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New York Third Party Bad Faith: Is It A Plaintiff's Dream Or A Defendant's Nightmare?

Honorable Joan B. Lefkowitz†

I. Introduction

New York is often perceived as a jurisdiction where innovative precedents are set; however, such is not the case in the area of insurer bad faith.† To the contrary, New York has been slow in providing clear definitions of what evidences bad faith² and

† Supreme Court Justice, Ninth Judicial District, presently presiding at an IAS Part in Rockland County. The author wishes to acknowledge the invaluable research and organizational assistance of Gerianne Hannibal, a Pace Law School 1992 graduate. Similarly, the review and commentary advice of the Judge's law secretary, James Fine, is acknowledged. Nevertheless, the views expressed herein are solely those of the author.

1. A "third-party" bad faith cause of action may arise when an insurer fails to settle a third-party liability claim brought against its insured for an amount within the policy limits and a verdict in excess of the limits is thereafter obtained, thereby exposing the insured to liability for the excess amount. Roldan v. Allstate Ins. Co., 149 A.D.2d 20, 29, 544 N.Y.S.2d 359, 361 (2d Dep't 1989). N.Y. INS. LAW § 2601, the Unfair Claim Settlement Practices statute, requires that insurers attempt "in good faith to effectuate prompt, fair and equitable settlements of claims submitted in which liability has become reasonably clear . . . ." Id. at § 2601(a)(4). See infra note 73 and accompanying text. Allegations that often accompany the failure to settle allegation include, among other things, the insurer's failure to investigate, failure to inform the insured of a compromise offer, and failure to induce the insured to contribute. Oppel v. Empire Mut. Ins. Co., 517 F. Supp. 1305, 1306 (S.D.N.Y. 1981).


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what measure of damages is applicable once bad faith has been
proven. Consequently, in many instances New York insurers
have escaped punishment for bad faith conduct. Given the inex-
orable increase in the size of personal injury verdicts and the
absence of a concomitant increase in the amount of automobile
liability coverage that people carry, the time is ripe for New
York to adopt bad faith standards for liability and damages that
promote fair compensation for accident victims and provide real
protection for premium-paying insureds — standards that are
applied in many jurisdictions throughout this country.

Consumers buy liability insurance primarily with one pur-

N.E.2d 364, 367, 381 N.Y.S.2d 433, 436 (1976). In charging the jury, the Knobloch judge
advised that "we do not have any specific definition in our law as to what indicates or
evidences bad faith." Id. The Court of Appeals chose not to rule on the accuracy of the
charge because no exception to it had been taken; the court ruled only that the trial
record contained evidence sufficient to sustain the bad faith verdict. Id. For discussion of
Knobloch, see infra text accompanying notes 59-62.


3, col. 1. Mr. Hoenig's article cites recent multi-million dollar verdicts including a $22.9
million verdict awarded by a Queens jury to a twenty-six-year-old motorcyclist who suf-
fered paraplegic injuries and a $20.7 million verdict awarded by a Bronx jury to a dia-
betic automobile accident victim who lost his leg, fractured his elbow and shoulder, and
sustained shoulder nerve damage. Id. See also 1991's Largest Verdicts, NATIONAL L.J.,
Jan. 20, 1992, at S14-15 (citing $25.6 million verdict awarded by a Bronx jury to the wife
and three children of a Clairol executive killed in a head-on collision). In Ecks v. Nizen,
Supreme Court Rockland County, Index No. 74 20/85, a motor vehicle accident case in
which the plaintiff suffered brain damage and was rendered quadriplegic, a jury verdict
was returned before the author on October 17, 1991, in the total sum of $46,804,530, of
which $44,000,000 was awarded for future medical expenses. An excellent summary of
the facts and relevant testimony is set forth in IX THE NEW YORK JURY VERDICT RE-

5. Abusive insurance claim settlement practices were not countenanced by the
courts until automobile liability insurance was created and automobile liability claims
became prevalent. The cause of action for bad faith was developed in the mid-twentieth
century to combat unscrupulous automobile insurer claims handling conduct. Stephen S.
Ashley, Bad Faith Actions Liability and Damages § 1:01 (Supp. 1991).

