IN THE
SUPREME COURT OF PENNSYLVANIA
MIDDLE DISTRICT

NOS. 25, 26, 27 & 28 M.D. Appeal Dkts. 2000

THE BIRTH CENTER,

v.

THE ST. PAUL COMPANIES, INC., ET AL.,

APPEAL OF: ST. PAUL COMPANIES, INC.

BRIEF OF AMICI CURIAE UNITED POLICYHOLDERS IN SUPPORT OF THE BIRTH CENTER

On Appeal from the Order of The Superior Court Dated March 9, 1999 at Nos. 2379 Philadelphia 1997, 2380 Philadelphia 1997, 2659 Philadelphia 1997 and 2670 Philadelphia 1997 (Consolidated Appeals) Reversing The Orders of the Court of Common Pleas of Delaware County Dated February 7, and August 11, 1997 Granting Judgment Notwithstanding The Verdict and Denying Post-Trial Relief

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John N. Ellison
John A. MacDonald
Timothy P. Law
ANDERSON KILL & OLICK, P.C.
1600 Market Street
32nd Floor
Philadelphia, PA 19103
(215) 568-4202
Attorneys for Amici Curiae

Of Counsel,
Amy Bach
United Policyholders
11 Pacific Avenue
No. 262
San Francisco, CA 94111
(415) 393-9990

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STATEMENT OF INTEREST OF *AMICUS CURIAE*

United Policyholders ("United Policyholders" or "*Amicus Curiae*") is incorporated as a not-for-profit educational organization and was granted tax exempt status under §501(c)(3) of the Internal Revenue Code. United Policyholders' mission is to educate the public on insurance issues and consumer rights thereto, and to assist policyholders secure prompt, fair, insurance settlements. United Policyholders provides educational materials, provides speakers at community and government forums, organizes meetings in disaster areas, and acts as a clearing house for information on insurance issues.

United Policyholders also provides assistance in large catastrophes. After a disastrous firestorm in 1991 that destroyed over three thousand structures in Oakland and Berkeley Hills, California, United Policyholders sponsored meetings, workshops, and seminars for the victims, and worked with local officials, insurers and relief agencies to facilitate claim settlements. United Policyholders has repeated this process in Florida for victims of Hurricane Andrew, in Texas, for victims of the Northridge Earthquake, and for Northern California victims of a wildfire.

United Policyholders also files *amicus curiae* briefs in insurance coverage cases of public importance. Filing *amicus curiae* briefs is a small, albeit important, part of United Policyholders' activities. United Policyholders' *amicus curiae* briefs have been accepted by courts throughout the country. See, e.g., Humana, Inc. v. Forsyth, 119 S. Ct. 710, 719 (1999) (citing to pages 19-23 of Brief for United Policyholders as *Amicus Curiae*); Western Alliance Ins. Co. v. Gill, 686 N.W. 2d 997 (Mass. 1997). [1]

[1] See also, Fleming v. United Services Auto. Assoc, 988 P.2d 378 (Ore. 1999); Vandenberg v. Superior Court, 88 Cal. Rptr. 2d 366 (Cal. 1999); Peace v. Northwestern

United Policyholders' activities are limited only to the extent that United Policyholders exists exclusively on donated labor and contributions of services and funds. This brief has been prepared pro bono by United Policyholders' counsel with no contributions from any other source.

Amicus Curiae has a vital interest in seeing that insurance companies comport with the duty of utmost good faith in representing the interests of their policyholders, which flows from the contracts of insurance sold to policyholders. *Amicus Curiae* also has an interest in maintaining and advancing the jurisprudence of "bad faith" in Pennsylvania, which was intended to protect policyholders from insurance company bad faith.

National Ins. Co., 596 N.W. 2d 429 (Wisc. 1999); United States v. Brennan, 183 F.2d 139 (2d Cir. 1998); Board of Ed. of Township High School District No. 211 v. International Ins. Co., 720 N.E.2d 622 (Ill. Ct. App. 1999); Ducote v. Koch Pipeline Co., L.P., 730 So.2d 432 (La. 1999); Carter-Wallace, Inc. v. Admiral Ins. Co., 712 A.2d 1116 (N.J. 1998); National Ins. Co. v. George 953 S.W.2d 946 (Ky. 1997).

COUNTER-STATEMENT OF QUESTIONS INVOLVED

A. Whether the insurer's payment of the excess verdict precludes the insured from maintaining a bad faith action;

B. Whether compensatory damages are recoverable in a bad faith action; and

C. Whether the trial court properly charged the jury on a breach of contract theory based on the insurer's bad faith conduct.

COUNTER-STATEMENT OF THE CASE

For the purposes of this *Amicus Curiae* brief, *Amicus Curiae* incorporates by reference the recitation of facts as presented in the opinion of Judge Kelly, speaking for a unanimous panel of the Superior Court in Birth Center v. St. Paul Cos. Inc., 727 A.2d 1144 (Pa. Super. 1999).

SUMMARY OF ARGUMENT

Insurance companies owe their policyholders an obligation to act with the utmost good faith. This duty of good faith arises from the creation of the insurance policy itself, recognizing the special trust and confidence reposed in the insurance company by the policyholder. When an insurance company breaches the duty of good faith, it contravenes the very essence of the contract of insurance. Thus, a breach of this implied duty of utmost good faith gives rise to a breach of contract. When an insurance company breaches its insurance policy by refusing to settle within limits and exposes its policyholders to a judgment in excess of the insurance policy limits, such breach cannot be excused by the payment of an excess judgment, which is often only one element of the policyholders damages.

When an insurance company breaches its duty of utmost good faith, the policyholder is entitled to those damages that will put the policyholder in the same position as if the insurance company had not breached the contract. An aggrieved policyholder, such as Birth Center, should be able to pursue the full panoply of contractual remedies, including the types of damages awarded to Birth Center by the jury in this action, in addition to any other damages that may be awarded under Pennsylvania's bad faith statute, 42 Pa. Cons. Stat. Ann. §8371.

The Superior Court properly instructed the jury on both the nature of Birth Center's action and the remedies available in such an action. The trial court's cogent instruction stated that if the jury found that St. Paul had violated its duty of utmost good faith, St. Paul could be found liable for an amount that would put Birth Center in the position it would have been in had St. Paul not breached its duty.

For all the foregoing reasons, this Court should affirm the Superior Court's decision reversing the trial court's entry of judgment notwithstanding the verdict.

