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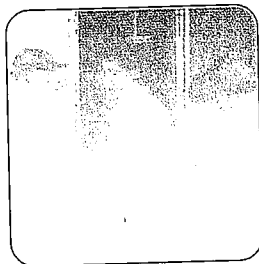
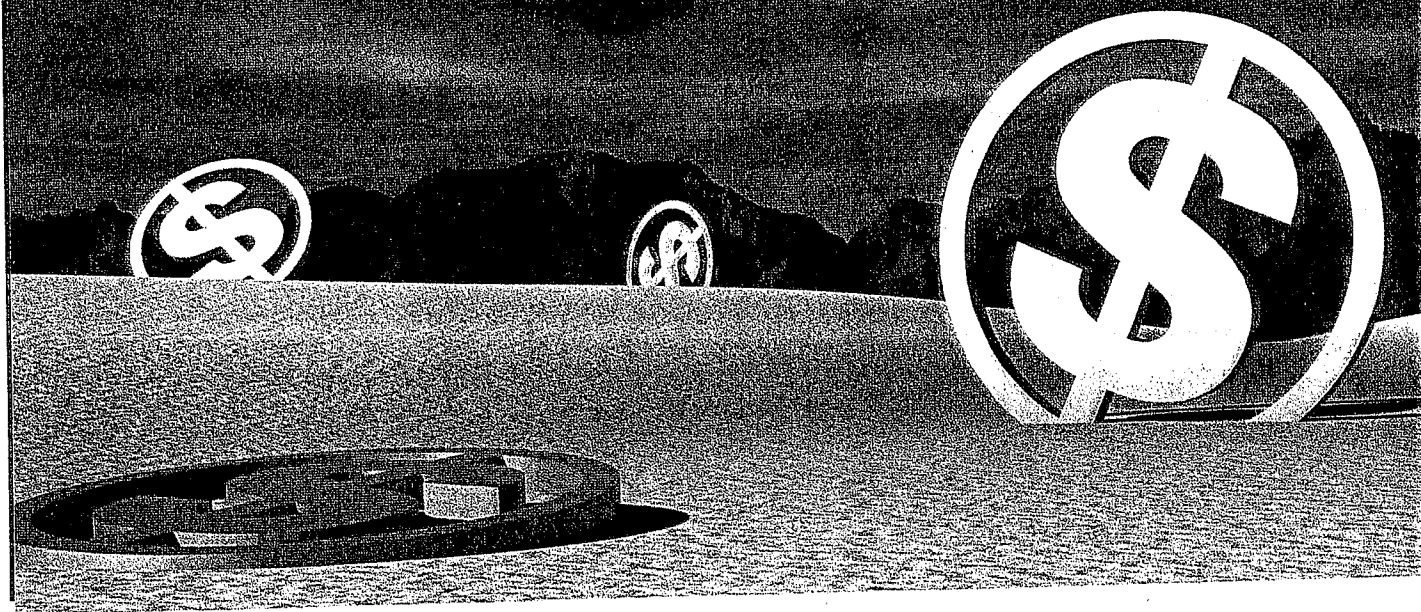


LEGAL ISSUES & FRAUDS IN INSURANCE



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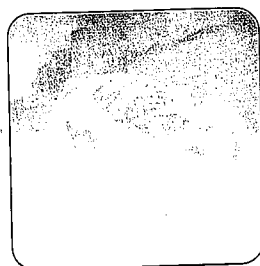
1

INSURANCE PERSPECTIVE

Technology as a means to arrest insurance fraud

— Dr. K. C. MISHRA

Director, National Insurance Academy, Pune.

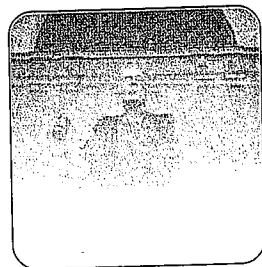


6

Effective Claims Management

— G. V. RAO

Chairman of GVR Risk Management Associates Pvt. Ltd.,
Hyderabad, India.



16

Insurance Frauds : Is anyone listening?

— Govind Johri

Associate Professor & Chief Manager on deputation from United
India Insurance Company Ltd at National Insurance Academy, Pune



UNDERLINE

22

Magnitude of fraud & State of anti-fraud efforts in the Insurance Sector in India – An overview

— ASHISH JOSHI

Head, Special Investigations Unit (Claims) at Tata AIG General Insurance Company Ltd.



34

The Doctrine of Utmost Good Faith

— KARISHMA JASANI PAROHA

Solicitor with Kennedys London, England.