6. New York State law requires automobile owners to carry automobile liability in-
surance to cover bodily injury and property damage claims brought against them. N.Y.
VEH. & TRAF. LAW § 311(4)(a) (McKinney 1986). The minimal policy limits permitted are
$10,000 per person and $20,000 per occurrence for bodily injury and $5,000 per occur-
rence for property damage. N.Y. COMP. CODES R. & REGS. tit. 11, § 60.1(a) (rev. 1988).
These minimum limits have not been changed in thirty-four years. Sam H. Verhovek,
Bill Would Raise Minimum For Car Insurance Liability, N.Y. TIMES, July 22, 1990, at
25, col. 1.

7. A liability insurance policy "promises to indemnify the insured against the risk of
pose in mind, protection for negligence claims brought against them in the event they accidentally injure someone or damage his or her property. Insureds pay more in premiums than the insurer pays out in liability claims on their behalf. When a liability claim is presented, insureds have the absolute right to expect that the insurer will negotiate settlement of the claim with the protection of the insured's financial interest in mind. They should be able to reasonably expect that the insurer will take no action that will burden them "with the crippling jeopardy of an excess judgment."10

Many would argue, however, that liability insurers have never had the protection of their insureds foremost in mind when presented with liability claims. In previous decades, keeping insurers in line was a task performed by regulators. Today, however, although insurance is still a regulated industry, "virtually every state is undermanned and underfunded with respect to the policing of insurance companies and has barely sufficient resources to enable only a cursory processing of new policy information and rate increase requests."11 Thus, the policing of liability claims is almost nonexistent.

Insureds who are put at financial risk as a result of action or inaction by their insurers can no longer rely on regulators. Instead, the insured must look to the insurer directly, by bring-

liability he may incur to third parties." ASHLEY, supra note 5, at § 1:06.
11. Murray & Delli Bovi, supra note 8, at 442.
12. Generally, an insured who faces an excess judgment and believes his insurer failed to settle the liability action against him in good faith, assigns his claim to the plaintiff in that liability action, who then initiates a bad faith cause of action against the insurer. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 125 (1987). The insured is amenable to assignment because he would prefer not to "bear the risks and costs of [bad faith] litigation only to forfeit any award." Moutsopoulos v. American Mut. Ins. Co., 607 F.2d 1185, 1189 (7th Cir. 1979). The plaintiff in the underlying tort action is amenable to
ing a bad faith claim. It may be argued that bad faith awards, which force insurers to pay the entire liability judgment, even one in excess of the insured's liability limits,\(^\text{13}\) may be the only way to deter insurer misconduct and fill the gaps created by regulatory oversight.\(^\text{14}\)

The author has presided as a State Supreme Court Justice, Ninth Judicial District, for nearly twenty three months (as of November 1992) and in that period has conferenced hundreds of negligence personal injury cases and has presided over dozens of such trials. The author has found that insurers and the defense bar almost uniformly have worked with plaintiff's counsel and the court in arriving at satisfactory monetary resolutions of the controversies. In virtually every case with which this author has been involved, the interests of the insured were more than adequately protected and of paramount concern to the insurer.

However, in a distinct minority of situations, less than a handful, it was this author's belief that if the case were to proceed to trial the insured would be exposed to liability in excess of the insurance coverage. Thus, the case was ripe for settlement at a figure within policy limits. When the insurer declined to set-

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assignment because he is not in privity of contract with the insurer, and thus in most states, including New York, cannot sue the insurer without the assignment. CLINTON E. MILLER, HOW INSURANCE COMPANIES SETTLE CASES § 1503 (rev. Nov. 1990). See also OppeI v. Empire Mut. Ins. Co., 517 F. Supp. 1305, 1307 (S.D.N.Y. 1981) (ruling that assignment of bad faith claims is permissible under New York law). But see Scannell, supra note 9, at 387-89, for discussion of minority jurisdictions that allow accident victims to proceed directly against the insurer without an assignment.