ARGUMENT

I. PAYMENT OF AN EXCESS VERDICT DOES NOT EXTINGUISH AN INSURANCE COMPANY'S BAD FAITH REFUSAL TO SETTLE BECAUSE PENNSYLVANIA LAW IMPOSES A FULL RANGE OF CONTRACTUAL AND STATUTORY REMEDIES FOR BAD FAITH.

A. Insurance Policies Include an Implied Covenant of Good Faith and Fair Dealing and Create Fiduciary Obligations.

The duty of an insurance company to its policyholder is one of trust and confidence, in which the policyholder relies on the insurance company to make good on its promises. While there is an implied duty of good faith in the performance of every contract,[2] the contract of insurance is special. When tragedy strikes – whether it is a lawsuit, a leaky roof, or a car accident – a policyholder's fortune is in the hands of his or her insurance company. For this reason, Pennsylvania law has long demanded that insurance companies engage in the "utmost fair dealing" toward their policyholders. Fedas v. Insurance Co. of State of Pa., 300 Pa. 555, 558, 151 A. 285, 286 (1930).

This duty of good faith and fair dealing is especially acute in the liability insurance context, where the insurance company takes control of the decision to settle or litigate actions brought by third parties. In this context, the insurance company owes its policyholder a "fiduciary duty." Gedeon v. State Farm Mut. Auto. Ins. Co., 410 Pa. 55, 60, 188 A.2d 320, 322 (1963). This Court has explained that "by asserting in the policy the right to handle all claims against the insured, including the right to make a binding settlement, the insurer assumes a fiduciary position towards the insured and becomes obligated to act in good faith and with due care in representing the interests of

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[2] See Restatement (Second) of Contracts § 205 (1979).

the insured." Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 504, 223 A.2d 8, 9 (1966); Gedeon, 410 Pa. at 60, 188 A.2d at 322.[3]

Among the duties assumed by a liability insurance company, one of the most important is the duty to settle reasonably and in good faith. The breach of the duty to settle in good faith "constitutes a breach of the insurance contract for which an action in assumpsit will lie." Gray, 422 Pa. at 508, 223 A.2d at 11; see also, Diamon v. Penn Mut. Fire Ins. Co., 247 Pa. Super. 534, 552, 372 A.2d 1218, 1227 (1977) (breach of duty to investigate in good faith "constitutes a breach of the insurance contract for which an action in assumpsit will lie"); Indemnity Cas. & Prop. Ltd. v. R.K. Watersports, Ltd., No. Civ. A. 95-2859, 2000 WL 298968, at * 8 (E.D. Pa. Mar. 14, 2000) (breach of duty to defend with due care is a breach of contract); Restatement (Second) of Contracts, § 205 (1979) (implying a duty of good faith into every contract). While the insurance company's bad faith may also give rise to tort claims for breach of fiduciary duty, fraud, or deceit,[4] and a statutory bad faith claim under 42 Pa. Cons. Stat. Ann. § 8371,[5] policyholders still have a valid claim for breach of contract based upon the breach of the

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[3] Importantly, it is the insurance company's duty to defend and settle claims, not the actual assumption of the defense, that causes the fiduciary duty to arise. If the insurance company improperly disclaims its duty to defend and settle, it breaches its fiduciary duty.

[4] While this Court has refused to recognize a common law tort of bad faith, it recognizes other tort remedies to combat insurance company bad faith. See Pekular v.Eich 355 Pa. Super. 276, 284, 513 A.2d 427, 431 (1986), alloc. denied 516 Pa. 635, 533 A.2d 93 (1987) (decision in D'Ambrosio not to recognize a tort of bad faith did not disturb existing tort remedies such as fraud and deceit); see also, D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Ins. Co, 494 Pa. 501, 511 n.8, 431 A.2d 966, 971 n.8 (1981) (refusing to reinstate the count in trespass for Outrageous Conduct Causing Severe Emotional Distress, not because such a tort was unavailable in this context, but because the facts did not warrant it); D'Ambrosio, 494 Pa. 501, 511 n.8, 431 A.2d 966, 971 n. 8 (1981) (concurring opinion) (noting that tort of deceit was still available to the plaintiff).

[5] Depending upon the circumstances of the case, policyholders may also have federal claims such as a claim under the RICO statute, 18 U.S.C. §1961 et seq. when the insurance company engages in a pattern of fraud. Humana, Inc. v. Forsyth, 119 S. Ct. 710 (1999).

implied covenant of good faith and fair dealing. See Brown v. Candelora, 708 A.2d 104, 110 (Pa. Super. 1998) (explaining that a policyholder has a claim for contractual damages – the excess judgment and other foreseeable damages caused by the breach – as well as interest, attorney fees and punitive damages under 42 Pa. Cons. Stat. Ann. § 8371 (West 1998)).

B. Insurance Companies Breach the Implied Covenant of Good Faith And Fair Dealing Whenever They Act in Bad Faith.

An insurance company breaches the implied covenant of good faith, and thus the contract, whenever it acts in "bad faith." Examples of "bad faith" are "evasion of the spirit of the bargain, lack of diligence or slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference or failure to cooperate in the other party's performance." Restatement (Second) of Contracts, § 205, comment d (1979). An insurance company acts in bad faith with regard to the performance of its right and duty to settle cases under liability insurance policies when it fails to "consider in good faith the interest of the insured as a factor in coming to a decision as to whether to settle or litigate a claim against the insured." Cowden v. Aetna Cas. and Sur. Co., 389 Pa. 459, 470, 134 A.2d 223, 228 (1957). The insurance company has no right to "hazard the insured's financial well-being" or to elevate its own interest in litigating a case over a policyholder's interest in settling it. Id., 389 Pa. at 470-71, 134 A.2d at 228. The insurance company must provide an intelligent and objective appraisal of the case to determine the advisability of settlement. Hall v. Brown, 363 Pa. Super. 415, 420, 526 A.2d 413, 415, alloc. denied, 522 Pa. 624, 564 A.2d 916 (1987); Shearer v. Reed, 286 Pa. Super. 188, 428 A.2d 635 (1981).