RESEARCH ANALYSIS



38

Risk Mitigation through Pooling In Multi Retailer Supply Chain

— ATUL SIDOLA

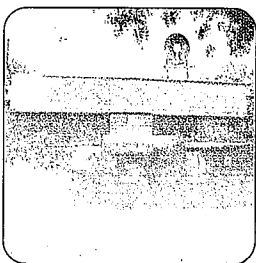
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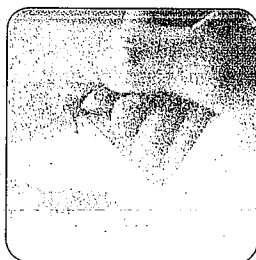


49

Bancassurance- An Emerging Distribution Channel for Insurance Products

— SHEKHAR V SAWANT

Campus Head of ICFAI National College (INC)- Margao, Goa.



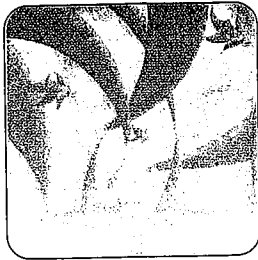
HUEBNER COLUMN

59

Legality of Discharge Voucher

— M. K. DAS

Law Officer with The New India Assurance Company Ltd., India.



69

Re-examining Some Myths and Problems of CAT Bonds

— Dr. ARTHUR HAU

Associate Professor in the Department of Finance and Insurance at Lingnan University, Hongkong.



78

First-Party Insurance Bad-Faith Liability

— Dr. SHARON TENNYSON

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— Dr. WILLIAM J. WARFEL

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First-Party Insurance Bad-Faith Liability

Dr. SHARON TENNYSON* AND Dr. WILLIAM J. WARFEL**

Abstract

U.S. common law has long recognized the unequal bargaining power of insurance companies and policyholders in the insurance relationship. As a practical matter, however, insurance policyholders historically had little legal recourse against an insurer that treated them unfairly in the claim settlement process. Over the past thirty years the law has changed dramatically. Most U.S. states recognize first-party insurance bad faith liability under tort law or contract law, but the legal standards for first-party insurance bad faith are still evolving. This article discusses the various approaches to first-party insurance bad faith law that have been taken by the states, and applies economic reasoning to elucidate the potential benefits and costs of permitting first-party bad faith actions. Empirical studies of the effects of permitting tort claims for insurance bad faith are summarized, and the limitations of existing evidence for evaluating the welfare consequences of first-party bad faith actions are discussed.

Introduction

Common law has long recognized the unequal bargaining power of insurance companies

and policyholders in the insurance relationship. Because the insurer writes the contract and controls the settlement of claims, insur-

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ers are held to high standards of "good faith and fair dealing" in the contractual relationship (Jerry, 1994). A policyholder is in a uniquely vulnerable position at the time of claim filing, and insurers have a disproportionate ability to cause severe economic dislocation to a policyholder as a result of unreasonably denying or unnecessarily delaying the payment of an insurance claim.

As a practical matter, however, until relatively recently insurance policyholders in the United States had little legal recourse against an insurer that unnecessarily delayed the payment of a policy benefit, or withheld payment of a rightful policy benefit. Legal disputes about such matters were settled under nineteenth-century English common law¹ which limited policyholders to recovering only the amounts specified in the insurance policy, even if the breach of contract was intentional on the part of the insurer.

Over the past thirty years the law has begun to provide policyholders with greater ability to obtain compensatory damages in cases where insurers are found to have treated them unfairly in the claim settlement process.² Damages vary by state but often include consequential damages, attorney's fees and prejudgment interest as well as the benefit owed under the policy. Moreover, in a majority of states that recognize first-party insurance bad faith liability, actions are adjudicated under tort law rather than

contract law. Tort actions threaten insurers with a wider range of damages due to the lower legal barriers to punitive damages and damages for mental anguish.

