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Demonstrating and Preserving The Deterrent Effect of Punitive Damages In Insurance Bad Faith Actions

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Introduction

IN THE PAST DECADE juries have rendered substantial punitive damages awards against insurance companies engaging in unfair, wrongful, and, in some instances, malicious claims practices. More significantly, appellate courts have rendered landmark decisions which have affirmed these substantial jury verdicts. In *Neal v. Farmers Insurance Co.*,¹ for example, the California Supreme Court affirmed a punitive damages award of \$750,000, even though the insured's special damages, incurred as a consequence of the insurer's wrongful claims practices,² were approximately \$9,000. In *Egan v. Mutual of Omaha*,³ the court affirmed the decision of the court of appeal modifying the award of punitive damages from five to two and one-half million dollars.

The imposition of punitive damages liability has signalled concern for the concept of exemplary damages.⁴ Major criticism has

1. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

2. In *Neal*, the plaintiff's decedent was injured by an uninsured motorist. The plaintiff's uninsured motorist coverage under her policy with Farmers was \$15,000 and medical coverage was \$5,000. The insurer maintained that its liability for uninsured motorist coverage was to be reduced by the amount of the medical payment coverage, \$5,000. An arbitrator's decision in favor of plaintiff's decedent precipitated this suit for bad faith refusal to pay benefits. *Id.*

3. 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979). In *Egan*, the defendant's liability rested on its breach of the covenant of good faith and fair dealing by failing to prudently investigate its insured's claim. *Id.* at 817, 598 P.2d at 455-56, 157 Cal. Rptr. at 485-86.

4. Exemplary or punitive damages are damages given as an enhancement of compensatory damages because of the wanton, reckless, malicious, or oppressive character of the acts

included the following suggestions. First, punitive damages increase the cost of insurance and are unnecessarily passed on to insurance consumers in the form of higher premiums.⁵ Second, the punitive damages award provides an unfair windfall to the plaintiff.⁶ Third, the punitive damages award is unconstitutional because the amount of damages which can be awarded lacks the precision which would provide sufficient due process of law.⁷

Nevertheless, contemporary tort law has assumed a most desirable regulatory function. The spirit of the common law appears to be progressing with more of an aura of public concern than has ever occurred in the history of American jurisprudence. There is, of course, an inevitable transitional social cost incidental to punitive damages liability.⁸ However, an analysis of the overall social benefit which attaches to punishing certain types of wrongful conduct clearly indicates the "costs" might be one of the best "purchases" in the history of the common law.

This article will illustrate the social desirability of the punitive damages doctrine by demonstrating its efficacy in reforming unfair insurance claims practices. Additionally, the article will focus upon the determinants of the punitive damages verdict in an effort to suggest criteria which will assist in preserving the admonitory potential of exemplary damages liability.

I. THE UTILITY OF PUNITIVE DAMAGES: RESPONDING TO QUESTIONS OF NEARLY FIFTY YEARS AGO

Nearly fifty years ago, Professor Morris, in an ageless and insightful article, considered the utility of the concept of punitive

complained of, as a "punishment" of the defendant and a deterrent to others. See CAL. CIV. CODE § 3294 (West 1970).

5. This contention was raised by the dissent in *Egan*, 24 Cal. 3d at 825, 598 P.2d at 460, 157 Cal. Rptr. at 490 (Clark, J., dissenting). See also *Austero v. National Cas. Co.*, 84 Cal. App. 3d 1, 30, 148 Cal. Rptr. 653, 672 (1978), in which this court considered this effect in refusing to hold that an insurer which refuses to pay benefits claimed under the policy does so at its own risk.

6. *Egan v. Mutual of Omaha*, 24 Cal. 3d at 827, 598 P.2d at 462, 157 Cal. Rptr. at 492 (Clark, J., dissenting). See also Note, *Insurance Coverage of Punitive Damages*, 10 IDAHO L. REV. 263, 268 (1974).

7. *Egan v. Mutual of Omaha*, 24 Cal. 3d at 826, 598 P.2d at 461, 157 Cal. Rptr. at 491 (Clark, J., dissenting).

8. Specific consideration of this factor is discussed by Justice Manuel in *Neal v. Farmers Ins. Co.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

damages by asking, "[i]s the admonitory function of the tort action more effective through the use of the doctrine of punitive damages than it would be without the use of the doctrine?"⁹ In 1931, Professor Morris felt it was too early to evaluate the role of exemplary damages, observing that:

[T]he punitive damage doctrine is evidence of an age-old feeling that the admonitory function is sometimes entitled to more emphasis than it receives when judgments in tort actions are limited to compensation . . . A complete justification of the doctrine's place in the law would be a demonstration of its usefulness; and an accurate knowledge of the limits and scope of its utility would be based on a richer acquaintance with the actual results of cases than is now available.¹⁰

The desirability of punitive damages awards may not have crystallized to the point of permitting their evaluation in 1931. However, contemporary tort law and punitive damages doctrines, when juxtaposed to the "accomplishments" of apathetic administrative agencies¹¹ and lethargic legislative bodies, appear to provide a ray of reformative hope for the American public. It is now possible, and indeed desirable, to attain a richer acquaintance with the actual results of cases¹² for purposes of evaluating the dynamic role of punitive damages doctrines in contemporary tort law.

The punitive damages award is beginning to acquire the characteristics of a strong, silent consumer public advocate. A comprehensive review¹³ of the response of the insurance industry to the bad faith cause of action and incidental awards of punitive damages provides an excellent foundation for evaluating the role of the law of torts as administered by common law courts and juries. This essential and crucial body of common law, marked by relative simplicity, is playing an increasingly significant role in protecting contemporary society from many nonregulated or inadequately regulated businesses and industries.

9. Morris, *Punitive Damages in Tort Cases*, 44 HARV. L. REV. 1173, 1184 (1931). See generally, Morris, *Rough Justice and Some Utopian Ideas*, 34 ILL. L. REV. 730, 736 (1930). See also Note, 70 YALE L. J. 1296 (1961).

10. Morris, *Punitive Damages in Tort Cases*, *supra* note 9, at 1206.

11. See text accompanying notes 89-90 *infra*.

12. See text accompanying notes 31-35 *infra*.

13. See text accompanying notes 52-88 *infra* and materials cited in note 52 *infra*.

A. *Evolving Theories of Recovery: Tort vs. Contract*

The marked and characteristic rigidity of basic contract law principles¹⁴ historically precluded many insureds from recovering damages incurred as a result of tortious breaches of insurance contracts.¹⁵ Traditionally, an insured seeking recovery of insurance contract benefits could not recover attorneys' fees, damages for emotional distress, or punitive damages because of the prevailing impact of the damages principles promulgated in *Hadley v. Baxendale*¹⁶ and the continued adoption of those principles by American courts.¹⁷ Fair claims practices were not encouraged by those principles.¹⁸ Wrongful denial of benefits required the insurer's payment of benefits only when a trial resulted in a verdict for the insured.¹⁹ As a result, contract law did not deter insurers from engaging in outrageous conduct when dealing with valid claims of insureds. Because of the claims practices engaged in by many insurance carriers,²⁰ it became necessary to mold tort theories of recovery in an effort to make insurers realize that bad faith claims practices could no longer be served to the American public on the spoon of rigid and antiquated principles of contract law.

