No. 03-2837

IN THE
UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

WILLOW, INN, INC.,
Plaintiff-Appellee,

v.

PUBLIC SERVICE MUTUAL INSURANCE CO.
Defendant-Appellant.

On Appeal from the United States District Court
For the Eastern District of Pennsylvania

BRIEF OF AMICUS CURIAE, UNITED POLICYHOLDERS, IN SUPPORT OF THE WILLOW INN, INC. AND IN SUPPORT OF AFFIRMANCE

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I. STATEMENT OF INTERST OF AMICUS CURIAE

United Policyholders ("UP") was founded in 1991 as a non-profit organization dedicated to educating the public on insurance issues and consumer rights. The organization is tax-exempt under Internal Revenue Code §501(c)(3). UP is funded by donations and grants from individuals, businesses, and foundations.

In addition to serving as a resource on insurance claims for disaster victims and commercial policyholders, UP actively monitors legal and marketplace developments affecting the interests of all policyholders. UP receives frequent invitations to testify at legislative and other public hearings, and to participate in regulatory proceedings on rate and policy issues.

A diverse range of policyholders throughout the United States communicate on a regular basis with UP, which allows UP to provide important and topical information to courts throughout the country via the submission of *amicus curiae* briefs in cases involving insurance principles that are likely to impact large segments of the public.

UP's *amicus* brief was cited in the United States Supreme Court's opinion in Humana v. Forsyth, 525 U.S. 299 (1999), and UP's arguments were adopted by the California Supreme Court in Vandenberg v. Superior Court, 982

P.2d 229 (Cal. 1999). UP has filed *amicus* briefs on behalf of policyholders in over one-hundred cases throughout the United States.

II. CONSENT TO FILE AMICUS BRIEFS

The parties have mutually consented to the filing of amicus briefs in this action. See Fed. R. App. P. 29.

III. SUMMARY OF ARGUMENT

The question at issue is whether the award of punitive damages in the current action is so "grossly excessive or arbitrary" that it violates substantive due process. See State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 123 S.Ct. 1513, 1519-20 (2003). "To the extent an award is grossly excessive," reasoned the Court, "it furthers no legitimate purpose and constitutes an arbitrary deprivation of property." Id. at 1520. In Campbell, the Supreme Court ruled that an award of measure of punitive damages of $145 million violated due process in a case in which the compensatory damages were $1 million.

The present case involves punitive damages of only $150,000 and is clearly distinguishable from Campbell. Simply put, the punitive damages imposed by the trial court were not grossly excessive. They were reasonably intended to punish and deter insurance company bad faith. The trial court examined the conduct of Public Service Mutual Insurance Company ("PSM") and found its actions and inaction to be bad faith, which is, by definition,

reprehensible conduct. Pennsylvania statutory law establishes punitive damages as the central method of punishment imposed upon insurance companies who act in bad faith against their policyholders.

IV. LEGAL ARGUMENT

A. Pennsylvania Has a Strong Public Policy Against Insurance Company Bad Faith.

States possess broad discretion to decide what is right and wrong, and to establish penalties for actions that are contrary to law. Pennsylvania has long held that insurance company bad faith is a serious wrong that requires strong remedies. The Pennsylvania legislature has selected punitive damages as the primary penalty for insurance company bad faith.

The Supreme Court has repeatedly held that States possess discretion over the amount of punitive damages. Campbell, 123 S.Ct. at 1519. As explained by the Supreme Court, the measure of punishment for proscribed conduct is an issue generally left to States to decide:

> A basic principal of federalism is that each State may make its own reasoned judgment about what conduct is permitted or proscribed within its borders, and each State alone can determine what measure of punishment, if any, to impose on a defendant who acts within its jurisdiction.

Campbell, 123 S.Ct. at 1523. In protecting against grossly excessive awards that constitute arbitrary deprivations of property, courts must be careful not to

interfere with State regulation of insurance. Under the McCarran-Ferguson Act, States are given broad discretion to regulate the business of insurance. See 15 U.S.C. § 1012. Only in the clearest cases of a violation of the United States Constitution should the Court reduce a punitive damages award.

The Pennsylvania legislature has adopted a statute specifically authorizing an award of punitive damages when an insurance company acts in bad faith. See 42 Pa. Cons. Stat. Ann. § 8371 (the "Bad Faith Statute") (authorizing an award of punitive damages against an insurance company that has acted in bad faith). The Bad Faith Statute is an important component of Pennsylvania's regulation of insurance company conduct. An examination of the development of punitive damages as a method for punishing insurance company bad faith in Pennsylvania demonstrates that strong punitive damage awards are fundamental to the regulation of insurance companies in this Commonwealth.

