action. Each dealt with the factors that trigger the insurer's duty to settle a liability claim against its policyholder, and each

30. In addition to *Crisci*, see Larraburu Bros., Inc. v. Royal Indem. Co., 604 F.2d 1208, 1215 (9th Cir. 1979) (holding that "[a]n unreasonable refusal to accept a settlement offer causes the insurer to be liable for . . . mental suffering . . . unless the insurer takes some action to eliminate the injury its conduct otherwise would have caused"); Purdy v. Pacific Auto. Ins. Co., 203 Cal. Rptr. 524, 537 (Ct. App. 1984) ("[E]motional distress damages occasioned by bad faith failure to settle are an integral part of the underlying cause of action."); Truestone Inc. v. Travelers Ins. Co., 127 Cal. Rptr. 386, 389-90 (Ct. App. 1976) (holding that because peace of mind is one reason people buy insurance, insured parties may recover for mental suffering caused by failure to settle); State Farm Mut. Auto. Ins. Co. v. Allstate Ins. Co., 88 Cal. Rptr. 246, 258-59 (Ct. App. 1970) (allowing damages for pain and distress based on an insurer's failure to defend); Gorab v. Equity Gen. Agents, Inc., 661 P.2d 1196, 1199 (Colo. Ct. App. 1983) (observing that an insured "injured by bad faith breach of an insurance contract may be entitled to . . . damages for emotional distress"); Farmers Group, Inc. v. Trimble, 658 P.2d 1370, 1375 (Colo. Ct. App. 1982) (holding that an insurer's intentional conduct can give rise to damages for emotional distress), *aff'd*, 691 P.2d 1138 (Colo. 1984); Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980) (holding that an insurer's bad faith refusal to settle can support an award of damages for emotional distress); Perry v. Safeco Ins. Co., 821 S.W.2d 279, 281 (Tex. App.—Houston [1st Dist.] 1991, writ denied) (clarifying that the trier of fact can award damages for physical pain and mental anguish); Campbell v. State Farm Mut. Auto. Ins. Co., 840 P.2d 130, 139 (Utah Ct. App.) (ruling that damages for mental anguish are available even when the insurer eventually pays the excess judgment), *cert. denied*, 853 P.2d 897 (Utah 1992).

involved a different form of "strict" liability for the insurer's failure to settle.

First, as the duty to accept reasonable offers to settle was being articulated, the Supreme Court of California suggested that the cause of action might actually encompass what amounted to the failure to accept any offer of settlement, whether reasonable or not.[31] In effect, the court indicated that in the future, it might hold the cause of action to sound in strict liability rather than negligence. The Supreme Court of New Jersey followed California's lead in making this suggestion, also in dictum,[32] and an important law review article enunciated a rationale for this approach.[33] Arguably, this strict liability approach would have little direct effect on insurer behavior,[34] but there is little doubt that such exposure would affect the tactics of the underlying litigation against the policyholder and that it would generate more duty-to-settle liability. The approach never was adopted in California or elsewhere, however, and claims for breach of the duty to settle have continued to require a showing that the insurer *unreasonably* rejected the offer to settle within policy limits.[35]

Second, in its 1975 decision in *Johansen v. California State Automobile Ass'n Inter-Insurance Bureau*,[36] the Supreme Court of California expanded the insurer's duty to settle by holding that the insurer's doubts about whether the claim against its policyholder is covered by the policy are irrelevant to the duty. Under the rule in *Johansen*, the reasonableness of the insurer's decision to reject an offer to settle the claim

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31. *See Crisci*, 426 P.2d at 177 ("The duty of the insurer to consider the insured's interest in settlement offers within the policy limits arises from an implied covenant in the contract, and ordinarily contract duties are strictly enforced and not subject to a standard of reasonableness.").

32. *See* Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 509 (N.J. 1974) (suggesting that an insurer who, for whatever reason, refuses to settle for the policy limits may be forced to "bear the unhappy financial results of that unilateral decision").

33. *See* Victor E. Schwartz, *Statutory Strict Liability for an Insurer's Refusal to Settle: A Balanced Plan for an Unresolved Problem*, 1975 DUKE L.J. 901, 905-11 (arguing that the policies which support strict products liability for manufacturers also apply to liability insurance); *see also* Phillip L. Deaver, Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, 50 S. CAL. L. REV. 751, 754, 794-808 (1977) (proposing a "modified scheme of strict liability" that addresses problems present in a "pure strict liability" approach); Robert W. Peterson, Note, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule*, 18 STAN. L. REV. 475, 482-85 (1966) (arguing for strict liability in light of the institutional interest of insurers); Darrell Waas, Note, *Expanding the Insurer's Duty to Attempt Settlement*, 49 U. COLO. L. REV. 251, 260 (1978) (suggesting that strict liability would resolve conflicts of interest between insurer and insured).