Generally, the attorney who represented the accident victim in the underlying action will represent him or her in the subsequent bad faith action. But see Zweig v. Safeco Ins. Co. of Am., 125 A.D.2d 205, 509 N.Y.S.2d 320 (1st Dep't 1986) (granting insurer's motion to disqualify plaintiff's counsel from conducting bad faith trial because he was alleged to have prevented any realistic opportunity to settle the liability claim and would likely be called by insurer as a witness at trial).

Critics of assignments claim they make "silk purses" out of "sows' ears," because the plaintiff in the underlying action obtains the opportunity to recover the entire judgment from the bad faith insurer when he never could have recovered it from an insured of modest means. Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1131 (D.C. Cir. 1989).

Critics have also claimed, unsuccessfully, that assignments are a collusive way to gain diversity and invoke the jurisdiction of the federal courts in cases in which the insured and his insurer are residents of one state but the accident victim is a resident of another state. See, e.g., DiLallo v. Fidelity and Cas. Co. of N.Y., 355 F. Supp. 519, 521 (S.D.N.Y. 1973).

14. Murray & Delli Bovi, supra note 8, at 442.
tle, the conclusion that the insured’s interests were not being adequately protected was inescapable. These few instances provoked lively discussion with colleagues and the bar, and was the impetus for this article.

Section I herein discusses the various bad faith rules with regard to liability and damages. Section II provides a look at the status of bad faith in New York today. Section III concludes that New York should adopt rules that hold insurers to a negligence standard with regard to liability for bad faith and that subject them to the judgment rule with regard to damages for bad faith regardless of the insured’s solvency.

II. How Other States Handle Bad Faith

A. Standards for Bad Faith Liability

1. Negligence Standard

It is clear that all insurers owe their insureds a duty to use some kind of care and skill in considering the insured's interests when making decisions on how to manage liability claims. Because an insurer has complete control in responding to settlement offers within policy limits, and is a professional in the claims business bound to perform with skill and diligence, some jurisdictions hold the insurer liable in bad faith for a negligent breach of its duty.

Consequently, if an insurer fails to settle a liability claim within policy limits through a lack of due care, it can then be held liable for an entire tort judgment in excess of the insured's policy limits. The negligence standard requires "the factfinder to determine whether a person of ordinary prudence, in the exercise of that degree of care which such a person would use in the management of his affairs, would have accepted the settlement offer." Critics of the negligence standard claim that it penalizes insurers for failing to predict correctly the outcome of the accident victim's action or for making a mistake of judgment.

Insurers are experienced enough to know that at trial a jury can react to many different factors. Jurors are human beings who bring their own life experiences and prejudices into a courtroom. Many well prepared attorneys who thought they selected the best jury for their case, and who presented a solid case, have been astounded by jury verdicts. If a set of facts can be interpreted two ways, and if interpretation against the insurer, for instance because of extensive injuries, would mean a verdict beyond policy limits, it is advisable for the insurer to offer to settle within policy limits.

The insurer is usually protected from a greedy plaintiff's bad faith action by stating on the record that it has offered the policy and the plaintiff has refused to accept it. The insurer is seemingly not adequately protected if it offers the policy after a judgment in favor of the injured plaintiff at the liability phase of the bifurcated trial, because it is highly unlikely that the plaintiff's lawyer would be interested in settling the case at that point. In permitting the case to go that far, absent a serious question on liability prior to verdict, it may be argued that the insurer did not have the best interests of the insured at heart. Juries are unpredictable and an insurer should be penalized for not recognizing that fact and for making a mistake in judgment.

373 A.2d 339, 340 (N.H. 1977) (reiterating state precedent that "insurer owes a duty to its insured to exercise due care in defending and settling claims against the insured").