B. Insurance Companies Owe A Special Duty of Utmost Good Faith.

Insurance companies hold a special place in the efficient operation of our society. The special public nature of insurance invests insurance companies with a unique position of trust with respect to their policyholders, as recognized by courts and commentators. For example, the California Supreme Court has stated that:

> The insurers' obligations are . . . rooted in their status as purveyors of a vital service labeled quasi-public in

> nature. Suppliers of services affected with a public interest must take the public's interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements . . . [A]s a supplier of a public service rather than a manufactured product, the obligations of insurers go beyond meeting reasonable expectations of coverage. The obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary.

Egan v. Mutual of Omaha Ins. Co., 620 P.2d 141, 146 (Cal. 1979), cert. denied, 445 U.S. 912 (1980) (citations omitted); see also, Abramson v. Kenwood Labs., Inc., 223 N.Y.S.2d 1005, 1007 (N.Y. Sup. Ct. 1961) (insurance companies are "duty bound to be cognizant of the public interest"), rev'd on other grounds, 230 N.Y.S.2d 247 (App. Div. 2d Dep't 1962).

Roscoe Pound has stated the following about the public interest nature of insurance:

> [W]e have taken the law of insurance practically out of the category of contract, and we have listed that the duties of public service companies are not contractual, as the nineteenth century sought to make them but are instead relational; they do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public.

Roscoe Pound, The Spirit of Common Law 29 (1929).[1]

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[1] Other prominent commentators have noted the important role of insurance for the public:

> With respect to the rule of liberal construction, the courts have kept in mind that the primary purpose of insurance is to insure or to provide for indemnity, and have so construed insurance contracts as not to defeat the dominant purpose by technical rules of interpretation.

Pennsylvania has long recognized the public interest nature of insurance and the deep responsibility insurance companies owe to their policyholders. Since at least 1930, the courts of the Commonwealth of Pennsylvania have held that "utmost fair dealing should characterize the transactions between an insurance company and the insured." Fedas v. Insurance Co. of State of Pa., 300 Pa. 555, 559, 151 A. 285, 286 (1930). Insurance companies owe their policyholders a duty of good faith and fair dealing. Birth Center v. St. Paul Cos., 567 Pa. 386, 400, 787 A.2d 376, 385 (2001).[2]

Utmost fair dealing requires insurance companies to act honestly, openly, fairly, and with an eye toward satisfying their contractual and public duties:

> The duty of good faith and fair dealing that an insurer owes an insured obligates the insurer to refrain from **(1) engaging in unfounded refusals to pay policy**

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13 Appleman § 7403, at 302-03 (1976) (footnote omitted) (emphasis added). See also James J. Markham, The Claims Environment 277 ("Insurance is a matter of public interest and deserves special attention by the courts to protect the public.").

[2] An insurance company is duty bound to conduct itself in accordance with the highest standards of good faith towards the policyholder.

> Insurance policies are contracts of the utmost good faith and must be administered and performed as such by the insurer. . . . [T]here is an implied covenant of good faith and fair dealing [in all insurance contracts] that the insurer will not do anything to injure the right of its policyholder to receive the benefits of his contract.

2A Couch § 23:11, at 785, citing Bowler v. Fidelity & Casualty Co., 53 N.J. 313, 250 A.2d 580, 587-88 (1969); see also 2A Couch at 787 ("[t]here is, . . . even after a loss, a relationship of trust and confidence between insurer and insured . . .").

> **proceeds, (2) causing unfounded delay in making payment,** (3) deceiving the insured, and (4) exercising any unfair advantage to pressure an insured into settlement of the insured's claim.

16A Appleman, Insurance Law and Practice, § 8878 (emphasis added). In this case, PSM violated the two most prominent duties of its duty of good faith. PSM engaged in an unfounded refusal to pay amounts unquestionably due and also unreasonably delayed in making payment.

The duty of good faith and fair dealing is a "heightened duty" that arises out of the special relationship that exists between an insurance company and its policyholder:

> The Pennsylvania Supreme Court has long held that an insurer must act with the "utmost good faith" toward its insured. This heightened duty is necessary because of the special relationship between an insurer and its insured and the very nature of the insurance contract.

Romano v. Nationwide Mut. Fire Ins. Co., 435 Pa. Super. 545, 550, 646 A.2d 1228,1231 (1994) (citations omitted). Accordingly, pursuant to its duty of utmost good faith and fair dealing, an insurance company must refrain from putting its own financial interests over the interests of its policyholders. Id. at 545, 646 A.2d 1228.