An insurance company breaches its duty to settle in good faith at the moment the insurance company makes a bad faith decision not to settle. See Cowden, 389 Pa. at 471, 134 A.2d at 229 (the question is "whether the evidence in the case was sufficient to justify the jury's finding that, in deciding to proceed with the trial to verdict, the defendant's representatives were guilty of bad faith in arriving at their decision") (emphasis added). Importantly, the breach of the duty of good faith and fair dealing occurs before an excess judgment is rendered. The insurance company's decision is wrongful whether or not an excess judgment results. The excess judgment is merely the most palpable form of damage caused by an insurance company's bad faith decision not to settle. Policyholders often suffer damages in addition to the excess judgment, such as those suffered by Birth Center in this case.[6] There is no basis in law or equity for absolving an insurance company that breaches the implied covenant of good faith and fair dealing from being subject to the full range of damages that are available for breach of contract. The excess judgment is often only part of the damages caused by the insurance company's breach of the duty of good faith, and the payment of the excess judgment should not extinguish the insurance company's liability for any other damages which may have been caused by the insurance company's bad faith decision not to settle.

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[6] In addition to the damages sustained by Birth Center in this case, an insurance company's bad faith refusal to settle within policy limits may cause yet another harm. If a settlement below policy limits is rejected, and a jury returns a verdict either at or in excess of policy limits, the insurance company's bad faith refusal to settle would have impaired the insurance policy's aggregate limits. If a second occurrence triggers coverage under the insurance policy, a policyholder will have less of their aggregate limit available for this subsequent claim.

C. The Legislature Has Provided A Statutory Cause of Action That Supplements the Damages Available in Contract or Tort Actions Under Insurance Policies.

The Legislature has provided for damages in addition to those that would normally be available in an action for breach of an insurance policy or in tort actions that arise under an insurance policy.[7] Under 42 Pa. Cons. Stat. Ann. § 8371, the Court can award additional damages, such as interest, punitive damages, court costs, and attorney fees whenever an insurance company acts in bad faith.

Similar to the implied covenant of good faith and fair dealing, the bad faith statute applies not just to bad faith settlement decisions, but to the wide variety of instances in which insurance companies act in bad faith toward their policyholders. See, e.g., Klinger v. State Farm Mut. Auto. Ins. Co., 115 F.3d 230 (3d Cir. 1997) (delay in paying claim for UIM benefits); Bracciale v. Nationwide Mut. Fire Ins. Co., No. 92-7190, 1993 WL 323594 (E.D. Pa. Aug. 20, 1993) (refusal to provide a defense, based on a policy exclusion that did not encompass all claims in the underlying complaint); Carpenter v. Federal Ins. Co., 432 Pa. Super. 111, 120-121, 637 A.2d 1008, 1013 (1994) (failure to undertake a reasonable investigation into the policyholder's change in name and corporate status prior to denying coverage and forcing the policyholder to institute a

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[7] The Legislature provided those damages in the Pennsylvania "bad faith" statute:

> In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may take all of the following actions:
>
> (1) Award interest on the amount of the claim from the date the claim was made by the insured in an amount equal to the prime rate of interest plus 3%;
>
> (2) Award punitive damages against the insurer;
>
> (3) Assess court costs and attorney fees against the insurer.

declaratory judgment action); see also, Diamon v. Penn Mut. Fire Ins. Co., 247 Pa. Super. 534, 372 A.2d 1218 (1977) (pressing criminal charges against the policyholder without a legitimate basis for doing so).

In addition to attempting to avoid liability for the full range of contractual damages caused by insurance company bad faith, St. Paul and the insurance industry *amici* ask this Court to eviscerate 42 Pa. Cons. Stat. Ann. § 8371 by judicially creating a loophole in the bad faith statute. If payment of an excess verdict could somehow erase the insurance company's bad faith decision not to settle, as St. Paul on its *amici* seek to have this court hold insurance companies could avoid the statutory damages provided by the bad faith statute – which include the possibility of punitive damages –simply by paying the excess verdict. If this Court rule as St. Paul and its *amici* wish, the statute will not longer be the deterrent to bad faith that the Legislature intended because insurance companies that act in bad faith could avoid the statute's reach. The bad faith statute would be unavailable to compensate the policyholder or punish the insurance company that acted in bad faith in failing to settle. In short, an insurance company cannot be permitted to avoid full contractual and statutory liability simply by paying the excess judgment.

D. Pennsylvania's Strong Public Policy Against Insurance Company Bad Faith Would Be Severely Undermined by a Rule Extinguishing Bad Faith Liability Upon Payment of an Excess Judgment.

Through the enactment of the bad faith statute, the Unfair Insurance Practices Act,[8] the Unfair Claims Settlement Practices regulations,[9] and through the

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42 Pa. Cons. Stat. Ann. § 8371.

[8] See 40 P.S. § 1171.

[9] See 31 Pa. Code § 146.

development of the common law, this Commonwealth has established a strong public policy against insurance company bad faith. Exempting insurance companies from liability for bad faith by payment of the excess judgment would undermine this strong public policy.

1. Exposing Insurance Companies to the Full Range of Damages for Their Bad Faith Actions and Practices Provides an Incentive for Insurance Companies to Act in Good Faith.

There is one central incentive created by exposing insurance companies who act in bad faith to the full range of damages provided by Pennsylvania contract law and the bad faith statute. Insurance companies have a clear incentive not to act in bad faith. They will know that if they do act in bad faith, they face substantial statutory and contractual damages.[10]

If insurance companies are exempted from full liability from their bad faith, it is Pennsylvania's policyholders that will suffer the consequences. For example, in a case in which the excess judgment is only a small part of the damages caused by an

[10] Unfortunately, many insurance companies who act in bad faith escape liability under the current system, because policyholders must prove bad faith by clear and convincing evidence. When the policyholder can prove bad faith by a preponderance of the evidence, but not by the higher standard of clear and convincing evidence, the insurance company gets away with bad faith. This result appears to have been unintended. When this Court adopted the clear and convincing evidence standard in Cowden, this Court had not decided whether bad faith would be treated as a tort or a contract claim. See Cowden, 389 Pa. at 469, 134 A.2d at 227 (noting the divergence of opinion on the rationale of recovery). While the court was unclear as to whether liability was to be based in contract or tort, the Court ruled that bad faith must be shown by clear and convincing evidence, which is rarely if ever the standard used to prove a breach of contract. It is normally applicable only to prove certain torts, such as fraud. Later, this Court held that bad faith was a contractual claim based on the implied covenant of good faith and fair dealing. Gray v. Nationwide Mut. Ins. Co., 422 Pa. 500, 223 A.2d 8 (1966). After that, this Court ruled that the tort of bad faith would not be recognized in Pennsylvania. See D'Ambrosio, 494 Pa. 501, 431 A.2d 966. The trial judge in this case properly instructed the jury that the current standard for proving bad faith is clear and convincing evidence. Based on this Court's decision that bad faith is a breach of contract, however, the more appropriate standard is preponderance of the evidence. Accordingly, United Policyholders requests that the preponderance standard be adopted for proving bad faith in Pennsylvania.