34. *See* KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 193 (1986) ("[I]n theory, the insurer's conduct under either standard will be the same . . . [because] [i]t would make no sense for an insurer to accept unreasonable offers even under a strict liability standard.").

35. *E.g.*, Rawlings v. Apodaca, 726 P.2d 565, 573 (Ariz. 1986); Glenn v. Fleming, 799 P.2d 79, 85-86 (Kan. 1990); Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 265 (Miss. 1988); Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990).

36. 538 P.2d 744 (Cal. 1975).

against its policyholder must be judged without regard to whether the policy actually provides coverage. If the insurer rejects a reasonable offer, so conceived, and a judgment against the policyholder in excess of the policy limits is later entered, then the insurer is liable for the full amount of the judgment if the policy in fact covers the policyholder's liability.[37] Even under *Johansen*, the insurer will bear no liability for rejecting a "reasonable" offer to settle a claim that turns out not to be covered by the policy. However, a rule that takes into account the insurer's legitimate doubts about its underlying contractual obligation to indemnify the policyholder in judging the reasonableness of the offer to settle will narrow that duty, thus diminishing the insurer's exposure to liability.

This latter rule, rather than the *Johansen* rule, has become the norm. Although the *Johansen* rule has gained limited acceptance,[38] in many jurisdictions there have been no authoritative rulings on the relevance to the duty to settle of the insurer's legitimate doubts about coverage. In many jurisdictions, the *Johansen* rule has been rejected in favor of an approach that judges the reasonableness of the insurer's behavior in light of the circumstances surrounding its action.[39] As in the case of the other California developments canvassed above, the risk that *Johansen* would take the country by storm never materialized.

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37. *Id.* at 750.

38. *See, e.g.*, Rider v. State Farm Mut. Auto. Ins. Co., 514 F.2d 780, 784-86 (10th Cir. 1975) (holding that a determination of liability for failure to accept a reasonable settlement offer within policy limits must be considered separately from a failure to defend); Buntin v. Continental Ins. Co., 525 F. Supp. 1077, 1083 (D.V.I. 1981) ("We hold that an insurer's honest but erroneous belief that there is no coverage under its policy of insurance in no way lessens the insurer's obligation to view a settlement offer as if it alone were liable for any eventual judgment, nor does it diminish the insurer's liability in the event it breaches its settlement obligations."); Parsons v. Continental Nat'l Am. Group, 550 P.2d 94, 100 (Ariz. 1976) (holding that the "fact that the carrier believed there was no coverage under the policy and so refused to give any consideration to the proposed settlements did not absolve them from liability for the entire judgment entered against the insured"); Eskridge v. Educator & Executive Insurers, Inc., 677 S.W.2d 887, 889-90 (Ky. 1984) (holding that the insurer's "erroneous belief that the policy had lapsed [was] not relevant to the determination of . . . whether, in good faith, [it] was required to accept an offer to settle the claim within the policy limits").

39. *See, e.g.*, Caldwell v. Allstate Ins. Co., 453 So. 2d 1187, 1190 (Fla. Dist. Ct. App. 1984) (finding no bad faith on the part of an insurer that failed to defend or settle because the insurer's attorney exercised reasonable diligence in investigating the claim and sought a declaratory judgment on the question of coverage); Dawn Frosted Meats, Inc. v. Insurance Co. of N. Am., 470 N.Y.S.2d 624, 625 (N.Y. App. Div.) (explaining that the insurer, which had an arguable case for denying coverage, did not act in bad faith because a bad faith showing "requires an extraordinary showing of disingenuous or dishonest failure to carry out [a] contract" (quoting Gordon v. Nationwide Mut. Ins. Co., 285 N.E.2d 849 (N.Y. 1972))), *aff'd*, 467 N.E.2d 531 (N.Y. 1984); National Serv. Fire Ins. Co. v. Williams, 454 S.W.2d 362, 365-66 (Tenn. Ct. App. 1969) (holding that when an insurer's refusal to defend a suit or accept a settlement is not fraudulent or in bad faith, the insurer cannot be held liable for a subsequent judgment to the extent the judgment exceeds the policy amount); Mowry v. Badger State Mut. Casualty Co., 385 N.W.2d 171, 178 (Wis. 1986) (holding that an insurer has the right to exercise its own judgment in determining whether to settle or contest a claim if made in good faith after "a thorough evaluation of the underlying circumstances of the claim and on informed interaction with the insured").