18. Spray, 739 P.2d at 42. According to Appleman, courts adopting the negligence standard "have applied the reasonable and prudent man test" for determining whether liability for failure to settle exists. Appleman, supra note 17, at § 4713.

19. Ashley, supra note 15.

20. Id. at 12.
Often there is no legally sufficient basis for a judge to set aside a jury verdict on liability, at which point the insurer’s failure to settle appropriately has placed it in a most tenuous position.

2. Dishonesty Standard

Some jurisdictions have rejected the negligence standard for bad faith liability and have instead embraced one that is more rigorous, namely the “dishonesty” standard. The “dishonesty” standard requires that for liability to be imposed on an insurer, its conduct must have manifested “a dishonest purpose, moral obliquity, conscious wrongdoing, [or a] breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud.”

3. Recklessness Standard

At least one court examining both the negligence standard and the dishonesty standard opted for a compromise. In Commercial Union Insurance Co. v. Liberty Mutual Ins. Co., the Supreme Court of Michigan reasoned that “bad faith should not be used interchangeably with either negligence or fraud.” Instead, the Michigan court ruled that to be liable, an insurer must have engaged in conduct that was “arbitrary, reckless, [or] indifferent” to the interests of the insured.

4. “Disregard the Limits” Standard

Some jurisdictions have embraced a standard for bad faith liability known as the “disregard the limits” standard. This standard is applied by asking whether a prudent insurer would have responded favorably to an offer if the policy limits had either exceeded the amount claimed, or been unlimited. If the

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24. Commercial Union, 393 N.W.2d at 164.
25. Id.
26. Richard D. Williams and Howard Wollitz, Emerging Trends in Bad Faith Liti-
answer is yes, and the insurer failed to accept the settlement offer within the policy limits, then bad faith is demonstrated.27

5. Statutory Violations

A few courts have construed their states’ unfair claims handling statutes to authorize private bad faith causes of action by insureds or accident victims.28 California had been one such state until 1988, when the Supreme Court overruled a ten-year precedent in Moradi-Shalal v. Fireman’s Fund Insurance Co.29 and determined that no private cause of action in favor of either insureds or accident victims exists under the California Unfair Claim Practices Act.30

The Moradi court listed a myriad of reasons to justify the rejection of its landmark decision in Royal Globe Insurance Co. v. Superior Court31 a decade earlier. For instance, it surveyed nineteen jurisdictions that had also considered the issue, noting that seventeen had refused to authorize private causes of action.32 Additionally, it reconsidered the California Unfair Claim Practices statute’s legislative history, and concluded that “the Legislature [had] never intended to create such a right of action.”33 Instead, the statute had been created to provide for ad-


27. Professor Keeton described the rule as requiring the insurer to “view the situation as it would if there were no policy limit applicable to the claim.” Robert E. Keeton, Liability Insurance and Responsibility for Settlement, 67 HARV. L. REV. 1136, 1148 (1954), cited in Brown v. United States Fid. & Guar. Co., 314 F.2d 675, 678 (2d Cir. 1963). A thorough discussion of the “disregard the limits” standard can be found in ASHLEY, supra note 15, at 39-41.


32. The Moradi decision did not mention Alaska, which only a month earlier had pronounced in O.K. Lumber Co. v. Providence Wash. Ins. Co., 759 P.2d 523 (Alaska 1988), that it would not recognize a private cause of action for breach of that state’s unfair claims practices statute. O.K. Lumber also provides a list of jurisdictions analyzing the private cause of action issue. Id. at 527 n.6.