insurance company's bad faith, an insurance company would pay little to exempt itself from bad faith liability, but a policyholder would suffer much. The excess judgment could be slight, such as only $10,000 above policy limits, but the insurance company's bad faith decision not to settle could cost the policyholder $100,000 or more in lost profits. Under the rule urged by St. Paul and the insurance industry *amici*, an insurance company could avoid paying the $100,000 in contract damages simply by paying the $10,000 excess judgment. The insurance company would also escape liability under the bad faith statute. In enacting the bad faith statute, the Legislature purposefully provided a remedy beyond those available under contract law to fight the serious problem of insurance company bad faith. The Legislature did not exempt insurance companies who act in bad faith, but pay an excess judgment, from liability under the statute. If such a rule were judicially created, an insurance company could ignore reasonable settlement demands causing serious damage to the policyholder, yet escape the bulk of its contractual and statutory liability simply by paying the excess judgment. The consequences of the insurance company's bad faith would be felt most severely by the policyholder, rather than by the insurance company. That is not what the Legislature intended.

2. Holding Insurance Companies Liable for Their Bad Faith, Despite the Payment of an Excess Judgment, Will Not Discourage the Payment of Excess Judgments.

St. Paul and the insurance industry *amici* argue that if payment of the excess verdict does not extinguish liability, insurance companies will not pay excess verdicts. This contention is demonstrably untrue.

St. Paul's own behavior in this case disproves its argument. St. Paul paid the excess verdict, even though it knew its policyholder would likely bring a bad faith claim. As reported by the Superior Court, "In consideration of its payment of the excess verdict, St. Paul requested a release from any and all claims Birth Center may have had against it, including all claims for bad faith and compensatory damages. Birth Center rejected this proposal because of the stated conditions." Birth Center v. St. Paul Cos., 727 A.2d 1144, 1151 (Pa. Super. 1999). Even though Birth Center refused to waive its claims, St. Paul still paid the excess verdict – but only after it hired independent counsel to analyze the law of bad faith and the advisability of indemnifying Birth Center for the verdict. Id. It is unlikely that St. Paul paid the excess verdict out of the goodness of its heart. St. Paul paid the excess verdict in an attempt to avoid a hefty punitive damages verdict under 42 Pa. Cons. Stat. Ann. § 8371, which St. Paul did successfully avert. If the threat of punitive damages were removed, insurance companies like St. Paul would behave quite differently. They would be far less likely to pay excess verdicts.

United Policyholders notes that even the insurance industry *amici* advocate the position that insurance companies should be encouraged to pay excess verdicts voluntarily. (Insurance Industry *Amici* Br. At 7). Right now, there is a competitive disadvantage for those insurance companies who do pay excess judgments voluntarily. The way to eradicate this competitive disadvantage and encourage the payment of excess verdicts is to require insurance companies to pay any excess verdict that results from the failure to settle within policy limits, without need for proof of bad faith. Under that rule, payment of the excess verdict would not imply bad faith, and the insurance company would benefit – or suffer the consequences – of its conscious

gamble to take a case to trial rather than settle.[11] The courts that have most thoroughly addressed this issue have extolled the benefits of establishing a rule of absolute liability when a failure to settle within policy limits results in an excess verdict. See Shearer v. Reed, 286 Pa. Super. 188, 196-97, 428 A.2d 635, 639 (1981); Crisci v. Security Ins. Co. of New Haven, Conn., 426 P.2d 173 (Cal. 1967); Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 509-10 (N.J. 1974).

3. Insurance Companies Will Be More Likely To Settle Cases Appropriately If They Are Subject to Full Bad Faith Liability For Their Bad Faith Refusals to Settle.

St. Paul and the insurance industry *amici* argue that insurance companies will be forced to settle more cases if they are subject to full bad faith liability for their bad faith refusals to settle. Settlements have long been favored by the public policy of this Commonwealth. See Rothman v. Fillette, 503 Pa. 259, 469 A.2d 543 (1983) (cited and quoted in St. Paul's Br., at 17). The insurance industry's position and desired result is one-hundred-and-eighty degrees contrary to this fundamental public policy favoring settlements.

If St. Paul had settled this case within policy limits, substantial resources -- judicial, the policyholder's, and even St. Paul's -- could have been put to better use. St. Paul would not have had to pay the excess verdict and the other damages caused by its bad faith decision. The court in the underlying action would not have had to try this

[11] If a case can be settled within policy limits, then the policyholder has purchased enough insurance to cover the policyholder for whatever catastrophe has occurred. There is absolutely no reason why a policyholder should ever have to pay money out of his or her own pocket when a case can be settled within the limits of an insurance policy for which the policyholder paid valuable premiums in order to obtain full protection against financial loss. The sensible rule that United Policyholders advocates discourages insurance companies from gambling with its policyholder's interests by refusing a settlement within insurance policy limits. If the insurance company chooses to take such a gamble, the insurance company should be held fully accountable.

case. As a direct result of St. Paul's bad faith, the resources of the Court and the parties were squandered, and the lives of the jurors were interrupted. This entire bad faith action, complete with an appeal to this high court, would (and should) never have occurred. Insurance companies should be forced to think long and hard before they decide to take a case to trial, rather than to seize an opportunity to settle within the limits of the insurance policy. If an insurance company knows it will be held liable for all of the damages that result from its bad faith if it does not settle a particular case, the insurance company will choose sensible settlements over riskier gambles. Encouraging such settlements is a worthwhile reason not to adopt the arguments of St. Paul and the insurance industry *amici*.

4. Providing Strong Remedies For All Bad Faith Conduct Creates A Competitive Advantage for Insurance Companies Who Act in Good Faith.

The insurance industry *amici* argue that a ruling in favor of the Birth Center will make it more expensive to write policies in Pennsylvania. This argument is meritless and without any support in the record. Indeed, the obverse is true. The record demonstrates that the exposure that could have been settled for a "high-low" settlement of $300,000 to $1,000,000 ballooned to over $4,000,000 because of St. Paul's bad faith. It should be obvious that the verdict in excess of $4,000,000 cost will increase insurance rates much more substantially than a $300,000 to $1,000,000 cost would have increased rates. Moreover, if the costs of engaging in bad faith conduct increase, the costs of writing policies will increase only for those insurance companies who act in bad faith.