3. *The Overruling of* Royal Globe.—Yet another California bombshell was *Royal Globe Insurance Co. v. Superior Court*,[40] a 1979 decision in which the Supreme Court of California held that under certain circumstances the insurer owed a duty to settle not only to its policyholder but also to the policyholder's adversary—the party who had sued the policyholder in tort.[41] The source of this duty was California's Unfair Insurance Practices Act,[42] a version of a model statute that was and still is in force in many states.[43] The Act made it an unfair practice, among other things, to "fail to attempt 'in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.'"[44] Violations were expressly subject to cease and desist orders by the insurance commissioner, but *Royal Globe* created a private right of action by a plaintiff against a defendant's liability insurer for violation of the Act.[45]

The implications of *Royal Globe* are easy to see. The decision gave the plaintiff in a personal injury action a potential claim against the defendant's liability insurer—conceivably for counsel fees or even punitive damages—in any case in which the defendant's liability insurer rejects an offer to settle. Under a typical liability insurance policy and long-established rules interpreting the defense provisions of such policies, the liability insurer has both a duty to indemnify its insured and a duty to defend the insured against all suits alleging liability that potentially fall within the terms of the policy.[46] Under *Royal Globe*, however, the liability insurer also owes a duty of good faith to its insured's adversary—the party who has sued the insured alleging liability that potentially falls within coverage. If *Royal Globe* were liberally applied, the decision could substantially expand liability insurers' exposure, by forcing them to settle claims brought against their policyholders that would not otherwise be settled, by exposing these insurers to substantial extracontractual liability to nonpolicyholders, or both.

40. 592 P.2d 329 (Cal. 1979).

41. *Id.* at 334-35.

42. *See* CAL. INS. CODE § 790.03 (West 1993); *Royal Globe*, 592 P.2d at 334-35.

43. *See* 2 OFFICIAL N.A.I.C. MODEL INSURANCE LAWS, REGULATIONS AND GUIDELINES 890-1 to 890-5 (Nat'l Ass'n of Ins. Comm'rs 1981). The relevant subportion of the *Official N.A.I.C. Model Insurance Laws, Regulations and Guidelines* is titled *Uniform Claim Settlement Practices Model Regulation*. The model regulation has been adopted in 7 states and was the basis for legislative or administrative action in 13 others. *Id.* at 890-6 to 890-7.

44. CAL. INS. CODE § 790.03(h)(5) (West 1993), *quoted in Royal Globe*, 592 P.2d at 334.

45. CAL. INS. CODE § 790.03 (West 1993); *Royal Globe*, 592 P.2d at 332.

46. KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION 540 (1990).

Notwithstanding the fire storm that *Royal Globe* generated for several years after it was decided,[47] few states followed it,[48] and the decision had little influence. More importantly, in 1988, the Supreme Court of California itself disowned *Royal Globe* and for all practical purposes overruled the case.[49]

E. *The Infrequency of Liability for Outright Denials of Coverage*

Even aside from the decline of California's influence, a final reason that the third-party insurer's extracontractual liability has remained stable is that the imposition of such liability for the outright denial of coverage has not occurred as often as might be supposed. In contrast to the many first-party cases in which liability has been imposed for outright denials of coverage,[50] there simply are few reported decisions in which a third-party insurer is held liable for a bad faith denial of liability insurance to its policyholder. Although the law permits such liability to be imposed, this seems to happen infrequently.[51] One possible explanation for the paucity of reported decisions, of course, may be that the threat of extracontractual

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47. *See, e.g.*, Allen, *supra* note 2, at 843 (claiming that the *Royal Globe* majority ignored the intent of the California legislature in interpreting § 790.03(h) of the California Insurance Code as providing the basis for private actions by third-party claimants); G. Robert Mecherle & Donald R. Overton, *A New Extra Contractual Cloud upon the Horizon: Do the Unfair Claim Settlement Practices Acts Create a Private Cause of Action?*, 50 INS. COUNSEL J. 262, 264-66 (1983) (questioning the California Supreme Court's interpretation of the Unfair Claim Settlement Practice Act in light of contrary interpretation of similar provisions in federal laws); Joan M. Price, 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, 1176-87 (1980) (detailing the strained interpretation of the Unfair Practices Act given by the *Royal Globe* majority and arguing that the Insurance Code section relied on by the court was not intended to create a private right of action); Michael Tancredi, Note, *Extending the Liability of Insurers for Bad Faith Acts:* Royal Globe Insurance Co. v. Superior Court, 7 PEPPERDINE L. REV. 777, 791-92 (1980) (noting the inherent conflict for an insurer in the existence of a duty to both the insured and the injured party under the *Royal Globe* standard for liability).