C. **The Bad Faith Statute Was A Legislative Response To The Inadequacy Of The Penalties For Insurance Company Bad Faith.**

As the remedies for insurance company bad faith were developing, he Pennsylvania Supreme Court struggled conceptually with whether bad faith

would be treated as a tort or a contract claim. See Cowden v. Aetna Cas. & Sur. Co., 389 Pa. 459, 469, 134 A.2d 223, 227 (1957) (noting the divergence of opinion on the rationale of recovery). Later, the Pennsylvania Supreme Court held that bad faith was contractual, 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, the Pennsylvania Supreme Court ruled that an independent tort of bad faith would not be recognized in Pennsylvania. See D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Co., 494 Pa. 501, 431 A.2d 966 (1981). In considering whether the trial court properly dismissed a count in trespass on preliminary objection, the Pennsylvania Supreme Court noted that "the seriousness of 'bad faith' conduct by insurance carriers cannot go unrecognized." Id. at 505, 431 A.2d at 969. Nevertheless, the Court found no evidence to suggest that the system of sanctions established in the Unfair Insurance Practices Act ("UIPA") needed to be "supplemented by a judicially created cause of action". Id. 507, 431 A.2d at 970. The Court reasoned that punitive damages were "unquestionably. . . a deterrent device" but were unnecessary given the administrative penalties. Id. The Pennsylvania Supreme Court invited the Legislature to provide for greater remedies if they were desirable:

> Surely, it is for the Legislature to announce and implement the Commonwealth's public policy governing the regulation of insurance carriers. In our view, it is equally for the Legislature to determine whether sanctions beyond those created by [UIPA] are required to deter conduct which is less than scrupulous.

Id. After D'Ambrosio, Pennsylvania law was clear that the bad faith cause of action was based upon contract and any additional remedies for bad faith would have to be provided by statutory enactment.

The Legislature took up the Pennsylvania Supreme Court's challenge in enacting the Bad Faith Statute, 42 Pa. Cons. Stat. Ann. § 8371. The Legislature provided remedies beyond those available under contract law to fight the serious problem of insurance company bad faith. The United States Court of Appeals for the Third Circuit has explained that the "obvious design" of the Bad Faith Statute is, first, to place the policyholder in the same economic position she would have been in had the insurance company performed as it had promised by awarding attorney fees, and second, to punish the insurance company by awarding punitive damages. Klinger v. State Farm Mut. Auto. Ins. Co., 115 F.3d 230, 236 (3d Cir. 1997). By statutory enactment, Pennsylvania has specifically adopted punitive damages as the punishment for insurance company bad faith, mandating a strong remedy for reprehensible conduct.

D. Insurance Company Bad Faith Is Reprehensible.

In Campbell, the Supreme Court reiterated that reprehensibility is the most important of the three guideposts in deciding whether a punitive damages

award is grossly excessive. 123 S.Ct. at 1521. As noted by the Supreme Court, punitive damages are awarded to impose punishment and foster deterrence, rather than to compensate the plaintiff. Id.

The insurance relationship creates more than the insurance company's bare promise to pay certain claims when forced to do so by an arbitrator or a court. If that were the case, the promise of the policy and the public interest in protecting against loss through insurance would be nullified by the burden and expense of litigation. When a policyholder pays its premiums up front it has a right to expect insurance coverage when a claim is made, "not a lot of vexatious, time consuming, expensive litigation with [the insurance company]." Hayseeds, Inc. v. State Farm Fire & Cas., 352 S.E.2d 73, 79 (W. Va. 1986).

Strong remedies and penalties are essential to enforce the public policy of this Commonwealth, which firmly condemns insurance company bad faith. Economic disincentives are essential because insurance companies can easily profit by breaking their insurance policies:

> With regard to claims for small amounts of money, the insurance company has some incentive to refuse payment because little likelihood exists that claimant will pursue the claim. As for large claims, the insurance company may find it profitable to delay payment as long as possible to keep for itself the time value of the amount due.
>
> Opportunistic breaches are especially likely, and traditional damage rules do not sufficiently deter them.

Pennington, Punitive Damages for Breach of Contract: A Core Sample from the Decisions of the Last Ten Years, 42 Ark. L. Rev. 31, 54 (1989). To analogize, one can only imagine how many more bank robberies there would be if the only punishment for bank robbery was to return the money – in the event the robber was caught.