On the other hand, if insurance companies attempt to profit from bad faith, a result contrary to public policy, then insurance companies who act only in good faith would be at a serious competitive disadvantage. If full contractual and statutory damages are available for bad faith, however, the costs of doing business will properly increase only for those companies who act in bad faith. Those companies who consistently act in good faith will be at a competitive advantage. Indeed, if strong punitive damages awards were meted out in cases like this one, policyholders would suffer significantly less misconduct. Instead of blithely ignoring the needs of its policyholders and offering absolutely no money to settle, like St. Paul did here, insurance companies will be forced to consider the full import, and potential impact, of their decisions to gamble at their policyholders' expense.

5. Providing Full Remedies to Redress Insurance Company Bad Faith Conduct Will Not Entice Policyholders to Commit Fraud.

Indicative of systemic problems in the insurance industry, the insurance industry *amici* argue that fully remedying the bad faith conduct of insurance companies will cause policyholders to commit fraud. (See Insurance Industry *Amici* Br. at 8-9). That argument is untrue and offensive. The Legislature and public policy condemns policyholder fraud, as well as insurance company bad faith, encouraging both insurance companies and policyholders to act honestly. It is simply ridiculous to assert, in effect, that this Court should encourage insurance companies to make risky litigation gambles and commit bad faith as a method for combating policyholder fraud. Such arguments advanced by the insurance industry *amici* merely serve to demonstrate that their position is fundamentally weak and morally bankrupt.

This case involves insurance company bad faith. More specifically, this case involves St. Paul's desire to be insulated from Pennsylvania's statutory and contract law for truly reprehensible conduct that was plainly bad faith, as the trial judge in the underlying action expressed on the record and as the jury in the insurance coverage action found. It is disconcerting, to say the least, that the insurance industry is so willing to overlook St. Paul's bad faith conduct and so recklessly seeks to divert this Court's attention by condemning the policyholding public as common crooks eagerly awaiting any opportunity to commit fraud.

II. COMPENSATORY DAMAGES ARE RECOVERABLE FOR BREACH OF THE DUTY OF GOOD FAITH AND FAIR DEALING.

A. St. Paul is Liable in Contract for Contract Damages Arising from its Breach of the Duty of Good Faith and Fair Dealing.

By violating its implied duty of utmost good faith, St. Paul breached the insurance policy it sold to Birth Center. This Court has held that a breach of the insurance company's obligation to represent the rights of its policyholder in good faith "constitutes a breach of the insurance contract for which an action in assumpsit will lie." Gray v. Nationwide Mutual Ins. Co., 422 Pa. 500, 508, 223 A.2d 8, 11 (1966).

Because St. Paul's violation of the implied covenant of good faith and fair dealing gives rise to an action for breach of contract, Birth Center is entitled to the full panoply of remedies under Pennsylvania's common law of contract. Those contractual remedies serve only to place Birth Center in the position it would have found itself, but for St. Paul's breach of its implied duty of good faith and fair dealing:

> in the law of contracts remedies for breach are designed to protect either a party's expectation interest by attempting to put him in as good a position as he would have been had the contract been performed, that is, had there been no breach;

> his reliance interest by attempting to put him back in the position in which he would have been had the contract not been made; or his restitution interest [by requiring] the other party to disgorge the benefit he has received by returning it to the party who conferred it.

Trosky v. Civil Serv. Comm'n, 539 Pa. 356, 363, 652 A.2d 813, 817 (1995) (internal quotation marks omitted) (citing Restatement (Second) of Contracts, § 344 cmt. a. (1979)); Department of Transp. v. James D. Morrissey, Inc., 682 A.2d 9, 14 (Pa. Commw. 1996), alloc. denied, 547 Pa. 745, 690 A.2d 1164 (1997). In applying Pennsylvania law, the Third Circuit has similarly held that "[i]n general contract law espouses three distinct, yet equally important, theories of damages to remedy a breach of contract: 'expectation' damages, 'reliance' damages, and 'restitution' damages.'" Atacs Corp. v. Trans World Communications, Inc., 155 F.3d 659, 669 (3d Cir. 1998). Of these three categories, "[t]he preferred basis of contract damages seeks to protect an injured party's expectation interest. . . . Toward that end, expectation damages are measured by 'the losses caused and gains prevented by defendant's breach, to the extent that [sic] are in excess of any savings made possible by nonperformance.'" Id. at 669 (internal quotation marks omitted).

Birth Center's contract damages serve only to protect its expectation interest under the insurance policy it purchased from St. Paul. Still, St. Paul and the insurance industry *amici* question the foreseeability of the contract damages claimed by Birth Center. (St. Paul's Br. at 17-19); (Insurance Industry *Amici* Br. at 10-12). It is true that Pennsylvania's common law of contracts and the Restatement limit a plaintiff's contract damages to those that were reasonably foreseeable to the parties when the contract was executed. AM/PM Franchise Ass'n v. Atlantic Richfield Co., 526 Pa. 110,

120, 584 A.2d 915, 920-21 (1990); R.I. Lampus Co. v. Neville Cement Prods. Corps., 474 Pa. 199, 206-209, 378 A.2d 288, 291-93 (1977);[12] Hazelton Area Sch. Dist. v. Bosak, 671 A.2d 277, 283 (Pa. Commw. 1996); Restatement (Second) of Contracts § 351. In this case, the jury was instructed that the damages had to be foreseeable, and the jury awarded the damages. Thus, St. Paul bears a heavy burden to reverse the jury's finding of foreseeability.

St. Paul's challenge to the contract damages awarded by the jury is meritless. The rhetoric of St. Paul resonates with the "tacit-agreement" formulation of contract damages that was rejected by this Court in Lampus and by the Restatement.[13] (St. Paul's Br. at 16-18). Second, and critically, St. Paul and insurance industry *amici* take an unreasonable view of the situation at bar. Birth Center is a small, local birthing clinic. Though Birth Center certainly purchases insurance for various "run of the mill" risks, there should have been no mystery that one central risk of Birth Center's business

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[12] Although these cases are decided under the Pennsylvania Uniform Commercial Code ("PAUCC"), they are persuasive for several reasons. First, as the Superior Court noted in Birth Center, the "precise issue" of whether reasonably foreseeable damages caused by the "insurer's unintelligent and unreasonable refusal to settle claim" are recoverable in a claim brought against an insurance company for breach of contract based on violation of the implied covenant of good faith and fair dealing is an issue "of first impression in Pennsylvania." Birth Center, 727 A.2d at 1157. In the absence of direct precedent, the analogous law of PAUCC provides some jurisprudential foundation for this Court's decision. Second, section 344 of the Restatement dealing with contract damages is based on Uniform Commercial Code § 1-106." Restatement § 344 reporter's note. Hence, there is a marked congruence of remedies under the common law of contract and the Uniform Commercial Code making precedent under the PAUCC particularly relevant.