48. *But see* Jenkins v. J.C. Penney Casualty Ins. Co., 280 S.E.2d 252, 256-57 (W. Va. 1981) (following *Royal Globe*). *Royal Globe* remains good law in West Virginia.

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

50. Foundation Reserve Ins. Co. v. Kelly, 388 F.2d 528, 530-31 (10th Cir. 1968) (affirming a summary judgment against the insurance company in a bad faith refusal-to-defend case); Rumford Property and Liab. Ins. Co. v. Carbone, 590 A.2d 398, 401-02 (R.I. 1991) (affirming the trial court's directed verdict for the insurance company on the insured's bad faith claim and holding that the existence of arguable questions of fact regarding coverage precluded a bad faith finding against the insurance company); Hanover Ins. Co. v. Jennings, 323 S.E.2d 863, 864 (Ga. Ct. App. 1984) (affirming a summary judgment on denial-of-coverage and bad faith claims); *see generally* Roger G. Henderson, *The Tort of Bad Faith in First Party Insurance Transactions: Refining the Standard of Culpability and Reformulating the Remedies by Statute*, 26 U. MICH. J.L. REF. 1 (1992) (exploring the statutory and common law background of the tort of bad faith in the first-party context).

51. For example, the Shernoff treatise contains no section expressly devoted to cases involving this kind of claim, although it does contain major sections devoted to bad faith claims for breach of the duty to defend, claims that in many cases subsume a cause of action for bad faith refusal to indemnify. SHERNOFF ET AL., BAD FAITH, *supra* note 2.

liability is performing its intended function by deterring bad faith denials of coverage that would otherwise take place. A more complex but also more accurate explanation, I think, is that at least with respect to consumers' liability insurance, if an insurer complies with its duty to defend the insured, it tends largely to eliminate any claim for bad faith denial of coverage. Thus, because the law governing breach of the duty to defend so strongly encourages compliance with that duty, few bad faith denials of coverage occur.

In virtually all jurisdictions, an insurer subject to the duty to defend (including almost any primary automobile, commercial general liability, or malpractice liability insurer) must defend any claims against its insured alleging liability that potentially falls within the terms of coverage, even if the claim is groundless, false, or fraudulent.[52] The question is not whether the claim against the insured is valid but whether the claim would be covered if it were valid. As the courts put it in seemingly endless repetition, the duty to defend is broader than the duty to indemnify.[53] To comply with the duty to defend without prejudicing their coverage defenses, insurers with such potential defenses typically defend their policyholders under a "reservation of rights" that reserves to them the right to contest coverage at a later time if the suit against the policyholder they are defending is successful. For example, that was how the insurer in *Johansen* came to be defending its policyholder even while the insurer entertained doubts about its coverage obligation.[54] In many jurisdictions, the consequence of the insurer's breach of its duty to defend is the loss of its right to contest coverage if the suit against the insured is successful or is reasonably settled by the insured.[55]

This form of liability for breach of the duty to defend creates a powerful incentive to comply with that duty, for under this rule an insurer that improperly refuses to defend its insured forfeits its right to contest coverage. In contrast, the insurer that defends subject to a reservation of

52. *See* ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW § 111[a] (1987).

53. *See, e.g.*, Enserch Corp. v. Shand Morahan & Co., 952 F.2d 1485, 1493 (5th Cir. 1992) ("It is axiomatic insurance law that the duty to defend is broader than the duty to indemnify or pay."); Beckwith Mach. Co. v. Travelers Indem. Co., 638 F. Supp. 1179, 1186 (W.D. Pa. 1986) ("It is well settled that . . . the insurer's duty to defend is broader than its obligation to indemnify the insured."), *appeal dismissed*, 815 F.2d 286 (3d Cir. 1987); Gray v. Zurich Ins. Co., 419 P.2d 168, 176 (Cal. 1966) ("[T]he carrier must defend a suit which *potentially* seeks damages within the coverage of the policy." (emphasis in original)).

54. Johansen v. California State Auto. Ass'n Inter-Insurance Bureau, 538 P.2d 744, 746 (Cal. 1975).

55. *See, e.g.*, Sauer v. Home Indem. Co., 841 P.2d 176, 183 (Alaska 1992) (holding that an insurer who breaches the duty to defend may not later contest coverage in an action on the policy); *see also* 7C JOHN A. APPLEMAN, INSURANCE LAW AND PRACTICE § 4692 (1979) (stating that an insurer who defends an insured without knowledge of the insured's policy breach and without disclaiming liability or reserving rights is estopped from subsequently invoking the insured's breach of the policy).

the right to contest coverage helps to protect itself from a claim of bad faith, because such an insurer can argue that it has not left its policyholder without protection against suit. Rather, the argument goes, the insurer has simply postponed to another day the question of whether it owes the policyholder coverage. If the suit against the policyholder is defeated, that question need not ever be reached.