Unless an insurance company is faced with the prospect of damages well in excess of the policy limits, it will have little economic incentive to honor its obligations under the insurance policy:

> Unlike most other commercial actors fighting for supremacy in a world where possession is nine-tenths of the law, insurers always have the nine-tenths advantage: They hold the money. Consequently, insurers always get to "play the float" in any dispute.

Jeffery W. Stempel, Interpretation of Insurance Contracts: Law and Strategy for Insurers and Policyholders, § 19.3, at 466-67 (1994).

When deciding whether to allow for punitive damages for the breach of an employment contract, the Delaware Supreme Court questioned: Why should insurance contracts be treated differently than all others? The Delaware Supreme Court recognized that insurance policies, which create a special relationship between insurance company and policyholder and involve sequential performance rendering the policyholder particularly vulnerable, are different than normal contracts:

> Insurance is different. Once an insured files a claim, the insurer has a strong incentive to conserve its financial resources balanced against the effect on its reputation of a "hard-ball" approach. Insurance contracts are like many other contracts in that one party (the insured) renders performance first (by paying premiums) and then awaits the counter-performance in the event of a claim. Insurance is different, however, if the insurance company breaches by refusing to render the counterperformance. In a typical contract, the non-breaching party can replace the performance of the breaching party by paying the then-prevailing market price for the counter-performance. With insurance this is simply not possible. This feature of insurance contracts distinguishes them from other contracts and justifies the availability of punitive damages in limited circumstances.

E.I. DuPont de Nemours & Co. v. Pressman, 679 A.2d 436, 447 (Del. 1996).

Insurance policies are aleatory, meaning that the policyholder performs first, by paying premiums, while the insurance company performs later – if it is called upon to perform at all. This renders the policyholder particularly vulnerable to unscrupulous practices. When one contracts to purchase a Cadillac, and is tendered a Yugo, the would-be purchaser can cancel his or her check and go to another car dealership. A policyholder, however, who is promised Cadillac insurance at the point of sale and receives Yugo insurance at the point of loss cannot "cover" by going back in time and purchasing alternative insurance. The Court in Campbell pointed to financial vulnerability as a relevant consideration. 123 S.Ct. at 1521. All policyholders are vulnerable to insurance company sharp practices because claims arise when bad things happen – auto accidents, fires, and lawsuits, to name but a few common examples.

Insurance policies are not physical products, which can be inspected prior to sale. When selling the policy, insurance companies induce trust from their policyholders. Insurance companies describe their products as protection. Then, when called upon to perform, some companies violate the trust and confidence that is the foundation of the insurance relationship, destroying the primary purpose of insurance – the peace of mind that comes from knowing that you are protected.

Moreover, insurance policies are classic examples of contracts of adhesion. See, e.g., Clement v. Smith, 16 Cal. App.4th 39, 45, review denied, 1993 Cal. LEXIS 4435 (Cal. Aug. 19, 1993); Graham v. State Farm Mut. Auto Ins. Co., 565 A.2d 908, 912 (Del. 1989); First Newton Nat'l Bank v. General Cas. Co. of Wis., 426 N.W.2d 618, 628 (Iowa 1988); Jones v. Bituminous Cas. Corp. 821 S.W.2d 798 (Ky. 1991); Meier v. New Jersey Life Ins. Co., 503 A.2d 862, 869 (N.J. 1986). In most instances, insurance consumers are not even afforded the opportunity to see the insurance policy when forced to adhere to its terms. This is true even for most large, commercial policyholders.

Insurance company bad faith, which occurs when policyholders are most financially vulnerable and involves deceit and the reckless disregard of those whom the insurance company owes a fiduciary duty to protect, is truly reprehensible and deserving of substantial punitive damages.

E. In This Action, PSM Was Punished For Pennsylvania Bad Faith Conduct Perpetrated Against A Pennsylvania Policyholder.

The primary issue regarding reprehensibility in Campbell was that State Farm was being punished for supposedly lawful out-of-state conduct. For this reason, among many others, the present case is distinguishable from Campbell. Unlike Utah, Pennsylvania has specifically enacted a statute authorizing an award of punitive damages in actions in which insurance companies act in bad faith toward their policyholders. PSM committed bad faith against a Pennsylvania resident and is being punished for that conduct.

As explained above, punitive damages are the primary tool in Pennsylvania for fighting bad faith conduct. Importantly, the remedies in the Unfair Insurance Practices Act ("UIPA") are meant to supplement – not limit – judicial and statutory remedies, including punitive damages under the Bad Faith

Statute.[3] While revocation or suspension of PSM's license to sell insurance in Pennsylvania under the UIPA, see 40 P.S. § 1171.9, would clearly cause significant damage to PSM, far in excess of the $150,000 punitive damages imposed in this case, the Legislature deemed those potential administrative remedies to be insufficient and enacted the Bad Faith Statute.