[13] The "tacit-agreement" test which allowed recovery for contract damages only when they "arose from special circumstances . . . the defendant fairly may be supposed to have assumed consciously," Lampus, 474 Pa. at 207, 378 A.2d at 291, was replaced by the "reason to know" test which requires that a plaintiff only need prove that the damages claimed were reasonably foreseeable when the contract was executed. Id. 474 Pa. at 206, 378 A.2d at 291-92. Although Lampus interpreted PAUCC section 2-715(2), the Restatement provides that section 351 of the Restatement is intended "to conform to the language of Uniform Commercial Code §§ 2-714(1) and 2-715(2)(a)." Restatement (Second) of Contracts § 351 reporter's note. Synthesizing this Court's holding in Lampus and its endorsement in Trosky of the Restatement's vision of contract

is that a complication may arise during a childbirth. When that risk occurs, business establishments such as Birth Center depend upon their insurance companies for valuable support.

As Birth Center's insurance company, St. Paul is charged with knowing its policyholder's business,[14] as well as the risks faced by that business. Given the type of risks inherent in childbirth—which can be catastrophic—it is reasonably foreseeable that Birth Center would eventually face allegations of malpractice. It is reasonably foreseeable that if the insurance company allowed such a claim to go to trial, and if liability were established, there would be publicity and resulting harm to Birth Center's reputation and status in the community. It is equally foreseeable that a loss of current and former clients would follow. Similarly, it is foreseeable that by allowing litigation to drag on for years, rather than settling reasonably and within the policies limits, St. Paul would cause Birth Center to lose business opportunities. The jury's finding that the damages suffered by Birth Center foreseeably resulted from St. Paul's bad faith decision not to settle was a reasonable resolution of these factual issues. The trial court should have accepted those findings and entered judgment.

St. Paul's bad faith position that it would take to trial "all of these bad baby cases," Birth Center, 727 A.2d at 1150, rather than reasonably considering settlement, caused Birth Center substantial and foreseeable damages for which Birth Center must

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remedies in section 344 leads to the inexorable conclusion that the "reason to know" test applies to all claims for contract damages.

[14] "Every under-writer is presumed to be acquainted with the practice of the trade he insures, and that whether it is recently established or not. If he does not know it, he should inform himself." Noble v. Kennaway, 2 Doug. 511 (K.B. 1780). Lord Mansfield's principle was adopted by the United States Supreme Court in Buck & Hendrick v. Chesapeake Ins. Co., 26 U.S. 151 (1828).

be compensated. Insurance companies must faithfully consider settlement and should contemplate the harm that could be suffered by failure to settle.

The insurance industry *amici* state that "[i]f the Superior Court's ruling is upheld, an insurer in Pennsylvania will now also have to foresee, and consider, the business consequences that the trying of the case and the entry of judgment against its insured might have on its insured's business." (Insurance Industry *Amici* Br. at 12). To this there can be only one response. It is the insurance company's business to foresee and consider all probable consequences arising from the defense of its policyholder. Such knowledge and foresight is not only consistent with, but is commanded by an, insurance company's duty of good faith and fair dealing. That is, when considering the consequences of taking a case to trial, good faith demands that the insurance company understand and account for the reasonably foreseeable effect an adverse judgment may have on its policyholder:

> While the view of the carrier or its attorney as to liability is one factor, a good faith evaluation requires more. . . . It includes consideration of the anticipated range of a verdict, should it be adverse; the strengths and weaknesses of all the evidence presented on either side so far as known; the history of the particular geographic area in cases of similar nature; and the relative appearance, persuasiveness, and likely appeal of the claimant, the insured, and the witnesses at trial.

Shearer, 286 Pa. Super. at 194, 428 A.2d at 638.

In that same vein, this Court has held that "the decision to expose the insured to personal pecuniary loss must be based on a bona fide belief by the insurer, predicated upon all the circumstances of the case, that it has a good possibility of winning the suit. . . . [I]t is not a right of the insurer to hazard the insured's financial well-being. Good faith requires that the chance of a finding of nonliability be real and

substantial and that the decision to litigate be made honestly." Cowden, 389 Pa. at 471, 134 A.2d at 228 (emphasis added). St. Paul's own medical experts determined Birth Center had, at best, a sixty percent chance of winning the underlying claim. Birth Center, 727 A.2d at 1149. More importantly, estimates of success of the defense attorneys for Birth Center and Dr. Soppas ranged from thirty-five percent to no higher than fifty percent, with possible jury verdicts ranging from one million, two hundred thousand dollars to as much as six million dollars. Id. at 1150. The four million dollar judgment was demonstrably foreseeable Still, St. Paul refused to settle before a verdict was entered. Having that information, it is impossible to conclude that St. Paul's decision to try this "bad baby case" and offer not a single penny in settlement was honest, intelligent, reasonable, and in utmost good faith.

The insurance industry *amici* add that "[l]iability insurers are not guarantors of the success of an insured's business or its reputation." (Insurance Industry *Amici* Br. at 11). Is it not the purpose of liability insurance in part to protect the financial success of business? But can an insurance company destroy the reputation of one of its policyholders by forcing a case to trial that can and should be settled? No doubt manufacturers made similar arguments before strict products liability became a fixture in the common law of this country. Does that mean that strict products liability law is unwise because it unfairly shifts the financial burden of product defects from individual customers to large corporate manufacturers who benefit financially from selling these products to consumers? Or, as the insurance industry *amici* would allege, does this mean that when a consumer purchases "protection"[15] from the risk of a third

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15 See (St. Paul's Br. at 17) ("[Birth Center] is buying protection. . . .").

party bringing litigation against him or her, the consumer should nevertheless bear the burden of an insurance company' bad faith decision not to settle that litigation? Justice requires that the answer should be no.[16]

The law of Pennsylvania is clear. An insurance company owes a duty of utmost good faith and fair dealing to its policyholders. When it breaches that duty, it breaches the contract of insurance it sold to the policyholder, and is liable in contract for the reasonably foreseeable consequences of that breach. Accordingly, the holding of the Superior Court should be affirmed.