I do not mean to suggest that compliance with the duty to defend will automatically immunize the liability insurer from liability for bad faith denial of coverage. A reservation of rights issued without any reasonable basis would still trigger bad faith liability.[56] It is interesting that, as I understand the Texas practice, it is common for Texas suits alleging breach of contract by liability insurers to contain a count alleging bad faith breach, sounding in common law and statute. In most jurisdictions, however, successful claims of this kind are comparatively rare.[57]

In retrospect, it is obvious that the insurer's liability for bad faith experienced an extraordinary period of instability beginning roughly two decades ago. On a number of different fronts, the possibility of both substantial doctrinal growth and materially increased liability remained real, in some respects, for more than a decade. Only after the period of relative calm that has existed for approximately the last five years can it be said with a measure of confidence that the field of liability for bad faith has in fact become stable and mature. Although there may always be surprises, neither wholesale expansion nor wholesale change seems likely.

II. The Functions of Liability for Bad Faith in an Era of Stability

Now that the field has matured, reflection about the functions of liability for the bad faith denial of insurance coverage is appropriate. Two different conceptions of the function of liability for bad faith are available, corresponding to the conceptions that dominate thinking about civil liability more generally: *ex ante* and *ex post* conceptions. Each conception has different implications, both for the direction that refinements of the law governing liability for bad faith should take and for research designed to sharpen our understanding of the impact of such liability on policyholders and insurers.

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56. *See* Continental Ins. Co. v. Bayless and Roberts, Inc., 608 P.2d 281, 291 (Alaska 1980) (affirming a trial court's decision that an insurer had breached its fiduciary duty to the insured by refusing to defend except under a reservation of rights); *Bad Faith Defense Taken Under Reservation of Rights Must Be in Good Faith and with Due Care*, 54 DEF. COUNS. J. 424, 424-25 (1987) (advising insurers to use caution when defending under a reservation of rights).

57. *See supra* note 51 and accompanying text.

A. *The* Ex Ante *Conception*

Under an *ex ante* conception, the function of the insurer's liability for bad faith is judged by the manner in which the threat of liability will affect insurer behavior. Under this conception, the threat of liability functions to correct possible underenforcement and conflict-of-interest problems. In first-party insurance, the cost to the policyholder of bringing suit for breach of contract makes it possible for the insurer to deny legitimate claims because the traditional rules governing damages award the successful claimant only the amount to which she is entitled under the policy.[58] By threatening insurers who wrongfully deny claims with liability for extra-contractual damages, bad faith liability has the potential to correct such underenforcement: Any benefit to be gained by denying a claim must be offset by the additional liability the insurer will face if it is later found to have denied the claim in "bad faith."[59]

Similarly, in third-party insurance, an insurer that refuses to accept an offer to settle a liability claim against its policyholder for an amount within the policy limits risks subjecting the policyholder to liability in excess of those limits. In such cases, the interests of the insurer and the policyholder conflict, because the insurer may be better served by going to trial and defeating the claim than by settling. The policyholder is likely to be better served by a settlement paid by the insurer for any sum within the policy limits.[60] If the policyholder is viewed as having a right not only to coverage in the event a judgment is entered against her, but also a right to protection—by way of settlement—against above-the-policy-limits judgments, then the insurer's failure to settle may deprive her of this "coverage." Imposing liability for the full amount of any judgment, when the insurer has refused to accept a reasonable offer to settle for a sum within the policy limits, neutralizes this conflict of interest and corrects the underenforcement of the policyholder's right to be protected through settlement. The insurer that refuses to accept a reasonable offer of settlement for a sum within its policy limits risks incurring additional liability beyond the limits of its policy.[61]

In both first-party and third-party insurance, then, an *ex ante* conception sees liability for bad faith denial of coverage as functioning to "top-

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58. *See* ABRAHAM, *supra* note 34, at 173 (concluding that because insurance claims "were simply subject to the ordinary rules of contract performance and breach," insurers who failed to settle or defend claims as provided for by policies had no special damage exposure); 1A ROWLAND H. LONG, THE LAW OF LIABILITY INSURANCE § 5.30, at 5-200 to 5-202 (1988) (outlining the remedies traditionally available in breach of insurance contract cases).

59. *See* ABRAHAM, *supra* note 34, at 183-85.

60. The exception involves professional liability and other forms of insurance in which the reputation of the policyholder is at stake.