Punitive damages must be sufficient in amount to deter bad faith conduct. Insurance companies regularly purchase punitive damage coverage for potential liability arising out of their bad faith conduct. This is called extra contractual coverage ("ECO"). The ECO provisions in reinsurance contracts are not reinsurance in the literal sense of the word because they operate as direct liability insurance running from the reinsurance company to the ceding insurance company for its liability in handling claims of its policyholders. See Ott v. All-Star

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[3] Most state unfair insurance practices acts are derived from the Unfair Trade Practices Model Act (the "Model Act") developed by the National Association of Insurance Commissioners ("NAIC"). Proposed Section 8(a)(C) to the Model Act would have given insurance commissioners the power to award "[s]uch other relief as is reasonable and appropriate." See Report of the Industry Advisory Committee to the NAIC B-6 Subcommittee to Review the Model Unfair Trade Practices Act, November 29, 1979, 1972-1 NAIC Proceedings, 490, 498. The NAII strongly argued against the adoption of Section 8(a)(C) because the authority to award "other relief" was "so all-encompassing as to grant the regulator the power to impose judicial type remedies without the protection of appropriate judicial procedures." Statement to the NAIC (B) Committee by Mr. Donald McHaugh on behalf of the NAII, AMIA, and State Farm Mutual Insurance Company, 1972-1 NAIC Proceedings 443, 448. Based largely on this opposition, the insurance commissioners' power to order restitution to policyholders embodied in Section 8(a)(C) was deleted from the proposed Model Act by the Law, Legislation & Regulation (B) Committee. See 1972-1 NAIC Proceedings, at 490. Thus, due to the insurance industry's strong opposition, the Model Act and the numerous state laws subsequently patterned after it have largely left the award of private damages for insurance company unfair trade practices and fraud, including punitive damages for bad faith, to other statutory law and the common law.

Ins. Co., 299 N.W.2d 839 (Wis. 1981). The existence of ECO coverage dilutes the effect of punitive damages on insurance companies. One can only speculate how high a punitive damages award would have to be to influence meaningfully a reinsurance premium that includes ECO coverage. Ironically, insurance companies regularly, and often successfully, argue that punitive damages are not insurable when policyholders seek coverage.

A ceding insurance company's tortious conduct covered under an ECO clause includes the denial of a policyholder's claim based on an inadequate investigation; intentional misrepresentations of claims or policy terms; false accusations by the ceding insurance company against its policyholder; failure to disclose the policyholder's rights; unfair marketing practices; the ceding insurance company's unreasonable rejection of a settlement offer within policy limits in a case against the policyholder; agent misrepresentation or fraud; and other acts of bad faith that expose a policyholder to liability beyond its policy limits. Larry P. Schiffer & William Bodkin, Caveat Reinsurer: Reinsuring Punitive Damages Under ECO Clauses, 37 TORT & INS. L.J. 147, 159 (2001).

The District Court's punitive damages award appropriately seeks to punish PSM's reprehensible misconduct and to deter future bad faith. The amount of punitive damages awarded by the court was well within constitutional bounds.

F. This Court Should Look To Other Bad Faith Verdicts In Pennsylvania In Its Application of the Third Guidepost.

The third guidepoast, established in Gore, is the disparity between the punitive damages award and the civil and criminal penalties authorized or imposed in comparable cases. See Campbell, 123 S.Ct. at 1526. Courts may also look to punitive damages imposed in comparable cases as evidence to support punitive damages. The Supreme Court in Gore explicitly stated that civil penalties can "take the form of legislatively authorized fines or judicially imposed punitive damages." BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 572 (1996). Especially in states like Pennsylvania that statutorily prohibit insurance company bad faith, limiting punitive damages based upon the amount of a civil penalty established in a separate unrelated statute undermines the Legislature's intent in establishing a punitive damages remedy in addition to any regulatory penalty. One must remember that the Pennsylvania Bad Faith Statute was enacted to supplement those administrative remedies, as well as the contractual remedies available under Pennsylvania common law. In its Brief, The Willow Inn has properly cited to other punitive damages awards in Pennsylvania. Those awards provided fair notice to all insurance companies that insurance company bad faith is taken seriously in Pennsylvania and that bad faith could result in very substantial punitive damages.