B. Because St. Paul is Liable in Contract for Contract Damages, This Court Need Not Reach or Discuss this Court's Holding in D'Ambrosio or the Bad Faith Statute.

1. This Court's Holding in D'Ambrosio Does Not Affect Birth Center's Claim for Breach of the Duty of Good Faith.

By violating the implied covenant of good faith and fair dealing, St. Paul breached the insurance policy it sold to Birth Center. As discussed above, Birth Center's cause of action sounds in contract, not in tort. Nonetheless, St. Paul argues that this Court's decision not to recognize an independent tort of bad faith precludes the award of contract damages in this case. St. Paul claims: "Nineteen years ago, this Court held that compensatory damages like those sought by the plaintiff in this case are

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[16] As the Supreme Court of New Jersey eloquently maintained, where the "carrier chooses not to offer the limits of coverage one wonders whether it should not bear the unhappy financial result of that unilateral decision, since it alone profits from the opposite result. This resolution would enable the insurer to pursue its own interests in great measure without sacrificing those of its insured so long as it was clear by whom the burden of mistake should be borne." Rova Farms Resort Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 509 (N.J. 1974), cited in, Shearer v. Reed, 286 Pa. Super. at 196-97, 428 A.2d at 639-40. The New Jersey Supreme Court even offered a rejoinder to the argument, made here by St. Paul and its insurance industry *amici*, that such a rule would inappropriately raise prices, when it observed "any conceivable effect on costs which such a rule could exert might be more than offset by other factors. For example, savings might be realized from the company's not having to maneuver for position on the issue

not recoverable through any cause of action under common law." (St. Paul's Br. at 19) (citing D'Ambrosio v. Pennsylvania Nat'l Mut. Ins. Co., 494 Pa. 501, 431 A.2d 966 (1981)).[17] Under St. Paul's construction of D'Ambrosio, "this Court held that the common law of Pennsylvania does not recognize any cause of action for [the damages claimed by Birth Center] arising from the bad faith of an insurance company." (St. Paul's Br. at 20).

To support this contention, St. Paul writes that the damages sought by the Birth Center are "substantially the same as those at issue in D'Ambrosio." Id. This statement is incorrect. First, the plaintiff in D'Ambrosio sought, at best, vague emotional distress damages. D'Ambrosio, 494 Pa. at 505 n. 2, 431 A.2d at 968 n. 2. In contrast, Birth Center is an ongoing business concern seeking lost profits due to St. Paul's failure to settle in good faith. Birth Center's damages are both calculable and traceable to St. Paul's violation of the covenant of good faith and fair dealing, which gives rise to its action for breach of contract. Second, the Court in D'Ambrosio considered only the plaintiff's claim in trespass, D'Ambrosio, 494 Pa. at 504, 431 A.2d at 967-68, and his action in assumpsit was not before the Court. Id. 494 Pa. at 504 & 504 n.1, 431 A.2d at 967 & 967 n. 1. In this action, Birth Center seeks redress in contract for damages flowing from St. Paul's breach of its contractual duty of utmost good faith. Birth Center's action both sounds in and may be remedied through an action in contract, in addition to the remedies available under the bad faith statute. Gray, 422 Pa. at 508, 223 A.2d at 11.

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of bad faith during the original trial, or from not having to litigate excess liability suits brought by its clients." Id. 323 A.2d at 509-10 n. 7.

Third, and perhaps most important, while this Court held in D'Ambrosio that a "count in trespass for alleged bad conduct of an insurer, which seeks both punitive damages and damages for emotional distress, must be rejected," D'Ambrosio, 494 Pa. at 509, 431 A.2d at 970, this Court noted the possibility that "emotional distress damages may be recoverable on a contract where . . . the breach is of such a kind that serious emotional disturbance was a particularly likely result." Id. 494 Pa. at 509 n.5, 431 A.2d at 970 n.5 (citing Restatement (Second) of Contracts § 367 (Tent. Draft No. 14, 1979). This Court found that the D'Ambrosio record fell "short of establishing such a breach." Id. Although the Court specifically rejected a new action in trespass for insurance company bad faith, other causes of action were available to the D'Ambrosio plaintiff to obtain precisely the type of emotional distress damages that St. Paul believes are unavailable in any action against an insurance company. Interestingly, in its action in assumpsit, the D'Ambrosio plaintiff sought interest and attorneys fees. Id. 494 Pa. at 403 & 503 n.1, 431 A.2d at 967 & 967 n. 1. Other damages, such as those sought by Birth Center here, are available for breach of the duty of good faith that is implied into every insurance policy.

Nothing in this Court's holding in D'Ambrosio indicates that the Court intended to wipe out all common law claims brought on any basis to remedy the breach by insurance companies of the duty of utmost good faith owed to all policyholders. Indeed, a divided panel of this Court pointed out that "an insured, who is aggrieved by the actions of an insurance company, may seek compensatory damages by pursuing an action for breach of contract or any of the traditional forms of recovery sounding in tort."

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[17] See also (Insurance Industry *Amici* Br. at 9) ("In D'Ambrosio. . . this Court ruled that a cause of action at common law for bad faith breach of an insurance contract did not exist under

Baker v. Pennsylvania Nat'l Mut. Cas. Ins. Co., 522 Pa. 80, 84 n.1, 559 A.2d 914, 916 n.1 (1989) (citing D'Ambrosio, 494 Pa. at 515, 431 A.2d at 974 (Nix, J., concurring) (emphasis added)).

2. This Court Need Not Reach the Question of Whether the Bad Faith Statute Provides for Compensatory Damages Because the Statute Does Not Limit Birth Center's Contract Remedies.

The bad faith statute does not foreclose liability for the contract damages Birth Center was awarded. Indeed, those damages should also be available under the bad faith statute. As the Superior Court recently opined:

> [T]he potential claims which an insured . . . has against his or her insurer as a result of Section 8371, are no longer restricted solely to the amount of any excess liability judgment . . . but include as well compensatory damages for foreseeable damages proximately caused by the insurer's breach of the fiduciary duties owed to the insured as a result of the contractual relationship between the insurer and the insured.