Between 1973 and 1989, the courts in 24 U.S. states began to recognize the rights of policyholders to file actions against their insurers for bad faith dealings in claims settlement. Between 1990 and 1999 courts in an additional 17 states followed this legal precedent, and several other states allow broad forms of recovery by statute. Currently all but a handful of U.S. states permit private actions by a policyholder against their insurer for bad faith dealings in claim settlement.³

Although the 1980s were the principal time period during which bad faith law developed and legal scholars viewed the law as relatively mature by the mid-1990s (Abraham, 1994), the expansion of policyholder remedies for unfair claim settlement practices has gained renewed momentum in recent years as states have enacted or considered new legislation relating to first-party insurer bad faith. Prominent examples include Minnesota, which passed legislation in 2008⁴ that creates a new private cause of action for first-party insurance bad faith where one previously did not exist. Recent Colorado legislation⁵ adopts the negligence standard, whereas the intentional tort standard previously applied under common law. Leg-

1. See *Hadley v. Baxendale*, 156 Eng. Rep. 145 (Ex. 1854).

2. Vance (1951) and Stempel (2008) provide discussion of the development of insurance bad faith liability. The first court decision that allowed the application of tort liability to first-party insurance bad faith was *Gruenberg v. Aetna Insurance Company*, adjudicated by the California Supreme Court in 1973.

3. This categorization is based on information compiled from GenRe (2008).

4. 2008 Minn. Laws § 604.18.

5. Colorado Rev. Stat. An. § 10-3-1113 (2008).

islation adopted in Washington⁶ expands the definition of first-party insurance bad faith and increases the damages awards available to policyholders in cases alleging insurer bad faith. Thus, the legal standards for first-party insurance bad faith are still evolving and consideration of the implications of these laws remains relevant.

This article discusses the various approaches to first-party insurance bad faith law that have been taken by the U.S. states, and applies economic theory to elucidate the potential benefits and costs of permitting private actions for bad faith in first-party insurance claim settlement. Existing empirical evidence on the effects of allowing first-party bad faith actions is summarized, and the limitations of this evidence for evaluating the welfare consequences of first-party bad faith actions is discussed.

Legal Standards for Bad Faith Liability

The states have adopted differing procedures and legal standards to facilitate the filing of private causes of action alleging unfair claim settlement practices.⁷ A majority of states permit a tort action based solely on breach of the implied covenant of utmost good faith (i.e., bad faith). Policyholders are not required to allege an independent tort such as fraud or intentional infliction of emotional distress in order to recover punitive damages. The general rule of damages in tort is that the injured party may recover for all harm or injuries sustained, regardless of whether they could have been anticipated.

Assuming that the conduct giving rise to liability was particularly egregious, punitive damages may be awarded.

Among the states that permit tort actions, the legal standard for determining whether an insurer has acted in bad faith varies substantially.⁸ Some state courts follow a "negligence" standard. This standard demands that an insurer not withhold unreasonably payment due under a policy (i.e., an insurer must have proper cause to deny payment for a claim submitted under a policy). Other states have adopted an "intentional tort" standard, under which an insurer is entitled to contest a claim so long as it has a reasonable basis grounded in law or fact. Whether the insurer ultimately is correct in its position is of no consequence in resolving the bad faith issue, and denying a claim whose validity is "fairly debatable" does not constitute bad faith.⁹

Rather than considering bad-faith claims against insurers under tort law, some states confine the good faith/bad faith inquiry to the realm of contract law. These states nonetheless broadly define damages to include both general damages (i.e., those following naturally from the breach) and consequential, or incidental, damages (i.e., those reasonably within the contemplation of, or reasonably foreseeable by, the parties at the time the contract was made). Consequential damages may reach beyond the strict contract terms and include prejudgment interest and legal expenses, and damages for economic loss and mental distress. In these

6. Wash. Rev Code § 48.30.010 (2007).

7. GenRe (2008) and Stempel (2008) provide details of the approaches taken by the individual states.

8. Although most states have adopted negligence or intentional tort standards, one state (Arkansas) has adopted a "quasi-criminal" standard. In adopting this standard, the court declared that "evidence of bad faith must be sufficient to show affirmative misconduct of a nature which is malicious, dishonest, or oppressive."⁸

9. See *Anderson v. Continental Insurance Company*, 85 Wis. 2d 675, 691, 271 N.W. 2d 368 (1978).

states, insurers may still be subject to tort claims for their actions, but only if an independent tort such as fraud or intentional infliction of emotional distress is alleged.

In addition, nearly half of the states recognize the right to file a private cause of action alleging bad faith based on a statute and judicial recognition of an implied, private cause of action under an Unfair Trade Practices Act that includes an unfair claim settlement practices provision. Damages permitted under such a statute may include prejudgment interest and legal expenses, consequential, or incidental, damages for economic loss and mental distress, and, in some instances, punitive damages. There is also considerable variation among statutes with respect to the standard of conduct, burden of proof, and damages that can be recovered.