Within the last ten years, the California courts have breathed life into contemporary tort theory so that those wronged could be compensated and those acting wrongfully could be deterred.²¹ Five

14. Generally, damages for breach of contract are limited to those damages foreseeable at the time the contract was formed. *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854). As a result, punitive damages are not available where the sole basis of liability is breach of contract. See note 17 infra.

15. See *California Press Mfg. Co. v. Stafford Packing Co.*, 192 Cal. 479, 221 P. 345 (1923); *Overstreet v. Merritt*, 186 Cal. 494, 200 P. 11 (1921); *Hunt Bros. Co. v. San Lorenzo Water Co.*, 150 Cal. 51, 87 P. 1093 (1906); *Christensen v. Slaughter*, 173 Cal. App.2d 325, 343 P. 341 (1959); *Hadley v. Baxendale*, 156 Eng. Rep. 145 (1854).

16. 156 Eng. Rep. 145 (1854). See note 15 *supra*.

17. See, e.g., *Cassady v. United Ins. Co. of America*, 370 F. Supp. 388 (W.D. Ark. 1974); *McDonald v. Pennsylvania Mut. Life Ins. Co.*, 276 So. 2d 232 (Fla. Dist. Ct. App. 1973); *Wallace v. Prudential Ins. Co. of America*, 12 Ill. App.3d 623, 299 N.E.2d 344 (1973); *Kocse v. Liberty Mut. Ins. Co.*, 152 N.J. Super. 371, 377 A.2d 1234 (1977). See generally 20 J. APPLEMAN, INSURANCE LAW AND PRACTICE § 11255 (Supp. 1978); Annot., 47 A.L.R.3d 314 (1973).

18. However, in cases brought under tort theories, such as intentional infliction of emotional distress and fraud, punitive damages awards have provided incentive to insurance companies to reform unfair claims practices. See generally *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

19. *Id.*

20. See, e.g., *Neal v. Farmers Ins. Co.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978); *Egan v. Mutual of Omaha*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979).

21. The evolution of theories of liability is beyond the scope of this article. For a discuss-

distinct tort theories of liability have been recognized by California courts as remedies for wrongful refusals to indemnify insureds for valid insurance claims. However, those theories of recovery frequently appear to be nothing more than public policy determinations by the courts which permit insureds to recover items of damages in addition to insurance policy proceeds. The theories of recovery are fraud,²² intentional infliction of mental distress,²³ breach of covenant of good faith and fair dealing,²⁴ tortious interference with a protected property interest,²⁵ and violation of statute.²⁶

The tort theories of recovery, unlike the rigid principles of contract law, are marked by resilient damages rules of law which now permit an insured to recover damages for emotional distress,²⁷ consequential economic losses and property damages,²⁸ attorneys' fees,²⁹

sion of these theories, see Levine & Shernoff, *The Evolution of Insurance Bad Faith Actions: Emerging Damages Issues*, 16 CAL. TRIAL LAW J. 131 (1977).

22. See Miller v. National Am. Life, 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1976); Wetherbee v. United Ins. Co. of America, 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968). In Miller, the court stated:

[S]ince direct proof of fraudulent intent is often an impossibility, because the real intent of the parties and the facts of a fraudulent transaction are peculiarly in the knowledge of those sought to be charged with fraud, proof indicative of fraud may come by inference from circumstances surrounding the transaction, the relationship, and interest of the parties Subsequent conduct of an insurer in processing a claim may support an inference of prior intent not to fulfill its representations.

54 Cal. App. 3d at 338, 126 Cal. Rptr. at 735 (citations omitted).

23. See Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); Little v. Stuyvesant Life Ins. Co., 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

24. See Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

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

26. The California Insurance Code precludes an insurer from engaging in certain unfair claims practices. CAL. INS. CODE § 790.03 (West Supp. 1979). More importantly, the courts have held that a violation of this section of the code can serve as a foundation for a civil action. For example, in Shernoff v. Superior Ct., 44 Cal. App. 3d 406, 118 Cal. Rptr. 680 (1975), the court held that the insurance commissioner's jurisdiction to restrain insurance companies' wrongful practices was "primary" but not "exclusive" and that a civil action could be based upon a violation of section 790.03.

27. See Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); Little v. Stuyvesant Life Ins. Co., 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

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

and, in a proper case, punitive damages.³⁰ The common characteristic of each of the above-enumerated theories of liability is that each permits recovery of punitive damages if the insurer acted with malice, oppression, or intent to injure, vex, or annoy the insured.³¹ Some juries which have considered the claims practices of insurance companies have rendered punitive damages verdicts which have greatly exceeded the compensatory damages verdicts. In *Neal v. Farmers Insurance Co.*,³² the California Supreme Court affirmed a jury verdict of \$749,010. The plaintiff's actual damages were \$9,010 and the punitive damages award was \$740,000.³³ In the earlier decision of *Wetherbee v. United Insurance Co. of America*,³⁴ the court of appeal affirmed a punitive damages verdict of \$200,000 despite the fact that the insured's actual damages were only \$1,050.³⁵ In upholding the exemplary damages award, the court in each case stressed the wealth of the defendant and the nature of the defendant's conduct towards the insured.³⁶

However, the true impact of punitive damages verdicts is best reflected by the case of *Egan v. Mutual of Omaha*.³⁷ In *Egan*, the

29. See *Mustachio v. Ohio Farmers Ins. Co.*, 44 Cal. App. 3d 358, 118 Cal. Rptr. 581 (1975).

30. *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974); *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973); *Little v. Stuyvesant Life Ins. Co.*, 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977); *Miller v. National Am. Life*, 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1976); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

31. CAL. CIV. CODE § 3294 (West 1970) is the statutory authority for awards of punitive damages in California.

32. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

33. The jury returned an undifferentiated verdict from which, typically, it is impossible to review the question of excessive damages. However, in this case the plaintiff was precluded by statute from recovering for emotional distress. The parties and the trial court agreed that the "economic damages" amounted to no more than \$10,000. The supreme court concluded that the punitive damages awarded was "in the neighborhood of \$740,000." *Id.* at 927, 582 P.2d at 990, 148 Cal. Rptr. at 399.

34. 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1971).

35. *Id.* at 272, 95 Cal. Rptr. at 681. In the same case, the court had previously reversed a \$500,000 punitive damages award. 265 Cal. App. 921, 71 Cal. Rptr. 769. On retrial of the damages issue, the jury awarded the plaintiff \$200,000 in punitive damages. *Id.* at 935, 71 Cal. Rptr. at 772.

36. *Neal v. Farmers Ins. Co.*, 21 Cal. 3d at 928, 582 P.2d at 993, 148 Cal. Rptr. at 399-400 (1978); *Wetherbee v. United Ins. Co. of America*, 18 Cal. App. 3d at 271, 95 Cal. Rptr. at 681 (1971).