33. Moradi, 758 P.2d at 63.

34. Id. at 65. For a discussion of Royal Globe and Moradi, see Hon. H. Walter Cros-
administrative regulation and discipline of insurers found guilty of unfair claims practices with such frequency as to indicate a general business practice. 35

Interestingly, the Moradi court omitted Massachusetts from its list of jurisdictions addressing the issue of whether their states' unfair claims handling statutes create a private cause of action. Five years earlier, the Supreme Court of Massachusetts 36 had authorized private causes of action under the consumer protection statute 37 for violations of that state's unfair claim settlement practices. 38

B. Measure of Bad Faith Damages

1. The Judgment Rule — Awarding the Excess Judgment Without Regard to the Insured's Solvency

Fourteen states hold that once an insurer has refused the opportunity to settle a liability claim against its insured within policy limits, and a verdict above policy limits is then reached, entry of the judgment "alone is sufficient damage to sustain a recovery from [the] insurer for its [bad faith]" without regard to the insured's financial ability to pay the judgment. 39 The measure of damages awarded in such a case is the amount by which

35. Moradi, 758 P.2d at 62.
38. MASS. GEN. L. ch. 176D, § 3(9) (1991). For more extensive discussion of the Van Dyke and DiMarzo decisions, see Scannell, supra note 9, at 379, 390-91.
39. Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1131 n.3 (D.C. Cir. 1989). Gray construed North Carolina law, thus becoming the fourteenth jurisdiction to adopt the judgment rule in every bad faith case. See also Crabb v. National Indemn. Co., 205 N.W.2d 633 (S.D. 1973) (affirming bench verdict that insurer owed the excess judgment even though insured was judgment proof). See also Annotation, Insured's Payment of Excess Judgment, or a Portion Thereof, as Prerequisite of Recovery Against Liability Insurer for Wrongful Failure to Settle Claim Against Insured, 63 A.L.R. 3d 627, 641-69 (1975) for list of jurisdictions.
the verdict exceeds the policy limits. 40 Put another way, damages are a fixed sum, a mathematical calculation that equals the difference between the insurance coverage and the jury verdict against the insured in the underlying case. 41 Whether the insured has satisfied or is able to satisfy the judgment is irrelevant.

2. The Payment Rule

The payment rule, which is "now generally discredited," 42 holds "that if an insured did not and cannot pay out any money in satisfaction of an excess judgment, the insured was not harmed, and, therefore, the insurer is not to be held responsible for its bad faith." 43 Put another way, under the payment rule, "damages are deemed to equal the judgment only to the extent the insured has satisfied or is able to satisfy the judgment." 44

3. The Hybrid Rule

Most states apply a hybrid rule, which is a compromise between the judgment and payment doctrines. 45 The hybrid rule rejects the payment rule to the extent that it requires actual prepayment of the judgment, or at least the ability to pay, before bringing a bad faith claim, but retains it "by precluding collection on the judgment from the insurer beyond what is or would actually be collectable from the insured." 46 Thus, insureds who are insolvent and unable to pay a penny of the excess judgment are considered not to have been damaged by the insurer's

42. Levantino v. Insurance Co. of N. Am., 102 Misc. 2d 77, 81, 422 N.Y.S.2d 995, 999 (N.Y. Sup. Ct. 1979); Hernandez v. Great Am. Ins. Co. of N.Y., 464 S.W.2d 91, 95 (Tex. 1971) (stating "[v]irtually everything that has been written on this subject in the past fifteen years has favored the judgment rule over the prepayment rule.").
44. Murray & Delli Bovi, supra note 8, at 442.
failure to settle. Consequently, no bad faith damages can be awarded. In other words, the amount of bad faith damages awarded depends on the solvency of the insured. The hybrid rule has become popular because, according to its advocates, it provides a more reasonable measure of damages than the judgment rule, referred to by some as punitive in nature.

II. How New York Handles Bad Faith Claims

A. The Standard for Liability

1. Common Law Standard

New York has rejected the negligence standard for bad faith liability. Three years ago in Roldan v. Allstate Insurance Co., the Second Department reiterated a sixty-year-old precedent that "a plaintiff must show more than mere negligence on the part of the insurer" to support a bad faith action.