Economic Perspectives on Bad Faith Liability

The predominant legal perspective on the purpose of liability for first-party insurer bad faith is the need to provide compensation to policyholders (Baker, 1994; Brothers, 1994).¹⁰ Exceptional legal enforcement may be warranted because the insurance contract offers a promise of payment contingent on certain events occurring, and the nature of the contracted-for events makes the policyholder particularly vulnerable at the time a claim is filed.

The economic perspective on insurance bad faith focuses on deterrence and promoting efficiency in insurance contracting (Abraham, 1994; Pryor, 1994; Sykes, 1996).¹¹ Allowing

the imposition extra-contractual liability on insurers in cases of bad faith denial of claims serves to deter unwarranted denial or delay of claims. The threat of financial penalties in the event that a policyholder's claim of bad faith is upheld by the courts will reduce the incentives of an insurer to deny, delay or underpay claims intentionally. It will also reduce the incentives of an insurer to engage in any claim settlement practices that the law might be inclined to find unreasonable. By providing insurers' with disincentives to engage in actions that may lead to charges of bad faith, permitting extra-contractual awards will reassure consumers that valid claims will be paid. This assurance will improve the insurance contracting environment and enhance the efficiency of insurance markets.

However, other – less beneficial – incentives may be created if in practice the law is not applied in the ways suggested by theory. One concern is the increased pressure on insurers to pay disputable claims (Abraham, 1986). Insurers balance the benefits of reduced fraud costs with the expected costs of litigation (Crocker and Tennyson, 2002, Sykes, 1996). If the expected costs of bad faith litigation exceed the expected gains from investigating and denying disputable claims, insurers will have too little incentive to engage in these efforts. This will raise the costs of fraud in both the immediate term because fewer fraudulent claims will be detected, and over the longer term because of reduced fraud deterrence (Shavell, 1987). The costs of fraud will increase as a result, and these costs will be borne by all insurance consumers.

10. Pryor (1994) identifies two distinct perspectives, one based on distributive justice and one based on correctional justice.

11. Many legal scholars view insurance bad faith through the lens of economic reasoning, of course. Abraham (1994) characterizes the compensation concerns as an *ex-post* perspective and the deterrence concerns as an *ex-ante* perspective.

By reducing insurer resistance to fraudulent claims and by increasing the payoffs from litigation, excessive liability for insurer bad faith will increase consumers' incentives to engage in claims fraud and exaggeration. Policyholders will also have greater incentives to file charges of bad faith handling of a claim even if the policyholder knows that the claim is invalid (Abraham, 1986). This will lead to further pressures on insurers to pay disputable claims, with the resulting increase in consumer incentives for claims fraud described above.

Alternatively, some insurers may become determined to meet the twin goals of paying only legitimate claims, while at the same time keeping the exposure to bad faith lawsuits at a minimum (Sykes, 1996). These insurers will over-invest in claims processing bureaucracy, procedures, or technology. In this case as well, the result will be unwarranted increases in claim costs that are ultimately distributed to the insuring public in the form of higher insurance premiums.

A second issue is the potential flexibility of the standard applied in finding insurer bad faith. If there is substantial variation across cases and jurisdictions, insurers face substantial uncertainty regarding their duties of good faith dealings in claims settlement. Uncertain bad faith standards for insurers will undermine the benefits of the bad faith remedy, reducing its effectiveness in deterring insurer misconduct (Sykes, 1996).

A final and related consideration is the standard for assessing punitive damages against an insurer. Punitive damages can be justified only if needed to create a sufficient incentive for the insurer not to engage in misconduct.

This suggests that punitive damages may play a useful role in cases involving extreme, intentional bad faith, particularly in cases involving institutional misconduct.¹² In institutional misconduct cases, a punitive damage award that disgorges profits derived from a company-wide policy of underpaying claims serves to deter future similar conduct by eliminating any profit incentive. However, if the standard for awarding punitive damages is not sufficiently strict, the result will be excessive and uncertain damages awards with the attendance effects identified above.

The Consequences of Bad Faith Liability

The theoretical discussion highlights the fact that, in practice, the welfare consequences of permitting first-party insurance bad faith liability will depend upon the relative strength of the competing incentive effects created by the law's implementation. An evaluation of the law must therefore rest on an empirical examination of its effects on the insurance contracting relationship. Moreover, it is important to consider the entire claim settlement process in this evaluation, and not just the settlement amount. The threat of bad faith liability may affect not only the insurer's incentives regarding the magnitude of claim payments, but also the claim investigation process, the prevalence of disputes with policyholders (or their attorneys), and the timeliness of claim settlements. Additionally, the propensity among policyholders to file claims, the character of claims that are filed, and the decision to hire an attorney may all be affected by the bad faith liability regime.¹³

12. See e.g., *Hawkins v. Allstate Insurance Company*, 733 P. 2d 1073 (Ariz. 1987).

13. Abraham (1994) notes that even the rate-making and underwriting decisions of insurers could be affected by the threat of bad faith liability.