37. 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976). The California Supreme Court recently affirmed the court of appeal on the issue of the defendant's liability. 24 Cal. 3d 809, 819, 598 P.2d 452, 457, 157 Cal. Rptr. 482, 487 (1979). However, the court reversed the punitive damages award as excess. *Id.* at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

jury rendered a verdict of \$45,000 in compensatory damages, \$78,000 in general damages, and \$5,000,000 in punitive damages. The court of appeal affirmed the verdict, but reduced the punitive damages award to \$2,500,000.³⁸ The California Supreme Court recently held that the punitive damages were excessive, but affirmed the remainder of the jury's verdict.³⁹ The substantial punitive damages verdicts which greatly exceed compensatory damages verdicts illustrate the importance of evaluating the bad faith action and its most vital characteristic—punitive damages.⁴⁰

B. *California Landmark Concepts: The National Impact*

The California Supreme Court has sparked explosive reform of insurance claims practices not only in California, but throughout the nation. In their recognition of recovery for punitive damages, the landmark decisions of *Fletcher v. Western Life Insurance Co.*,⁴¹ *Gruenberg v. Aetna Insurance Co.*,⁴² and the progeny⁴³ of California first-party bad faith claims have had an immeasurable impact upon courts of other states.

In *Campbell v. Government Employees Insurance Co.*,⁴⁴ the Florida Supreme Court recently stated: "[T]here has been a recent spate of cases, several out of California, that vividly underscore the point that insurance companies are vulnerable to punitive damage suits by their policyholders when carriers attempt to deal with their insureds unethically."⁴⁵ In *Fisher v. Executive Fund Insurance Co.*,⁴⁶ the Nevada Supreme Court relied upon California law in holding: "the other allegations state an action for mental distress caused by bad faith refusal to pay policy proceeds."⁴⁷ The Nevada Supreme

38. 63 Cal. App. 3d at 693, 133 Cal. Rptr. at 920.

39. 24 Cal. 3d at 824, 598 P.2d at 460, 157 Cal. Rptr. at 490.

40. In addition to all the reported appellate decisions relating to the propriety and amount of punitive damages awards, it is reasonable to assume that numerous unappealed punitive damages verdicts have been rendered by juries and that innumerable cases have been settled for significant amounts of punitive damages before trial.

41. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

42. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

43. See, e.g., *Egan v. Mutual of Omaha*, 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976), *aff'd*, 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979); *Neal v. Farmers Ins. Co.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978); *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

44. 306 So. 2d 525 (Fla. 1974).

45. *Id.* at 631 (citations omitted).

46. 88 Nev. 704, 504 P.2d 700 (1972).

47. *Id.* at 704, 504 P. 2d at 702 (Gunderson, J., concurring), *citing Fletcher v. National Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

Court also cited the California cases of *Fletcher* and *Gruenberg* with favor in *United States Fidelity and Guaranty Co. v. Peterson*.⁴⁸ The Supreme Courts of Iowa⁴⁹ and Wisconsin⁵⁰ have relied upon *Fletcher*, and other bad faith cases having their origin in *Fletcher*, as a means of preventing bad faith practices in those states.

In addition to numerous reported appellate decisions,⁵¹ many law review and magazine articles⁵² have brought national attention to the unconscionable and unfair claims practices of numerous insurance companies by describing the changing nature of the law

48. 91 Nev. 617, 540 P.2d 1070 (1975).

49. See *Amsden v. Grinnell Mut. Reins. Co.*, 203 N.W.2d 252 (Iowa 1972).

50. See *Anderson v. Continental Ins. Co.*, 85 Wis. 675, 271 N.W.2d 368 (1978).

51. See text accompanying notes 41-43 *supra*.

52. The following bibliography was compiled by the author and, at the time of this writing, represents a comprehensive list of articles in insurance defense law journals and various other insurance communications media. See generally, Dubois & Bronson, *The Spectre of Punitive Damages in First Party Actions*, 40 INS. COUNS. J. 290 (1973); Dubois, *The Spectre of Punitive Damages in First Party Actions—Part II*, 42 INS. COUNS. J. 242 (1975); Hilts, *Insurer's Refusal to Settle Claims: Intentional Creation of Distress*, 23 DEF. L.J. 335 (1974); Hirsch, Carpenter & Carpenter, *Strict Liability: A Response to the Gruenberg-Silberg Conflict Regarding Insurance Litigation Awards*, 7 SW. U.L. REV. 310 (1975); Houser & Knoll, *Claim Handling and Bad Faith Claims—The Hazards of Saying "No,"* 15 FOR THE DEF. 93 (1974); Keenan & Gillespie, *The Insurer and the Tort of the Intentional Infliction of Mental Distress: Fletcher v. Western National Life Insurance Co.*, 39 INS. COUNS. J. 335 (1972); Kelly, *The Workable Sanction and Solution in Excess Liability Cases: Strict Liability for Insurance Carriers*, 10 U.S.F. L. REV. 159 (1975); Lev, *Punitive Damages in First-Party Insurance Claims: Reaching the Age of Maturity*, CASE & COM., Sept.-Oct., 1978 at 48; Levit, *Punitive Damages Today*, INS. L.J. 483 (Sept. 1974); Levit, *Punitive Damages Extended to Uninsured Motorist Provision*, INS. L.J. 515 (Sept. 1972); Levit, *Punitive Damages Today: What Can Be Done to Protect Against Imposition of Such Damages*, INS. L.J. 211 (April 1972); Levit, *Fletcher v. Western National: Punitive Damage Exposure Substantially Increased for Insurers*, INS. L.J., 304 (June 1971); Parks, *Recovery of Extra-Contract Damages in Suits on Insurance Policies*, 9 FORUM 43 (1973); Parks and Heil, *The Tort of "Bad Faith"—The Impact of Gruenberg v. Aetna Insurance Company*, 24 FED'N OF INS. COUN. Q. NO. 3, 3 (1974); Note, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164 (1976); Note, *Good Faith and Fair Dealing in Insurance Contracts: Gruenberg v. Aetna Insurance Co.*, 25 HASTINGS L.J. 699 (1974); Note, *The Widening Scope of Insurer's Liability*, 63 KY. L.J. 145 (1975); Note, *Contracting for Punitive Damages: Fletcher v. Western National Insurance Co.*, 4 LOY. U.L. REV. 208 (1971); Note, *Damages for Mental Suffering Caused by Insurers: Recent Developments in the Law of Tort and Contract*, 48 NOTRE DAME LAW. 1303 (1973); Note, *Damages: Compensating the Insured for Injury Resulting From Insurer's Misconduct in Claims Dispositions—Is It Tort or Contract?*, 28 OKLA. L. REV. 394 (1975); Note, *Exemplary Damages in Contract Cases*, 7 WILLAMETTE L.J. 137 (1971); Note, *The New Tort of Bad Faith Breach of Contract: Christian v. American Home Assurance Corp.*, 13 TULSA L.J. 605 (1978); Wier, *Liability Exposures in Tort Growing Out of Breach of Insurance Contract*, BEST'S REV. 32 (Oct. 1975); Kornblum & Thornton, *The Seismic Impact of Punitive Damages in Actions Against Insurers*, BEST'S REV. 36 (Dec. 1976); Raymont, *Punitive Damages and Property Insurance Claims*, BEST'S REV. 30 (July 1975).

relating to insurance contracts, the recognized theories of recovery based on tort, and punitive damages liability. The impact of the changing theories of liability and exposure to exemplary damages liability is well reflected by the concern expressed in the publications discussing these landmark decisions.

II. THE RESPONSE OF THE INSURANCE INDUSTRY: THE *SINE QUA NON* FOR EVALUATING THE PUNITIVE DAMAGES VERDICT

The best way to evaluate the efficacy, impact, and utility of the punitive damages award is to engage in a comprehensive review of the response of the insurance industry to the bad faith action and punitive damages awards. The response of the insurance industry is best reflected by the observation that "[t]he specter of recent punitive damages awards against insurance companies, most of which have occurred in California, is awesome. They have resulted in a shock wave throughout the insurance industry which is not measurable on the Richter Scale."⁵³ A partial survey of the responses⁵⁴ provides a meaningful evaluation of the exemplary damages doctrine and concurrently stresses the need for preservation of this vital component of the common law.