61. ABRAHAM, *supra* note 34, at 188-93.

off" the insurer's potential liability in order to promote optimal deterrence of breaches of contract. On this view of liability for bad faith, the debates of the past decade over the precise contours of the cause of action are somewhat beside the point.[62] Whether first-party bad faith includes reckless or even negligent disregard of the legitimacy of the policyholder's claim for coverage and whether the liability insurer's duty to settle is governed by a negligence or a strict liability standard matters little, because liability for bad faith serves a largely *ex ante* function. By threatening the insurer with liability for extracontractual damages, promise-keeping by insurers is more nearly optimized. Because even under a fairly clear test for bad faith the insurer can never predict with any kind of precision the scope of the liability for extracontractual damages it will incur by denying coverage, the test for bad faith liability is not critically important to its goal. At the margin, a test that threatens more liability will generate more promise-keeping by insurers, whereas a test that threatens less liability will generate less promise-keeping. In the absence of any firm idea of how great the background level of promise-breaking by insurers is, however, it is impossible to say exactly how much extracontractual liability there ought to be in order to make up for this shortfall.

This "topping-off" rationale for a new form of liability is far from unique. It is, for example, an important rationale for the imposition of liability for pain and suffering,[63] punitive damages,[64] pure emotional distress,[65] and pure economic loss in tort.[66] The topping-off rationale also formed the basis of the decision imposing liability for foreseeable consequential loss for breach of contract in *Hadley v. Baxendale*.[67] As an antidote to the traditional view of civil liability as a system of corrective justice, this modern way of thinking about civil liability from the *ex ante*

62. For a discussion of this issue in the first-party context, see generally Henderson, *supra* note 50 (describing the development of the tort of bad faith and discussing the standards of culpability established by various states).

63. 2 AMERICAN LAW INSTITUTE, *supra* note 9, at 211-13.

64. *See* 2 *id.* at 241-42; Dorsey D. Ellis, Jr., *Fairness and Efficiency in the Law of Punitive Damages*, 56 S. CAL. L. REV. 1, 3 (1982); David G. Owen, *The Moral Foundations of Punitive Damages*, 40 ALA. L. REV. 705, 705 (1989) (all noting that deterrence is one of the purposes for imposing punitive damages).

65. *See* Dillon v. Legg, 441 P.2d 912, 921 (Cal. 1968) (holding that a mother's witnessing, at close range, the death of her child resulting from a motorist's negligent operation of his automobile alleged a sufficient prima facie case against the motorist).

66. *See* Union Oil Co. v. Oppen, 501 F.2d 558, 568-70 (9th Cir. 1974) (holding that oil companies had a duty to commercial fishermen to conduct offshore drilling and production in a reasonably prudent manner so as to avoid negligent harm to fish and to prevent economic loss).

67. 156 Eng. Rep. 145, 151 (Ex. Ch. 1854) (announcing the rule that a party who breaches a contract must pay damages that "may fairly and reasonably be considered either arising naturally . . . from such breach" or "as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the provable result of the breach").

perspective has been extraordinarily useful. It has encouraged judges and legal scholars to consider more carefully what has always been obvious—that liability rules not only compensate, but also deter.

On the other hand, because rules that permit the topping-off of liability are open-ended, they generate uncertainty about outcomes, or at the least about the magnitude of outcomes. The courts that create topping-off rules tend over time to try to increase the rules' specificity and thus to enhance the predictability of outcomes.[68] As that specificity increases, the degree of flexibility available to perform the topping-off function narrows. From the *ex ante* standpoint, then, the ultimate question about the scope of liability for bad faith is whether the law has now achieved an optimal degree of specificity. My own intuition is that the law as it now stands is probably within close range of being optimal, but objective data about the effects of the threat of liability, confirming or refuting that intuition, would be valuable.

B. The Ex Post *Conception*

A different conception sees the function of liability for bad faith from an *ex post* perspective. Under this conception, the principal function of such liability is to correct a wrong committed by the insurer that harms the policyholder. Although a legal commitment to correct similar wrongs in the future may have a deterrent effect on other insurers, from the *ex post* standpoint such deterrence is merely a side effect of the central, wrong-correcting purpose of bad faith liability. Even this side effect must be understood to be a correlate of the notion of corrective justice: It is axiomatic that all insurer practices which ought to be deterred are also wrongs deserving of correction when they do occur.