The punitive damages authorized by the Pennsylvania Bad Faith statute cannot be limited in any way by reference to the administrative penalties

for unfair insurance practices. In this regard, the drafting history of the Unfair Trade Practices Model Act ("Model Act") developed by the National Association of Insurance Commissioners ("NAIC") is instructive. In the early 1970's, when the Model Act was revised, the insurance industry resisted strenuously allowing the insurance commissioner discretion to provide "such other relief as is reasonable and appropriate" when addressing unfair insurance company acts and practices – leaving such remedies to the courts. See generally 1972-1 NAIC Proceedings 490, et seq. Given that the state system of insurance regulation in Pennsylvania leaves to the Courts the responsibility to award punitive damages for insurance company bad faith conduct, it would be improper to restrict that remedy based on potential administrative penalties, which were designed to supplement judicial remedies not to supplant them.

G. This Court May Consider PSM's Wealth In Determining Whether The Punitive Damages Award Will Have The Desired Deterrent Effect.

The wealth of a defendant remains a consideration in analyzing whether a punitive damages award is unconstitutionally excessive. See Eden Electrical, Ltd. v. Amana Co., L.P., 258 F. Supp.2d 958, 972 (N.D. Iowa 2003) ("Contrary to various media accounts of the opinion, it may still be proper for the jury to consider the financial condition of a defendant."); Simon v. San Paolo U.S. Holding Co., 7 Cal Rptr.3d 367, 389 (Cal. App. 4th Dep't 2003) ("We conclude that wealth is still useful in determining a punitive amount, but that amount must

still comport with due process as determined along the Supreme Court guidelines.").

In Eden Electrical, the court concluded that "if punitive damages award is to have any punitive or deterrent effect – the stated rationale of such damages – then it is apparent that Amana's wealth and financial condition *must* be taken into consideration." Id. at 974. The court reasoned that an award that would effectively punish and deter General Motors or Bill Gates would have to be "many, many times greater" than an award that would adequately punish a small businessperson. Id. In Eden Electrical, the court reduced a punitive damages award of $17.875 million to $10 million, which still equaled approximately 3% of Amana's net worth. Here, the punitive damages award is only a small fraction of 1% of PSM's net worth.

An influential article in the Harvard Law Review addresses the economics of punitive damages. See A. Mitchell Polinsky and Stephen Shavell, Punitive Damages: An Economic Analysis, 111 Harvard L. Rev. 869 (1998). The lower the rate of detection and punishment, the higher the award must be to meet its legitimate deterrent function. See Mathias v. Accor Economy Lodging, Inc., 347 F.3d 672, 676 (7th Cir. 2003) ("If a tortfeasor is 'caught' only half the time he commits torts, then when he is caught he should be punished twice as heavily in order to make up for the times he gets away."). Empirical studies have found that punitive damages are infrequently awarded. See, e.g., Neil Vidmar et

al., Punitive Damages By Juries, 38 Harv. J. Legis. 487 (2001). Given the infrequency that bad faith is detected and punished and the high net worth of PSM, punitive damage awards must be sufficiently large when awarded to provide some measure of deterrence.

One has to wonder whether the award in the present case is large enough to have any deterrent effect whatsoever. If punitive damages are reduced in this case, no attorney will ever have an incentive to bring a bad faith case in which an insurance company intentionally delays payment of a small claim or totally ignores its obligations under a modest insurance policy. A reduction in punitive damages in this case would wholly undermine Pennsylvania's well established public policy to punish and deter insurance company bad faith. The United States Constitution does not prohibit the imposition of punitive damages that are reasonably related to the legitimate state interest of punishing and deterring insurance company bad faith conduct. Here, the reduction of punitive damages would shock the conscience far more than their imposition.

In most cases, compensatory damages will not include a punitive element. Cf. Gibson v. Overnite Transp. Co., 671 N.W.2d 388, 394 n.3 (Wis. Ct. App. 2003) (distinguishing Campbell because $22,000 of the $33,000 awarded for compensatory damages was for financial damages). Here, The Willow Inn received no compensation, other than punitive damages, for the mental anguish

and distress caused by its insurance company's refusal to pay admittedly legitimate claims within a reasonable time. One must wonder if its claim was $1,000, rather than over $100,000, if The Willow Inn simply would have given up. Many policyholders faced with insurance company delay or an improper denial of coverage do just take what they can get and walk away.