The effect of first-party bad faith liability law on insurance claim settlements has not been extensively studied. Anecdotal evidence suggests that many attorneys believe it leads to improved settlement behaviours by insurers (Brothers, 1994). However, Sykes (1996) presents an analysis of selected case law to argue that tort liability standards are too lax and/or damages awards are too high in some cases. However, this type of evidence does not allow a systematic evaluation of the impact of bad faith liability on the claim settlement environment.

There are a few systematic studies that use data from insurance claims to examine these questions. All of them use data from automobile insurance. Browne, Pryor and Puelz (2004) analyze claim settlement amounts in a large dataset of first-party automobile insurance claims settled in 38 different states in 1992. The study uses multiple regression analysis in order to control settlement amounts for characteristics of the claims such as injury severity and treatments received; the regression models also control for features of states' legal environments that may influence claim settlements. The results of the analysis show that claim settlements are significantly higher in states that allow tort actions for insurer bad faith than in other states.

A study of the impact of *third party* bad faith tort liability claims in California on insurance claim payments found similar effects (Hawken, Carroll and Abrahamse, 2001).¹⁴ Using a large database of third party automobile insurance claims, this study found that when third-party bad faith tort liability

was permitted in California, claim payments for automobile bodily injury liability (BIL) claims were 25 per cent higher than similar claims in other states. This difference ceased to exist after tort-based bad faith liability was overturned.¹⁵

These studies demonstrate that insurers appear to take into account the bad faith regime when determining claim settlement amounts. However, higher claim payments should not be construed negatively if, in the absence of bad faith liability, insurers are prone to underpay or to wrongfully deny claims. Absent a benchmark measure of the "appropriate" level of payment, it is difficult to determine from these studies whether tort-based liability for insurer bad faith has the intended effects or leads to excessive claim payments.

Tennyson and Warfel (2009) attempt to ascertain whether higher claims payments may be occurring because insurers are paying unwarranted amounts or paying illegitimate claims in order to avoid potential bad faith liability. Like Browne, Pryor and Puelz (2004) we examine a large database of first-party automobile insurance claims. Rather than focusing on claim settlement amounts, we explore the relationship between tort-based bad faith liability, claim characteristics and insurers' use of claim investigations. The study results suggest that tort liability for first-party bad faith reduces insurers' incentives to monitor for claim fraud, leading to less intensive use of investigative techniques and to more paid claims that contain characteristics often associated with fraud. One

14. The case that allowed third-party insurance bad faith liability in California was *Royal Globe Insurance Company v. Superior Court* (Koeppel), 592 P.2d 329 (Cal. 1979). Ultimately, this decision was overruled in *Moradi-Shalal v. Fireman's Fund Insurance Company*, 758 P.2d 58 (Cal. 1988).

15. The Abrahamse study also found that the frequency of BIL claims was higher in California when third-party bad faith tort liability was allowed, and this frequency declined when the ruling was overturned. This suggests that tort-based bad faith increased policyholders' incentives to file claims.

particularly interesting finding is that the percentage of claims for which insurers disallowed some claimed amounts did not differ across states that permit tort-based bad faith and those that do not, even though fraud suspicion indicators were found to be more prevalent in the claims in states that permit tort-based bad faith. This suggests that insurers may be more reluctant to challenge claims when faced with potential tort liability for bad faith.

Conclusion

Economic theory predicts that allowing policyholders to recover damages over and above the value of the insurance benefit owed will provide insurers with added incentives to engage in fair claims settlement, and that this may enhance the efficiency of contracting in insurance markets. Implementation in law will determine how well these objectives are met in practice. First-party insurance bad faith liability may not perform as well as theory suggests, either in protecting policyholders from insurer bad faith or in facilitating efficient claims settlement in insurance markets. Thus, policymakers should carefully consider whether the benefits of expanded bad faith liability outweigh the potential costs. Unfortunately there are relatively few empirical studies available to inform the policy debate. Additional empirical work on the impact of first-party insurance bad faith liability on insurance claiming and settlement behaviours is sorely needed.

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