In contrast to the *ex ante* view, which regards the precise test that is employed in deciding whether to impose liability as a secondary issue, the *ex post* view considers the liability standard that the law employs in bad faith cases to be critically important, for that standard defines the wrongs to be corrected. As the degree of wrongdoing by the insurer declines from deliberate infliction of harm toward merely negligent denial of coverage, the argument for imposing liability on the insurer for the consequences of its actions weakens, for well-recognized substantive and administrative

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68. This certainly has been true in the development of the law governing recovery in negligence for pure emotional distress. *Compare Dillon*, 441 P.2d at 924 (creating such liability) *with* Thing v. La Chusa, 771 P.2d 814, 829-30 (Cal. 1989) (placing limitations on the scope of the cause of action); *compare* Rodrigues v. State, 472 P.2d 509, 520 (Haw. 1970) (creating such liability) *with* Kelley v. Kokua Sales and Supply, Ltd., 532 P.2d 673, 676 (Haw. 1975) (placing limitations on the scope of the cause of action). *See also* John L. Diamond, Dillon v. Legg *Revisited: Toward a Unified Theory of Compensating Bystanders and Relatives for Intangible Injuries*, 35 HASTINGS L.J. 477, 500-01 (1984) (describing the efforts by California courts to limit the potential liability imposed by *Dillon*).

reasons.[69] Efforts to sharpen and clarify the standard through the application of judicial and academic analysis are therefore entirely sensible under the *ex post* conception.

Moreover, any negative side effects resulting from the threat of liability for bad faith are, in a sense, less significant under an *ex post* conception than they would be under an *ex ante* conception. Under the *ex post* conception, the focus on doing justice in the individual case is likely both to obscure the effects of the imposition of liability in that case on other actors in the system and to render these effects less important than they are under an *ex ante* conception. In contrast, under an *ex ante* conception, the insurer's incentive to change its behavior as a result of the threat of liability is not a mere *side effect*; rather, it is the very effect that the imposition of liability seeks to achieve. Consequently, under an *ex ante* conception, the negative and positive effects of the decision to threaten liability are more likely to be balanced against each other in fashioning an overall rule governing liability.

C. *The Effects of Bad Faith Liability*

Both the *ex ante* and *ex post* conceptions of the basis for imposing liability for bad faith raise a number of questions about the effects of this form of liability. First, liability for bad faith not only encourages the payment of legitimate claims, but at the margin, the threat of liability for bad faith also is likely to encourage the payment of borderline claims that are not, in fact, covered by the insurance policy in question. I once characterized this extension of insurance coverage to losses that do not fall within the terms of the policy as "insurance against the risk of not being insured."[70] Although that description remains accurate, it is also incomplete. In considering how to shape a form of liability that extends insurance coverage beyond what might otherwise have been provided, two questions must be asked. The first is whether the cost of the additional coverage is worth paying for, and the second is whether that cost is appropriately distributed. These questions ought to be asked about the threat of liability for bad faith, for that threat creates additional coverage as surely as if it were written into every insurance policy.

Unfortunately, these questions are more easily asked than answered.

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69. *See* Fleming James, Jr., *Limitations on Liability for Economic Loss Caused by Negligence: A Pragmatic Appraisal*, 25 VAND. L. REV. 43, 51-52 (1972) (noting that in some areas of tort law, the deterrent effect fulfills an important societal function—assisting in the control of human behavior—while in other areas, such as accidental injuries, the deterrence is much less significant). Substantively, commercial norms of behavior may demand only abstention from conscious wrongdoing rather then the exercise of due care; administratively, determining what constitutes due care is likely to be difficult and costly in commercial settings in which norms are not uniform.

70. ABRAHAM, *supra* note 34, at 174.

I am not aware of any quantitative analysis of the effects of the threat of bad faith liability on rate-making, underwriting, claim processing, or settlement decisions. Thus, while we might be able to get a general idea of how much bad faith costs when liability is imposed by looking at bad faith judgments and settlements, we still would have no idea how much it costs for insurers to refrain from acting in bad faith. Yet, knowing that cost would be essential to any determination of the overall net benefit—or net cost—of liability for bad faith. From an *ex ante* (behavior-influencing) standpoint, the answer is centrally important, for it would help us to know whether the deterrence game is worth the candle. And from an *ex post* (remedial) standpoint, the answer is at least potentially relevant, for even under this conception, presumably at some point the costs of assuring that insurer wrongs are corrected become too high.

For similar reasons, it would be extremely useful to know how the additional costs and additional benefits of bad faith liability are distributed. At one extreme would lie a pro rata distribution of both costs and benefits among policyholders; at the other extreme would lie a distribution that in one way or another disproportionately burdens certain classes of policyholders. Although I have no reason to suppose that the costs and benefits of bad faith liability are distributed disproportionately, it is nonetheless conceivable that certain classes of policyholders do capture a disproportionate share of the benefits of the threat of liability for bad faith. For example, those who buy auto liability insurance with comparatively low policy limits may well receive a disproportionate amount of protection from the risk of an above-the-policy-limits judgment because of the third-party insurer's liability for rejection of a reasonable offer of settlement within the policy limits.[71] It is unclear what the exact demographic and other characteristics of this class are, and whether its members receive this disproportionate share of protection from bad faith without paying a proportionate share of the cost of dealing with this threat.[72] In the absence of information about the distribution of these burdens and benefits, it is difficult to be confident about the net *ex ante* effects of the cause of action for the rejection of reasonable offers to settle within the policy limits.