*Fletcher v. Western National Life Insurance Co.*⁵⁵ alerted the insurance companies that the law of bad faith would have a national impact on first-party insurance claims for disability benefits.⁵⁶ It became evident that the same rule would be extended to a property insurer or any insurer who breached a contract under similar conditions⁵⁷ and would constitute a tort for which punitive damages might be recovered.⁵⁸ Therefore, insurers were advised of the type of cases which would be forthcoming. Among these was *Gruenberg v. Aetna Insurance Co.*,⁵⁹ which extended the bad faith action to all

53. Kornblum & Thornton, *The Seismic Impact of Punitive Damages in Actions Against Insurers*, 77 *BEST's Rev.* 36, 44 (1976).

54. See the bibliography set out at note 52 *supra*.

55. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

56. See Levit, *Fletcher v. Western National: Punitive Damage Exposure Substantially Increased for Insurers*, 1971 *INS. L.J.* 304.

57. See *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973), where the court extended protection from insurers' bad faith actions to all first-party insurance claims.

58. See Levit, *supra* note 56, at 308.

59. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

types of first party insurance claims on the theory that the insurance policy was a protected property interest which could not be tortiously interfered with by an insurer wrongfully refusing to pay policy proceeds.⁶⁰ Insurers were further advised that *Fletcher* would be a leading case in insurance, contract, and tort law in the United States for many years and that the principles the case stated were quite sound.⁶¹

In a 1972 article,⁶² insurance companies were reminded of the need to stress a cautious and fair approach to the handling of claims practices in response to *Fletcher*. Another article⁶³ warned insurance companies of the effect of bad faith refusals to indemnify insureds:

It is expected that the new orientation of the court, as evidenced in the *Wetherbee* and *Drake* cases, may help keep many a disability insurer on its toes in the future. There is considerable doubt that many state insurance departments or commissions have been doing so; company transgressions are often overlooked, and even when an insurer or its salesmen are disciplined, the public seldom hears about it.⁶⁴

The deterrent effect of *Gruenberg v. Aetna Insurance Co.*⁶⁵ is well reflected in an article appearing in an insurance journal.⁶⁶ After a description of the holding in *Gruenberg*, and an extensive discussion of the claims practices initiated by Aetna Insurance Company in that case, the article advised insurers of the need to improve their unfair claims practices. The article stated that insurers must engage in fair investigations before denying claims and avoid engaging in any deceptive practices while processing claims.⁶⁷ The article concluded that "none of the warnings discussed above nor the threat of a bad faith claim should hinder a thorough investigation of a questionable claim. As mentioned earlier, the policy provides extensive investigative channels through which the company may properly gather data from the insured."⁶⁸

60. *Id.* at 580, 510 P.2d at 1041, 108 Cal. Rptr. at 489.

61. See Levit, *supra* note 56, at 309.

62. Keenan & Gillespie, *The Insurer and the Tort of Intentional Infliction of Mental Distress: Fletcher v. Western National Life Insurance Company*, 39 INS. COUNS. J. 335 (1972).

63. Wall Street J., Jan. 28, 1974, at 1, col. 6.

64. *Id.*

65. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

66. House & Knoll, *Claim Handling and Bad Faith Claims: The Hazard of Saying No, 15 FOR THE DEF.* 93 (Defense Memo, Sept. 1974).

67. *Id.* at 95.

68. *Id.* at 96.

A further indication of the deterrent value of punitive damages verdicts is offered in a 1973 article⁶⁹ which sets forth preventative steps that are now necessary given the status of bad faith laws. The author notes that "the failure to make prompt settlement of amounts admittedly owing can result in large punitive damages awards for oppression and also subject the insurer to a charge of unfair claims practices"⁷⁰ for which its license to do business can be revoked if such practice is systematic. In the same article, insurers were told that punitive damages awards were often related to the financial worth of the defendant.⁷¹

In a presentation at an insurance claims seminar in 1975, a claims secretary for a large insurance company stated that "insurance companies, because of their financial strength, can expect heavy punitive damages awards to be imposed on them, particularly in today's volatile, consumerist environment."⁷² The claims secretary specifically responded to *Egan v. Mutual of Omaha*,⁷³ in which the jury rendered a punitive damages verdict of \$5,000,000 for wrongful denial of an insured's disability benefits, by addressing himself to the manner in which companies can prevent punitive damages awards. The basic suggestions offered by the author are most significant in ascertaining the specific and general deterrent effect the *Egan* verdict has had upon the insurance industry. The desirable effects of such a verdict are reflected in the warning to insurers that the following steps⁷⁴ must be taken in order to avoid punitive damages awards. First, conduct a thorough investigation and develop all the facts relating to the damages. Second, ascertain the nature of such facts prior to declining any claim. Third, if there are any doubts, resolve the doubts in the favor of an insured. Finally, make all payments of losses as promptly as possible.

In a recent article⁷⁵ regarding the effect of bad faith actions in other jurisdictions, a senior vice president of claims observed that "[i]n the future I believe we can anticipate more and more tort action growing out of insurance contracts in California as well as in

69. Levit, *Punitive Damages Today*, 1974 INS. L.J. 483.

70. *Id.* at 486.

71. *Id.* at 484.

72. Raymont, *Punitive Damages and Property Claims*, 76 BEST'S REV. 30 (1975).

73. 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976).

74. RAYMONT, *Punitive Damages*, *supra* note 72, at 32-33.

75. Wier, *Liability Exposures and Tort Growing Out of Breach of Insurance Contracts*, 76 BEST'S REV. 32 (1975).

other jurisdictions. Efforts will undoubtedly be made to transplant California decisions in other states. Such action can be costly and troublesome even if ultimately defeated.⁷⁶

One author⁷⁷ has suggested that insurers' liability will not only grow in jurisdictions such as California, but will extend to causes of action throughout the United States. The author traces the response to the California decisions in other jurisdictions and suggests that the significance and far-reaching effect of *Fletcher v. Western National Insurance Co.*⁷⁸ deserves close examination.⁷⁹ More importantly, the article reflects the reformative and rehabilitative function of the tort action of bad faith.

The lesson of the cases thus far decided is quite clear. Insurers must give careful consideration to the interest, both pecuniary and emotional, of their policy holders.

The greatest direct exposure to liability for tort damages exists in the first-party field such as life insurance, accident and health insurance, fire insurance, etc. Claims personnel for insurers in these fields must be specially trained to deal promptly and courteously with claimants, and when denials of claims are made the insurer must be quite certain of the grounds for making such denial.

The situation is not entirely bleak, however. Tort liability has been imposed, thus far, only in rather aggravated circumstances. Nonetheless, the time has passed when the insurance industry was governed primarily by the law of contracts.⁸⁰

In 1976, two authors suggested that the bad faith cases have had an astounding effect upon insurance claims practices throughout the industry.⁸¹ These authors suggested that the insurance industry take heed because these verdicts reflected a great public dissatisfaction with insurers' claims, sales, and underwriting practices and therefore served as examples of conduct which should be avoided.⁸² Most significantly, the authors provide suggestions which indicate the desirable effect punitive damages verdicts have had

76. *Id.* at 40.