Numerous articles by Herb Denenberg – the former Harvard Law graduate, Wharton professor, Pennsylvania Insurance Commissioner, and consumer advocate – explain why policyholders are not protected by their insurance company or the insurance commissioner.[4] In an insightful article, Mr. Denenberg explains the systemic problems in the insurance industry's adjustment of claims:

> First, insurance companies are adept at stalling and stonewalling on a claim. They move claims along slowly. They may ask for more evidence of loss or proof of value. This is often the start of the process of wearing down the policyholder. Send this form. Get that document. Pretty soon the policyholder may give up without even getting a denial or payment or settle for less than should be paid.
>
> Second, a large proportion of policyholders don't know enough about their policy and the claims process to know they've had an unreasonable denial. So they don't challenge or appeal the denial of their claim. Insurance companies are notorious for writing unreadable policies and for confusing rather than helping and educating their policyholders.

[4] Articles by former-Commissioner Denenberg are available at http://www.badfaithinsurance.org/reference/HDenenberg.

> Third, even if they know or suspect an improper denial, policyholders may have neither the will nor resources for a protracted battle. It's hard to get an attorney except for the largest and most meritorious of claims. A policyholder hesitates to do legal battle with a gigantic insurance corporation. Sometimes the policyholder needs money and can't hold out for the full entitlement and can't wait for extended negotiations or litigation to come to an end.
>
> Fourth, even if they have the resources and connections to fight a battle, it may take years to collect as the insurer may vigorously defend itself and drag out the proceedings. If they win a verdict at trial there may be appeals. For the typical policyholder a lawsuit is an unmitigated disaster bringing nothing but uncertainty, aggravation, inconvenience and expense. But to an insurance company, a lawsuit is just a routine cost of business. A large insurer may spend a hundred million dollars a year or more on lawyers and thinks nothing of defending one more lawsuit.
>
> Fifth, most policyholders need a lawyer to assert their claim. But lawyers are not likely to take a case unless there is a substantial amount at stake. But most insurance claims are for small amounts, so lawyers aren't interested in a battle with an insurance company that is likely to produce a minor fee. What's more, even if a lot is at stake lawyers tend to go only for the slam-dunk cases, and turn down most of the rest.

Herb Denenberg, "Taking the Protection, Security and Peace of Mind Right Out of the Policy: Improper Claim Denials" (Nov. 13, 1999).[5] Mr. Denenberg explained that the Pennsylvania Bad Faith Statute protects the entire insurance marketplace by providing an incentive for insurance companies to treat policyholders fairly and by punishing and deterring unfair practices by the insurance industry. Id.

[5] Available at http://www.badfaithinsurance.org/reference/Hdenenberg/1999-11-13_TakingTheProtectionRightOutOfThePolicy-ImproperClaimDenials.htm.

This is not always a neat distinction. The Supreme Court cited to the Restatement (Second) of Torts § 908, cmt. c, 466 (1977), which states: "In many cases in which compensatory damages include an amount for emotional distress, such as humiliation or indignation aroused by the defendant's act, there is no clear line of demarcation between punishment and compensation and a verdict for a specified amount frequently includes elements of both."[6]

In Haslip, the out-of-pocket damages were only $4,000, and a general jury award of damages (constituting compensatory and punitive damages) was $1,040,000. See Pacific Mut. Life Ins. Co. v. Haslip, 499 U.S. 1, 6 n. 2 (1991). The Court stated that it was "probable" that the jury award contained a punitive element of "not less than $840,000." Id. It is very possible that the compensatory damages in that case were $40,000 (or less) and the punitives were $1 million or more. Yet, the punitive damages award was not so grossly excessive as to violate the United States Constitution. The award was not grossly excessive because the injury was difficult to quantify and the punitive damages served a legitimate state interest.

[6] In the present case, The Willow Inn received no compensation for emotional distress. Accordingly, The Willow Inn's actual damages included amounts that may not have been recoverable under Pennsylvania law. Applying Campbell, one court looked not only to the damages that could be recovered under California law, but to other damages that were suffered but which were not recoverable. Simon v. San Paolo U.S. Holding Co., 7 Cal Rptr.3d 367 (Cal. App. 4th Dep't 2003) (using $400,000 benefit-of-the-bargain damages, which were not recoverable under California law, to calculate ratio even though compensatory damages awarded were only $5,000 in out-of-pocket expenses).

In addition to the actual damages suffered, potential damages must be considered. For purposes of the ratio between punitive and compensatory damages, it is the potential harm that could have been caused by an insurance company's bad faith conduct, not the compensatory damages actually awarded, that are the basis for comparison. This is not a narrow exception; but a fundamental precept. The Supreme Court stated the following in TXO:

> It is appropriate to consider the magnitude of the *potential harm* that the defendant's conduct would have caused to the victim if the wrongful plan had succeeded, as well as the possible harm to other victims that might have resulted if similar future behavior were not deterred. In this case the State Supreme Court of Appeals concluded that TXO's pattern of behavior "could potentially cause millions of dollars in damages to other victims."