The standard that New York ostensibly applies is strict and was set forth in the 1972 landmark case of Gordon v. Nationwide Mutual Insurance Co. In Gordon, the Court of Appeals

50. 149 A.D.2d 20, 544 N.Y.S.2d 359 (2d Dep't 1989).
53. 30 N.Y.2d 427, 285 N.E.2d 849, 334 N.Y.S.2d 601, cert. denied, 410 U.S. 942 (1972); see, e.g., Crawford v. Hospital of the Albert Einstein College of Medicine, 159
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was faced with a claim of bad faith after a verdict of almost $260,000 was reached following the insurer’s refusal to defend liability claims and settle within the $20,000 policy limits. The insurer alleged the policy had been canceled prior to the loss. It was ultimately determined that the policy had been improperly canceled and the insurer should have defended the claims. In ruling that no bad faith had been demonstrated, the court stated, “bad faith requires an extraordinary showing of a disingenuous or dishonest failure to carry out [the insurance] contract.”

Despite the precedent established in Gordon, it is arguable that the courts are, in practice, applying a liability standard that is far less rigorous. For instance, in Peterson v. Allcity Insurance Co., a Second Circuit case decided six months after Gordon, the court defined bad faith as the insurer’s failure to “give at least equal consideration to the insured’s interests as to its own when making settlement decisions.”

The Peterson court affirmed a finding of bad faith in a case that arose out of an accident in which the insured drove over a divider and collided with an oncoming car. The accident left the insured’s passenger partially blinded. The insured’s liability policy limit was $10,000 and the jury verdict was $80,000. The insurer had refused to settle for the $10,000 limits because it contended the passenger was contributorily negligent “in accepting a ride with a driver she had reason to believe was intoxicated.”

A.D.2d 304, 305, 552 N.Y.S.2d 582, 584 (1st Dep’t 1990).
54. Id. at 431, 285 N.E.2d at 850, 334 N.Y.S.2d at 603.
55. Id. at 438, 285 N.E.2d at 855, 334 N.Y.S.2d at 609. See also Dawn Frosted Meats, Inc. v. Insurance Co. of N. Am., 99 A.D.2d 448, 470 N.Y.S.2d 624 (1st Dep’t), aff’d, 62 N.Y.2d 895, 467 N.E.2d 531, 478 N.Y.S.2d 867 (1984). Seven years before Gordon, the Fourth Department reinstated a bad faith complaint and granted the plaintiff a new bad faith trial because the trial court had erroneously charged as bad faith elements “a sinister motive — guilty knowledge — an intent to do harm or deprive another of his just rights and property — a willful refusal to carry out an obligation with intent to injure — the deliberate doing of something the actor knows to be wrong.” Cappano v. Phoenix Assur. Co. of N.Y., 28 A.D.2d 639, 640, 280 N.Y.S.2d 695, 697 (4th Dep’t 1967).
56. 472 F.2d 71 (2d Cir. 1972).
57. Id. at 77.
58. Id. at 77. Prior to the advent of comparative negligence in New York in 1975 (C.P.L.R. § 1411), if the plaintiff was guilty of any negligence, his complaint was dismissed. 1 NEW YORK PATTERN JURY INSTRUCTIONS — CIVIL 2:35 (2d ed. 1986).
Instead, it had offered $1,000 when the case reached the trial calendar, and $5,000 after jury selection.

Four years later, in Knobloch v. Royal Globe Insurance Co., another insured with a $10,000 policy lost control of his car, injuring his passenger. The insurer, aware that the passenger was hospitalized for three weeks, wanted to save money on the policy, and refused to offer more than $9,500 until the day before trial, when it offered the full $10,000, which was then rejected by the passenger. The jury awarded the passenger $75,383.50.

After paying the excess judgment, the insured instituted a bad faith action against the insurer. At trial, the judge's charge to the jury on liability utilized the Peterson court's language. Because no exception to the charge was taken, the Court of Appeals did not address its sufficiency, and ruled only that the evidence was sufficient to sustain a jury verdict of bad faith.