77. See Hilts, *Insurer's Refusal to Settle Claims: Intentional Creation of Distress*, 23 DEF. L.J. 335, 345 (1974).

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

79. See Hilts, *supra* note 77, at 345.

80. *Id.* at 351.

81. Kornblum & Thornton, *The Seismic Impact of Punitive Damages in Actions Against Insurers*, 77 BEST'S REV. 36 (1976).

82. *Id.* at 38.

upon first-party insurance claims practices. The authors state that, based on hindsight, these cases point out a number of problem areas which, if there is any hope of avoiding the punitive damages verdict, must be corrected.⁸³ The most significant suggestions are as follows. First, any claims investigation should be conducted without tampering with the evidence and with full disclosure to the party whom the investigator or adjustor is representing. Second, all claims should be handled promptly, efficiently, and courteously. Third, claims must be handled with full disclosure to the insured. Fourth, if a claim is payable, it should be paid promptly. Fifth, insurers should develop sound and thorough training programs for their claims personnel, field adjustors, and investigators. In addition, companies should develop methods for updating their claims personnel on recent developments in the medical and legal areas frequently involved in claims handling. Sixth, claims personnel should be encouraged to seek consultation from available legal and medical staff personnel when in doubt with respect to problems confronted in handling claims. Seventh, claims procedures in the administrative structure of handling claims should be formulated. Eighth, efforts should be made to implement procedures when a claimant and the company act expeditiously. Finally, companies should strive for the highest quality of professionalism in all phases of claims resolution.

In a 1973 article,⁸⁴ the author advised insurance companies that "in this era of the conscious consumer and the class action, the punitive damage action is a powerful weapon. I suggest that the way to prepare to meet this threat is before you are faced with an actual suit for punitive damages."⁸⁵ Likewise, an insurance executive, after delineating the elements of the bad faith action in California, noted that "every judgment [such as *Egan*] impairs the industry's character in the eyes of the public. The best defense against punitive damages suits is to avoid them by thoughtful, careful, equitable administration of our contracts."⁸⁶

A review of the response of the insurance industry to punitive damages verdicts reflects the admonitory function of punitive damages concepts. However, it is significant that the industry's response

83. *Id.* at 44.

84. Levit, *Punitive Damages—Preventive Steps*, 1973 Ins. L.J. 332.

85. *Id.* at 332.

86. Address by Earl Clark, Joint Annual Meeting of the American Life Insurance Association and the Institute of Life Insurance (Nov. 4, 1975).

discussed above does not indicate concern for the need to reform claims practices from a moral perspective and with a view toward developing business practices based on sound public policy. Those authors and speakers do not condemn the practices of the past, nor do they consider the need for formulating a foundation of social conscience in the future. Instead, each of the authors and speakers, without exception, has merely focused upon the need to improve claims practices so as to avoid punitive damages verdicts. The suggested reforms do not grow out of condemnations of unscrupulous treatment of insureds; they are mere defensive efforts to avoid punitive damages verdicts. Absent the development of the tort theory of recovery and the incidental punitive damages verdicts, it is doubtful that the claims practices of insurers would be any less unconscionable than they were prior to the imposition of substantial exemplary damages liability. The suggestion by Professor Morris, in his 1931 article,⁸⁷ that the value of punitive damages can only be judged by "richer acquaintance with the actual results of cases"⁸⁸ is reflected in the partially depicted response of the industry to the California bad faith cases.

The full impact of the reformative, regulatory, and admonitory function of punitive damages verdicts should not be viewed solely from the perspective of case law and the industry's response to the cases. Juxtaposing the development of insurance bad faith law with recent evaluations of the administrative agencies responsible for regulating insurance companies magnifies the significance of the documented deterrent and admonitory function of punitive damages concepts. The apathy, ineffectiveness, and failure of administrative agencies to adequately regulate insurance companies is well reflected in the recent report of the California Joint Legislative Audit Committee. In its *Review of the Disciplinary Function of the Department of Insurance*, the committee found that:

The Department of Insurance's organization and procedures for investigating and resolving public complaints against insurance companies and agents are seriously deficient. Little effort is made to investigate overall patterns of complaints about insurers' business practices upon which serious discipline might be based. Although the Department more effectively addresses public complaints against insurance agents, inadequate man-

87. Morris, *Punitive Damages in Tort Cases*, *supra* note 9.

88. *Id.* at 1206. See text accompanying note 10 *supra*.

agement of the investigation of these complaints has resulted in insufficient investigations and an unnecessary backlog of work. The Department's fragmented organization of investigative and disciplinary functions and a lack of uniform procedures compound these problems.

In its disciplinary actions, the Department's Legal Division has given preferential treatment to selected licensees, notably insurance companies and those insurance agents whose attorneys are former key Department officials. Such licensees have been permitted to negotiate and reduce proposed discipline in a manner inconsistent with normal Department procedure.⁸⁹

Comparing the regulatory function of punitive damages verdicts to the function of "regulatory" agencies reflects the effective simplicity of exemplary damages rules of law administered by judges and jurors and the ineffective complexity in the maze of administrative agencies and regulations. Paradoxically, from an economic perspective, the cost of regulation through punitive damages sanctions is borne by the insurer acting wrongfully⁹⁰ and not by taxpayers supporting ineffective administrative agencies.

III. PRESERVING THE DETERRENT EFFECT OF PUNITIVE DAMAGES VERDICTS

The most desirable characteristic of the punitive damages verdict is its admonitory function, and it is essential that the factors considered in reaching the exemplary damages decision be aimed at satisfying the intended purpose of the doctrine. One of the most controversial issues surrounding the punitive damages doctrine concerns the criteria which are to be utilized by judges and juries in reaching a determination of the proper amount of the punitive damages verdict. The question is whether the exemplary damages determination should be based on a ratio of punitive to compensatory damages or whether the wealth of the defendant should govern. In many instances, the ratio test⁹¹ and the wealth of the defendant

89. JOINT LEGISLATIVE AUDIT COMMITTEE, REPORT TO THE CALIFORNIA LEGISLATURE: REVIEW OF THE DISCIPLINARY FUNCTIONS OF THE DEPARTMENT OF INSURANCE, SUMMARY 1 (1977).

90. See text accompanying notes 141-43 *infra* for a discussion of whether the effect of punitive damages verdicts is increased insurance premium costs to consumers. For a specific rejection of this contention, see *Neal v. Farmers Ins. Co.*, 21 Cal. 3d 910, 929 n.14, 582 P.2d 980, 991 n.14, 148 Cal. Rptr. 389, 400 n.14 (1978).

91. The ratio test restricts punitive damages to a mathematically reasonable multiple of the actual compensatory damages suffered by the plaintiff.

test⁹² cannot function well as concurrent considerations. The basic purpose of one test frequently collides with or dilutes the effect of the other. The clash between the two tests has resulted in varied and conflicting appellate decisions and it is apparent that the issue will need resolution if the punitive damages doctrine is to continue to serve its socially desirable purpose.