Brown v. Candelora, 708 A.2d 104, 110 (Pa. Super. 1998). As the Superior Court has recognized, the damages listed in section 8371 are not meant to preclude the remedies available to plaintiffs in claims against insurance companies for breach of contract, but rather, are meant to complement any damages recoverable "[i]n an action arising under an insurance policy." 42 Pa. Cons. Stat. Ann. § 8371.

The narrow holding of D'Ambrosio, refusing to create a new tort of bad faith does not preclude a policyholder from pursuing a contract action "arising under an insurance policy" and obtaining a judgment for the full panoply of contract damages. See supra Part B.1. St. Paul and the insurance industry *amici* cite no cases for the proposition that Pennsylvania's bad faith statute is intended to impinge upon

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Pennsylvania law.").

Pennsylvania's common law of contract and the remedies available thereunder. Indeed, the language of the bad faith statute presupposes that an aggrieved policyholder will bring some cause of action "arising under an insurance policy," wherein the bad faith conduct of an insurance company may give rise to additional damages under the statute. Under the logic of St. Paul and the insurance industry *amici*, in a contract action "arising under an insurance policy" where the policyholder adduces proof of an insurance company's bad faith conduct, a policyholder could not even pursue damages for the amount owed under the policy, because such damages are not listed in the statute.

The purpose of the bad faith statute encompasses the primary purpose of contract damages -- to put the non-breaching party in as good a position as he would have been had the contract not been breached or to "make whole" the non-breaching party. Allowing an action "arising under the insurance policy" does nothing "further than shall be necessary for carrying such statute into effect." 1 Pa. Cons. Stat. Ann. § 1504 (West 1995). In fact, such an action is specifically contemplated by the "arising under" language so to fully effectuate the "make whole" purpose of the bad faith statute. Polselli v. Nationwide Mut. Fire Ins. Co., 126 F.3d 524 (3d Cir. 1997).[18] The breadth and scope of section 8371 evidences the Legislature's intent to make the policyholder whole and to punish insurance company bad faith. Policyholders can bring contract and

[18] Polselli is important for other reasons. In Polselli, the Third Circuit found that section 8371 was enacted in "response" to this Court's holding in D'Ambrosio and that by creating a separate cause of action for bad faith, the statute implicitly overruled this Court's holding in D'Ambrosio. Polselli, 126 F.3d at 528-30. Moreover, to the extent the Third Circuit held that D'Ambrosio "refused to create a common law 'bad faith' cause of action," such a holding is not inconsistent with the premise that policyholders may still pursue viable cause of actions which already exist, such as breach of contract based on breach of the implied duty of utmost good faith owed to policyholders by insurance companies. Gray, 422 Pa. at 508, 223 A.2d at 11.

established tort claims as claims "arising under" the insurance policies and may also bring a claim under the bad faith statute. This in harmony with the "arising under" language of section 8371, the make whole purpose of the bad faith statute, the common law of contract, and the rules of statutory construction in Pennsylvania.

Accordingly, the Superior Court's award of compensatory damages for St. Paul's breach of the insurance contract it sold to Birth Center should be affirmed.

III. THE TRIAL COURT PROPERLY CHARGED THE JURY ON BIRTH CENTER'S BREACH OF CONTRACT CLAIM.

The trial judge properly instructed the jury on Birth Center's breach of contract claim. The pertinent portions of the jury instruction are as follows:

> I am first going to talk about compensatory damages. Where one party to a contract breaches that contract, the other party may recover for those injuries which have been proved to you with reasonable certainty. Certainly the measure of damages is the sum which will - generally the measure of damages i[s] that sum which will compensate the [Birth Center] for the losses sustained as a result of [St. Paul]'s conduct.
>
> If you find that ... St. Paul breached its contract with The Birth Center, you must then decide based on all of the evidence presented what amount of money will compensate the [Birth Center] for those injuries, which were a direct and foreseeable result of the breach by St. Paul which the parties could have reasonably foreseen at the time of the [St. Paul]'s breach of the contract.
>
> [Birth Center] claims that it is entitled to compensatory damages to compensate it for losses caused to it by [St. Paul]'s bad faith breach of its duties.

Birth Center, 727 A.2d at 1159 (emphasis added). In light of this Court's holding that the breach of an insurance company's duty to act with the utmost good faith when representing the rights of its policyholders "constitutes a breach of the insurance contract," Gray, 422 Pa. at 508, 223 A.2d at 11, the Superior Court correctly concluded

that the trial court had properly instructed the jury on Birth Center's breach of contract claim based on St. Paul's bad faith conduct. Bad faith is a breach of the insurance policy. All foreseeable damages resulting from that breach are recoverable. That is the law, and the trial judge properly instructed the jury about that law. The jury did its job, finding bad faith and awarding reasonably foreseeable damages resulting from the bad faith. Accordingly, the trail judge erred in awarding J.N.O.V. and should have let the jury verdict stand, as the Superior Court wisely ruled. Accordingly, the holding of the Superior Court should be affirmed.

CONCLUSION

For all the foregoing reasons, *Amicus Curiae* respectfully requests this Court to affirm the decision of the Superior Court.

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JOHN N. ELLISON (I.D. No. 510098)
JOHN A. MacDONALD (I.D. No. 47892)
TIMOTHY P. LAW (I.D. No. 76793)
Anderson Kill & Olick
1600 Market Street
32nd Floor, Suite 3201
Philadelphia, PA 19103
(215) 568-4202

Attorneys for Amicus Curiae
United Policyholders

Of Counsel
Amy Bach, Esquire
United Policyholders
11 Pacific Avenue
No. 262
San Francisco, California 94111
(415) 393-9990

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Brief of *Amici Curiae* of The United Policyholders was served this date, at my direction, via U.S. First Mail, postage prepaid, which service satisfies the requirements of Pa.R.A.P. 121, upon the following:

John S.J. Brooks, Esquire
Michael Bradley, Esquire
Brooks, Bradley & Kenney
2nd and Plum Streets
Media, PA 19063
(610) 656-4800

Keithley Mulvihill, Esquire
900 Oliver Building
Pittsburgh, PA 15222
(412) 434-8865

Thomas P. Wagner, Esquire
Rawle & Henderson, LLP
The Widener Building
One S. Penn Square
Philadelphia, PA 19107
(215) 575-4307

Stephen C. Baker
Jane Landes Foster
Stephen R. Harris
Nancy L. Margolis
Stradley, Ronon, Stevens & Young, LLP
2600 One Commerce Square
Philadelphia, PA 19103-7098
(215) 564-8000

TIMOTHY P. LAW

Date: May 15, 2000