The threat of liability for bad faith has potential *ex post* effects that must also be taken into account in evaluating the various forms of bad faith liability. For example, adding a bad faith count to a complaint claiming that an insurer has breached its first-party insurance contract by denying coverage is commonplace. Given the enormous exposure facing any insur-

71. This is simply because the lower the limits of a given liability policy, the greater the likelihood that a judgment will exceed those limits.

72. To make this determination it would be necessary to know, among other things, whether auto liability insurers set premiums for basic-limits liability insurance in light of the risk of bad faith liability, or on the contrary, ignore this risk.

er sued for bad faith, the availability of a bad faith claim may substantially raise the asset value of a coverage claim. In one sense, this is merely a truism: If the whole point of liability for bad faith is, in appropriate instances, to increase an insurer's exposure for denying legitimate claims, then it follows that an insurer that is sued for bad faith has greater potential liability than an insurer sued only for breach of contract. And the greater the insurer's potential liability, the greater the asset value of the claim.

In another sense, however, the addition of a bad faith count to a complaint does more than merely increase the insurer's exposure. An ordinary breach of contract claim typically has a liquidated value, or at least a relatively narrow range of possible damages. Damages awarded for bad faith breach of a first-party policy, in contrast, are unliquidated. Even when the damages are compensatory only, they amount to an award of pain and suffering for failure to pay a claim; and when punitive damages are recoverable, the amount awarded may vary depending on the degree of insurer "wrongdoing" that is proved and the jury's reaction to this proof. Even a relatively low probability that a bad faith claim will be successful cannot be ignored, because the potential award to the successful claimant may be enormous. Consequently, the expected value of the entire claim becomes much less certain, and risk aversion on the part of the insurer may disproportionately increase the settlement value of the policyholder's claim.[73]

In contrast, the *ex post* effects of the insurer's extracontractual liability for failure to accept a reasonable offer of settlement within the policy limits and of the insurer's bad faith refusal to defend its insured seem much less disruptive. The amount of any above-the-policy-limits judgment rendered after the insurer's refusal to settle is liquidated and known by both parties at the time the extracontractual claim is made; the issue is simply whether the offer of settlement was reasonable.[74] Similarly, by the time a claim for bad faith failure to defend is made, the amount of each possible element of damages[75] is likely either to be known or to be reasonably estimable.

73. Ironically, an insurer that is the object of frequent bad faith claims is somewhat more protected against this effect than an insurer that is only an occasional bad faith defendant, because the variance in the distribution of an insurer's expected loss over a large number of claims is likely to be smaller than over a small number.

74. In some jurisdictions, of course, the issue also is whether the insurer harbored legitimate doubts about its coverage obligation. *Compare* Johansen v. California State Auto. Ass'n Inter-Insurance Bureau, 538 P.2d 744 (Cal. 1975) (holding that the insurer's doubts are irrelevant to the duty to settle) *with* Mowry v. Badger State Mut. Casualty Co., 385 N.W.2d 171 (Wis. 1986) (holding that an insurer does not breach its duty to settle when its doubts are reasonable under the circumstances). *See* notes 38-39 and accompanying text.

75. Depending on the jurisdiction, these can include the cost of defense, of indemnity, and of counsel fees for prosecuting the claim itself. *See* LONG, *supra* note 58, § 5.30, at 5-207 to 5-209 (listing the damage elements for bad faith failure to defend).

In these classes of claims for extracontractual damages against insurers, the existence of a cause of action also raises the asset value of the insured's claim, but in a manner that is proportionate to the strength of the claim itself. Thus, with respect to these kinds of claims, the threat of liability for bad faith is not disruptive from either an *ex ante* or an *ex post* standpoint.

III. Conclusion

The law governing the insurer's liability for bad faith has evolved from an undefined, vague set of threats into a relatively mature body of settled rules and accepted goals. For a variety of reasons, the legitimate concern of a decade or more ago that the law of bad faith would expand indefinitely should by now have nearly disappeared. We still know a good deal less about the effects of liability for bad faith, however, than would be desirable. The work of the other authors contributing to this Symposium should help to close the gap between what we know about bad faith liability and what we ought to know in order to evaluate this field with suitable precision. But as the law governing liability for bad faith continues to mature, it is important that we develop a better understanding of the effect of this form of liability on the behavior of insurers and on the level and distribution of the costs incurred by policyholders as a result of the threat of liability for bad faith.