In *Wetherbee v. United Insurance Co. of America*,⁹³ the court of appeal affirmed a punitive damages verdict of \$200,000 despite the fact that the insured's actual damages were only \$1,050. The court stressed the nature of the defendant's conduct and the wealth of the defendant, and upheld the exemplary damages verdict which was approximately two hundred times the compensatory damages verdict.⁹⁴ In *Little v. Stuyvesant Life Insurance Co.*,⁹⁵ on the other hand, the jury awarded the plaintiff compensatory damages of \$172,325 and rendered a punitive damages verdict of \$2,500,000 as a consequence of the defendant insurer's wrongful denial of disability insurance benefits.⁹⁶ The court of appeal held the ratio of punitive damages to compensatory damages was excessive and in reducing the punitive damages verdict to \$250,000 observed that "[t]he ratio of the compensatory damages is in excess of 14 to 1 and in dollar amount the punitive damage award exceeds the compensatory award by almost two and a third million dollars."⁹⁷

However, in the recent decision of *Neal v. Farmers Insurance Co.*,⁹⁸ the California Supreme Court focused upon the defendant's wealth as a significant determinant of the proper amount of punitive damages.⁹⁹ The court stated that the defendant's wealth should be a factor because "the purpose of punitive damages is to punish wrongdoers and thereby deter the commission of wrongful acts."¹⁰⁰

The disparity between the ratios acceptable by trial and appellate courts reviewing punitive damages verdicts indicates a need to analyze the intended purpose of the punitive damages award. It

92. The wealth of the defendant is a determinant when considering the amount of punitive damages which will be sufficient to punish the wrongdoer. See, e.g., *Neal v. Farmers Ins. Co.*, 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

93. 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1971).

94. *Id.* at 272, 95 Cal. Rptr. at 682.

95. 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977).

96. *Id.* at 456, 136 Cal. Rptr. at 655.

97. *Id.* at 469, 136 Cal. Rptr. at 670.

98. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389.

99. *Id.* at 929, 582 P.2d at 990, 148 Cal. Rptr. at 399.

100. *Id.* at 928 n.13, 582 P.2d at 990 n.13, 148 Cal. Rptr. at 399 n.13.

must be determined whether the ratio of punitive to compensatory damages or the wealth of the defendant should act as the primary determinant in calculating the amount of the punitive damages award.

A. *The Theoretical Foundations of Punitive Damages*

The punitive damages award serves a multiplicity of desirable purposes. It provides compensation,¹⁰¹ retribution,¹⁰² punishment,¹⁰³ deterrence,¹⁰⁴ and an incentive to litigate actions which might otherwise remain unnoticed.¹⁰⁴ Each of the purposes satisfies the basic needs of a society dominated by corporate entities wielding vast amounts of wealth. Evidently, the reformative potential of punitive damages awards rests in their consequential deterrent effect. The punitive and deterrent functions of exemplary damages are inextricably intertwined. Punishment provides a dual dimension of deterrence because the individual punished is specifically deterred and other members of the insurance industry are generally deterred. The social concern for compensation coincides with a societal interest in prevention and is directed at disturbing the attitude of complacency which might precede the actions of prospective tortfeasors.

One of the most desirable aspects of contemporary tort law is its ability to couple the compensatory and deterrent functions in the same cause of action. Many statutes providing punitive damages sanctions specifically state that the purpose of the doctrine is to deter others. For example, California Civil Code section 3294 provides that:

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

101. See, e.g., *Doroszka v. Lavine*, 111 Conn. 575, 580, 150 A. 692, 693 (1930).

102. See, e.g., *Gostkowski v. Roman Catholic Church of the Sacred Hearts*, 262 N.Y. 320, 324, 186 N.E. 798, 800 (1933).

103. See *Bertero v. National Gen. Corp.*, 13 Cal. 3d 43, 529 P.2d 608, 118 Cal. Rptr. 184 (1974); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970); *Lambert, Commercial Litigation—The Case For Punitive Damages*, 35 ASS'N TRIAL LAW. AMERICA L.J. 164, 172 (1974); *Williams, The Aims of the Law of Tort*, 4 CURRENT LEGAL PROB. 137, 140 (1951); Note, *Exemplary Damages in the Law of Torts*, 70 HARV. L. REV. 517, 520 (1957).

104. See C. MCCORMICK, DAMAGES § 77 (1935); *Lambert, The Case For Punitive Damages, supra* note 103, at 170.

Addressing the need for punitive damages in the commercial context, the New York Court of Appeals accurately observed that:

[T]hose who deliberately and coolly [sic] engage in a far-flung fraudulent scheme, systematically conducted for profit, are very much more likely to pause and consider the consequences if they have to pay more than the actual loss suffered by the individual plaintiff. An occasional award of compensatory damages against such parties would have little deterrent effect . . . In the calculation of his expected profits, the wrongdoer is likely to allow for a certain amount of money which will have to be returned to those victims who object too vigorously, and he will be perfectly content to bear the additional cost of litigation as the price for continuing his illicit business.¹⁰⁵

B. *The Significant Balance: Protecting the Public and Punishing the Wrongdoer through Punitive Damages*

Careful consideration of the evolution of the insurance bad faith action provides a framework of legal principles to be utilized in defining the nature and limits of the punitive damages sanction. A significant characteristic of recent decisions has been an increased focus on the nature of the defendant's conduct, as distinguished from a preoccupation with the nature of plaintiff's injury, as a means of establishing the parameters of liability. In an effort to acquire a complete perspective of the nature, extent, and characteristics of recent insurance bad faith tort theories, it is essential to take cognizance of the principles of damages law which have become intertwined with the theoretical underpinnings of the issue of liability. A consideration of the tort theories which have evolved in California courts will hopefully provide guidelines for resolving many of the legal issues relating to the limits of punitive damages liability.

Fraud was one of the early legal theories offered by the California courts as a means of allowing recovery of compensatory and punitive damages for wrongful refusals to indemnify an insured,¹⁰⁶ and this theory of recovery has provided a basis for recovery in recent cases against insurers.¹⁰⁷ Although fraud was used as the

105. *Walker v. Sheldon*, 10 App. Div. 2d 401, 406, 179 N.E.2d 497, 499 (1961). See Rice, *Exemplary Damages in Private Consumer Actions*, 55 IOWA L. REV. 307, 322 (1969).

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

107. See, e.g., *Miller v. National Am. Life Ins. Co.*, 54 Cal. App. 3d 331, 126 Cal. Rptr. 731 (1976).

theoretical basis of liability in some cases,¹⁰⁸ much of contemporary insurance bad faith law owes its origins to the tort of intentional infliction of mental distress.¹⁰⁹ Traditionally, damages for mental distress were recoverable if they were incurred as a consequence of one of the more conventional torts such as assault, battery, false imprisonment, or defamation.¹¹⁰

Additionally, mental distress was often an item of recoverable damages if the defendant intentionally subjected the plaintiff to serious mental distress and the emotional upset manifested itself in a physical injury.¹¹¹ Therefore, recovery for mental distress was determined primarily by viewing the nature and extent of the plaintiff's injuries rather than focusing upon the nature or character of the defendant's conduct. In the landmark case of *State Rubbish Collectors Association v. Siliznoff*,¹¹² the California Supreme Court held that primary consideration should be given to the nature of the defendant's wrong rather than to the quality of plaintiff's injury.¹¹³ In rejecting the requirement that a plaintiff prove the fact of physical injury in an action for intentional infliction of emotional distress, the court took a realistic approach to identifying the nature of the protected interest:

It may be contended that to allow recovery in the absence of physical injury will open the door to unfounded claims and a flood of litigation, and that the requirement that there be physical injury is necessary to insure that serious mental suffering actually occurred. The jury is ordinarily in a better position, however, to determine whether outrageous conduct results in mental distress than whether that distress in turn results in physical injury. From their own experience jurors are aware of the extent and character of the disagreeable emotions that may result from the defendant's conduct, but a difficult medical question is presented when it must be determined if emotional distress resulted in physical injury Greater proof that mental suffering occurred is found in the defendant's conduct

108. See, e.g., *Wetherbee v. United Ins. Co. of America*, 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1971).

109. See, e.g., *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

110. See *Deevy v. Tassi*, 21 Cal. 2d 109, 130 P.2d 389, 397 (1942); **RESTATEMENT OF TORTS** § 905, Comment c (1939).

111. See, e.g., *Richardson v. Pridmure*, 97 Cal. App. 2d 124, 217 P.2d 113 (1950).

112. 38 Cal. 2d 330, 240 P.2d 282 (1952).