TXO Prod. Corp. v. Alliance Res. Corp., 509 U.S. 443, 460-61 (1993). In TXO, the ratio between punitive and compensatory damages was 526:1, yet withstood constitutional scrutiny because of the potential harm that could have been caused by the fraudulent scheme. Citing Gore and TXO, the Supreme Court in Campbell noted that it remained reluctant to establish "constitutional limits on the ratio between the harm, or potential harm, to the plaintiff and the punitive damages award." Campbell, 123 S.Ct. at 1524. Applying Campbell, the Wisconsin Supreme Court upheld millions in punitive damages, even though no compensatory damages were awarded because the insurance company eventually had paid. Trinity Evangelical Lutheran Church & Sch. v. Tower Ins.

Co., 661 N.W.2d 789 (Wis.), cert. Denied, No. 03-502, 2003 WL 22303317 (Dec. 8, 2003) (upholding award of $3.5 million punitive damages where insurance policy was reformed and carrier ultimately paid $490,000 to settle underlying tort suit, but no compensatory damages were awarded).

Imagine a case where the insurance company clearly owes coverage, and refuses to pay for no reason. Summary judgment for breach of contract is then granted for the policyholder and the insurance company is forced to pay the full $1 million dollar claim, plus interest. The bad faith claim goes to trial, and the court awards attorneys' fees, costs, and punitive damages under the bad faith statute. What is the constitutional limit on punitive damages in such a case? Most would agree that the ratio would include at least the $1 million actually awarded on summary judgment, plus attorneys' fees, costs, and interest. Should the result be different if an insurance company knows the claim is covered, but waits to pay the claim in full until the policyholder initiates litigation? Would the compensatory side of the ratio include the $1 million that was improperly withheld and which would not have been paid absent the litigation? The compensatory damages to be considered for the ratio must include the $1 million ultimately paid by the insurance company, whether under court compulsion or not, or courts will create an incentive for insurance companies to withhold payment until a policyholder takes the difficult and costly action of finding an attorney and bringing litigation. The Pennsylvania Supreme Court's

decision in Birth Center is instructive where it rejects the idea that an insurance company's payment of the full verdict against the policyholder, including amounts in excess of the policy limits, precludes a bad faith claim:

> St. Paul did not pay the excess verdict out of the goodness of its heart. It had reason to believe that The Birth Center was going to sue for bad faith and it knew that if it were found to have acted in bad faith, it would be liable for punitive damages as well as the amount of the excess verdict. 42 Pa. C.S.A. §8371. It, therefore, appears that St. Paul paid the excess in an attempt to avoid a punitive damages award.

Birth Center v. St. Paul Cos., Inc., 567 Pa. 386, 787 A.2d 376 (2001). Without the fear of substantial punitive damages, some insurance companies will not pay out of the "goodness of their hearts."

V. CONCLUSION

For all of the foregoing reasons, the District Court's judgment should be affirmed.

Respectfully submitted,

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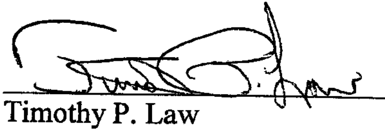
CERTIFICATION OF ADMISSION

I, Timothy P. Law, attorney for Amicus Curiae United Policyholders, do hereby certify, in accordance with Local Appellate Rule 28.3(d), that I have been admitted to the bar of the Court of Appeals for the Third Circuit.

Timothy P. Law

CERTIFICATE OF COMPLIANCE

I, Timothy P. Law, attorney for Amicus Curiae United Policyholders, do hereby certify, in accordance with Federal Rule of Appellate Procedure 32(a)(7)(C), that this brief complies with Federal Rule of Appellate Procedure 32(a)(7)(B) and Local Rule 32.1, and that this brief, excluding the Title Page, Table of Authorities, Table of Contents and certifications of counsel contains 6,933 words.



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CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of January 2004, the foregoing Brief of Amicus Curiae United Policyholders in Support of The Willow Inn was filed with the Clerk of Court, United States Court of Appeals for the Third Circuit, by hand delivery; and that true and correct copies thereof were served by first-class, postage prepaid mail on the following:

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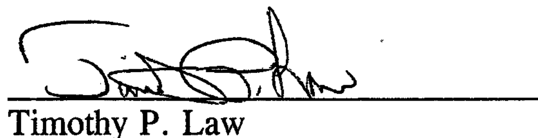

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