113. *Id.* at 338, 240 P.2d at 286.

designed to bring it about than in physical injury that may or may not have resulted therefrom.¹¹⁴

By its recognition of the tort of intentional infliction of mental distress, *Silizinoff* has served as a theoretical foundation from which insurance bad faith law has evolved. For example, in *Fletcher*¹¹⁵ the court of appeal relied upon the reasoning in *Silizinoff* and awarded compensatory and punitive damages for the insurer's wrongful refusal of a valid claim, although there was no showing of physical injury to the plaintiff.¹¹⁶

Although *Fletcher* required that an insured suffer severe emotional distress,¹¹⁷ subsequent decisions have held that an insured may state a *prima facie* bad faith cause of action without having sustained severe emotional distress. This shift is a result of the recognition that the cause of action is based on a tortious invasion of a protected property interest.¹¹⁸ This increasing recognition of a cause of action for the invasion of the insured's property interest has had an extensive impact on the law of first-party bad faith claims. Prior to *Gruenberg*,¹¹⁹ many actions for unfair claims practices were unsuccessful as a result of the plaintiff's inability to satisfy the requirement of having suffered severe emotional distress as mandated by *Fletcher*. However, under the expanded protection afforded by *Gruenberg*, an insured could establish that the wrongful denial of a valid claim interfered with his or her property interest (*i.e.*, the policy proceeds). Therefore, recovery could be maintained for policy benefits, economic losses caused by the absence of policy benefits, damages for emotional distress, and punitive damages.¹²⁰ Consequently, insureds may now maintain bad faith actions for the denial of benefits under any first-party insurance contract irrespective of whether they suffered severe emotional distress. More re-

114. *Id.*

115. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

116. *Id.* at 397, 89 Cal. Rptr. at 90-91.

117. *Id.* at 396-98, 89 Cal. Rptr. at 90-91.

118. See *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973), where the court held: "[W]e are concerned with mental distress resulting from a substantial invasion of property interests of the insured and not with the independent tort of intentional infliction of emotional distress . . ." *Id.* at 580, 510 P.2d at 1041, 108 Cal. Rptr. at 489.

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

120. See *id.*; *Silberg v. California Life Ins. Co.*, 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).

cently, in *Neal v. Farmers Insurance Co.*,¹²¹ the California Supreme Court held that a significant factor governing the proper amount of a punitive damages award is "the particular nature of the defendant's acts in light of the whole record"¹²² The court further observed that "different acts may be of varying degrees of reprehensibility, and the more reprehensible the act, the greater the appropriate punishment"¹²³

Thus, in *Gruenberg* the California Supreme Court expanded the nature of the protected interest of the plaintiff in bad faith actions. By eliminating the requirement of showing severe mental distress, the court authorized recovery in the event that any insurer wrongfully refuses to indemnify an insured for a valid first-party claim. In *Neal*, the court affirmed its position taken in *Silizinoff*, i.e., that the primary focus belongs on the nature of the defendant's conduct. The significance of these decisions is the profound deterrent and reformative effect they have had upon insurance claims practices in California and nationwide.¹²⁴

C. *The Ratio Test and the Defendant's Wealth Test*

The deterrent effect of punitive damages awards in this area is more than lip service to conventional legal theory. The national response of the insurance industry¹²⁵ reflects the reformative impact of jury verdicts such as the one returned in *Egan v. Mutual of Omaha*.¹²⁶ The guidelines for determining the scope of punitive damages verdicts should not be approached from a jurisprudential perspective divorced from the admonitory function of such verdicts; rather, the criteria should be designed to preserve and strengthen the socially desirable effects of landmark bad faith decisions and exemplary damages verdicts.¹²⁷

The ratio test,¹²⁸ when used as a basis for modifying punitive

121. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

122. *Id.* at 928, 582 P.2d at 990, 148 Cal. Rptr. at 399.

123. *Id.*

124. See text accompanying notes 41-52 *supra*. See also materials collected in note 52 *supra*.

125. *Id.*

126. 63 Cal. App. 3d 659, 133 Cal. Rptr. 899 (1976).

127. In *Bertero v. National Gen. Corp.*, 13 Cal. 3d 43, 529 P.2d 608, 118 Cal. Rptr. 184 (1974), the court stated that "the wealthier the wrongdoing defendant, the larger the award of exemplary damages need be in order to accomplish the statutory objective."

128. The ratio test requires that the ratio of punitive to compensatory damages not exceed some outer limit acceptable to the court. One of the problems with the use of the ratio

damages verdicts, frustrates and detracts from the spirit and purpose of exemplary damages. The wealth of the defendant should be the primary focal point of punitive damages determinations so that the deterrent function of exemplary damages concepts will be preserved. As early as 1931 one of the most cogent critics of the "ratio test" suggested:

Courts often insist that "punitive damages must bear some relation to actual damages," and attempt to test verdicts in terms of mathematical ratios. The opinions contain statements to the effect that a verdict for punitive damages X times as great as the actual damages is clearly excessive. This practice appears to place an arbitrary limit on the amount of punitive damages which juries may give, similar in operation to the maximum punishment provisions of criminal statutes.

The test is probably more often a rationalization of results than a means of obtaining them. The proper ratio between actual damages and punitive damages is placed at a figure which supports the judge's view of the verdict, formulated before the test is thought of.¹²⁹

Furthermore, exclusive reliance upon the ratio test as grounds for modifying an award of punitive damages too often results in a violation of the well-established rule which provides that:

The reviewing court's power to declare an award of damages excessive exists only when from the facts the amount appears at first blush to suggest passion or prejudice on the part of the jury. There is no distinction when the review is an award of exemplary rather than actual damages . . . it is the province of the jury and the trial court on motion for new trial, to say whether punitive damages should be awarded. The presumptions are in favor of the correctness of the verdict and judgment. After an award has been approved by the trial court the reviewing court will hesitate to declare the amount excessive unless upon consideration of the entire record, including the evidence it must be said that the award was the result of passion or prejudice.¹³⁰

test is determining what is an unacceptable ratio. Compare *Wetherbee v. United States Ins. Co. of America*, 18 Cal. App. 3d 266, 95 Cal. Rptr. 678 (1971) (a 200-to-1 ratio affirmed) with *Little v. Stuyvesant Life Ins. Co.*, 67 Cal. App. 3d 451, 136 Cal. Rptr. 653 (1977) (ratio in excess of 14-to-1 held to be excessive).

129. Morris, *Punitive Damages in Tort Cases*, *supra* note 9, at 1180.

130. *Finney v. Lockhart*, 35 Cal. 2d 161, 164, 217 P.2d 19, 21 (1950).

A conclusion that a high ratio of punitive to actual damages is the "result of passion or prejudice"¹³¹ represents a weak link in the chain of logic. Application of the ratio test as grounds for modifying a jury verdict of punitive damages ignores a critical aspect of the law of damages.

The damage which the defendant actually does may have little or no relation to the size of the money judgment which would be the most effective admonition for the particular case. Of course, it is more important to forestall conduct which is *likely* to cause serious injury than it is to forestall conduct which is *likely* to cause only inconsequential damage. The probable result of a defendant's behavior is an important consideration in determining whether it is desirable to discourage such behavior in the future; the probable result is the measure of the "seriousness" of this wrong. The actual result may have no bearing on this question. For example, the grossly negligent hunter may shoot into a crowd of people and only break a ten dollar pair of eye glasses. The admonition meted out to him should be the same as though he had killed or injured someone.¹³²

Focusing upon the admonitory function of the law of punitive damages and the demonstrated deterrent effect that such verdicts have had upon insurance claims practices throughout the United States, it is apparent that the ratio test provides a distraction from the needed tendencies and objectives of contemporary tort law in this area.

The ratio test should be used sparingly by the appellate courts because as one noted scholar has suggested:

The ratio test, in diverting attention away from the tendency of defendant's conduct, diverts attention from the value of discouraging such conduct in the future. In focusing attention on the specific harm which has happened to result from the defendant's conduct, it points to a false guide for effective admonition.¹³³

In testing whether punitive damages awards are excessive, the meaningful determination should be guided by the following principles:

131. *Id.*

132. Morris, *Punitive Damages in Tort Cases*, *supra* note 9, at 1181.

133. *Id.* at 1182 n.11.

Admonition is a tool for the control of future behavior; it can not [sic] change past conduct . . . When an act with a vicious tendency happens to result in a small injury the "compensatory" damages are necessarily small. If it must also follow that the punitive damages must also be small, the total verdict might be lenient where severity is desirable.¹³⁴

If ratios are to be used in the assessment of punitive damages, the operative factors which influence such a ratio should reflect the seriousness of the defendant's wrong and the need to deter tortious conduct. For example, the ratio truly reflective of a defendant's culpability in the area of insurance claims practices is the relative financial strengths of the parties. The disparity in wealth between an insurer and an insured is itself evidence of the need to deter the defendant insurer from wielding the power incident to such wealth in an unfair and oppressive manner.

IV. RESPONDING TO THE CRITICS OF THE PUNITIVE DAMAGES DOCTRINE

One of the basic criticisms of punitive damages in general, and of verdicts based on the wealth of the defendant in particular, is that the plaintiff and his or her attorney incur a windfall.¹³⁵ However, remedying intolerable social wrongs should take priority over such considerations. The benefit conferred upon the plaintiff and plaintiff's counsel should be viewed in context of the observation that "the prospect of substantial recoveries may be, given the structure of the present legal system and the interests of the Bar, the only way in which to fully involve lawyers in attempts to resolve serious economic and social problems."¹³⁶ Whatever the benefit to the plaintiff and his or her counsel, such awards inure to the benefit of society as well in light of the fact that "punitive damages . . . are awarded to the injured party as a reward for his public service in bringing the wrongdoer to account."¹³⁷

However, given the substantial punitive damages awards which have been essential in improving and deterring wrongful claims

134. *Id.* at 1181-82.

135. See Duffy, *Punitive Damages: A Doctrine Which Should Be Abolished*, 1969 DEF. RESEARCH INST. 4.

136. Rice, *Exemplary Damages in Private Consumer Actions*, *supra* note 105, at 343.

137. Neal v. Newburger Co., 154 Miss. 691, 700, 123 So. 861, 868 (1929), cited in Lambert, *supra* note 76, at 171.

practices, punitive damages statutes should be amended so that a portion of the punitive damages award is conferred upon the general public. Specifically, section 3294 of the California Civil Code,¹³⁸ which provides the statutory authority for punitive damages liability, should be amended so that the trial court, upon final determination of the action, would distribute 25 per cent of the punitive damages to a non-profit public interest entity. Such a proposed revision would meet the objection that the plaintiff and his or her attorney incur a windfall and would also preserve the demonstrated social contribution of the punitive damages doctrine.

The second major criticism of the application of punitive damages liability in this area is that it will increase the cost of insurance.¹³⁹ This argument was raised by amici on behalf of the defendant in *Neal v. Farmers Insurance Co.*¹⁴⁰ The fallacy of this argument is well illustrated by the observation of Justice Manuel:

We take this opportunity to express our disagreement with the notion, suggested in the briefs amicus curiae filed in support of defendant Farmers, that substantial awards of punitive damages against insurers are to be discouraged because such awards will be "passed on" to consumers in the form of higher future premiums. It is quite true that an insurer which has been subjected to a substantial award of punitive damages may decide to raise future premiums in order to offset the award. This does not necessarily mean, however, that competing insurance companies which have *not* sustained such an award will follow suit. In fact, the principles upon which the American system of free enterprise is based would suggest to the contrary,—*i.e.*, that other companies would proceed to capitalize upon the resulting competitive advantage. If the ultimate result is to cause the offending company to lose business to those whose practices have not been such as to subject them to substantial punitive awards, *it would seem that the object of deterrence will be well served—resulting in an ultimate benefit to insurance consumers as a whole.*¹⁴¹

138. CAL. CIV. CODE § 3294 (West 1970). Section 3294 is set out in the text accompanying notes 104-05 *supra*.

139. See, e.g., *Egan v. Mutual of Omaha*, 24 Cal. 3d 809, 825, 598 P.2d 460, 157 Cal. Rptr. 490 (1979) (Clark, J., dissenting).

140. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

141. *Id.* at 929 n.14, 582 P.2d at 991 n.14, 148 Cal. Rptr. at 400 n.14 (emphasis added).

Conclusion

The marked lack of social or moral concern which has too frequently characterized insurance claims practices demands that the deterrent effect of exemplary damages verdicts in bad faith actions be preserved. Recent decisions in this area, such as those of the California Supreme Court in *Gruenberg*¹⁴² and *Neal*¹⁴³ are welcome evidence of the responsiveness of contemporary tort law to the dictates of social need.

As demonstrated by the insurance industry's response to these decisions,¹⁴⁴ the exposure of insurance companies to liability for punitive damages has had a desirable, reformative impact. Before such substantial punitive damages awards are criticized, we should carefully consider the sterilizing effect of such verdicts on unfair claims practices. Potential tortfeasors must be reminded that exemplary damages are designed to punish and jurors will, in proper cases, condemn and punish conduct adjudged intolerable in contemporary society.

Given the demonstrated benefits conferred on society as a result of these recent decisions, we should, as a society, view the "cost" of such verdicts as a necessary price to be paid in the transition from a world of wrongful claims practices to one of meaningful insurance and fair dealings between insurers and their insureds. Finally, if ratios are to govern punitive damages assessments, such ratios should be predicated on meaningful comparisons rather than the purely arbitrary comparison of punitive to actual damages.

142. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).

143. 21 Cal. 3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

144. See text accompanying 52-88 *supra*.