Almost a decade after Knobloch, the liability standard again seemed less stringent than required under Gordon. In State v. Merchants Insurance Co. of New Hampshire, the Third Department was presented with a bad faith case arising out of an accident in which a State-owned vehicle crossed the center line and collided with a pick-up truck, killing the truck driver, a thirty-five-year-old wife and mother of two who worked outside the home. Despite a settlement demand for $90,000, which was later reduced to $75,000, the State's insurer offered only $45,000 of the $100,000 policy. Trial resulted in a verdict of $180,000. Subsequently, in an action for bad faith refusal to settle, the plaintiff recovered judgment for the excess.

In affirming the bad faith jury verdict, the Appellate Division held:

[D]efendant was well aware that its proposed $45,000 settlement figure was substantially lower than the liability it could reasonably expect to incur. The jury could reasonably have reached the

60. Id. at 474-75, 344 N.E.2d at 366, 381 N.Y.S.2d at 434-35.
61. Id. at 478, 344 N.E.2d at 368, 381 N.Y.S.2d at 438.
62. Id. at 480, 344 N.E.2d at 369, 381 N.Y.S.2d at 438. The court expressly rejected the insurer's argument that tender of the policy limits on the eve of trial insulated it from bad faith liability. Id. at 478, 344 N.E.2d at 368, 381 N.Y.S.2d at 437.
Conclusion that defendant exercised bad faith in failing to protect the interest of its insured by coming forth with a reasonable and fair settlement offer, as it was contractually and statutorily required to do. 64

In DiBlasi v. Aetna Life and Casualty Insurance Co., 65 the Appellate Division, Second Department, without discussion of the Gordon liability standard, ruled that an insurer was liable for bad faith "only if the decision not to settle within the policy limits was made . . . in gross disregard of its insured's interests." 66

The allegation of bad faith in DiBlasi arose out of an accident in which the insured's vehicle crossed the double yellow line and struck another vehicle. The insured vehicle's passenger sustained a dislocation and fracture of the elbow, which brought on post-traumatic arthritis. The passenger offered to settle the liability claim for $23,000 of the insured's $25,000 policy limit, but the insurer refused to pay more than $17,500. The jury verdict for the passenger was $42,000.

In refusing to grant the insurer's motion for summary judgment on the issue of bad faith liability, the DiBlasi court found that "a reasonably prudent insurance adjuster and/or defense attorney must have realized that since DiBlasi, who was 22 years old at the time of the accident, sustained an indisputably painful, permanent and progressive injury to the right elbow, it was 'highly probable' that the verdict would be in excess of $25,000." 67

Less than two months later, in Roldan v. Allstate Insurance Co., 68 the Second Department described the bad faith liability standard as requiring "the rejection by the insurer of an offer of settlement within its policy limits [that] constitute[s] a deliberate, or at least reckless, decision to disregard the interests of its insured." 69

New York's Pattern Jury Instructions 4:67 lend some guid-

64. Id. at 936, 486 N.Y.S.2d at 413 (citing Kulak v. Nationwide Mut. Ins. Co., 40 N.Y.2d 140, 351 N.E.2d 735, 386 N.Y.S.2d 87 (1976)).
65. 147 A.D.2d 93, 542 N.Y.S.2d 187 (2d Dep't 1989).
66. Id. at 99, 542 N.Y.S.2d at 191.
67. Id. at 98, 542 N.Y.S.2d at 192.
68. 149 A.D.2d 20, 544 N.Y.S.2d 359 (2d Dep't 1989).
69. Id. at 37, 544 N.Y.S.2d at 370 (emphasis added).
ance in clarifying the current standard of liability for insurer bad faith, but fall far short of being definitive. According to PJI 4:67, an insurer cannot be held liable for bad faith due to an “error of judgment” or a “failure . . . to exercise reasonable care.” To be culpable, however, the insurer need not “have acted maliciously or dishonestly . . . . It is enough that it acted intentionally and in gross disregard of [the insured’s] interests.” Of significance is the PJI 4:67 caveat, which authorizes a judge to charge that to be culpable, it is enough that the insurer acted “intentionally and unfairly disregarded” the insured’s interests, if that judge believes the “gross disregard” language is too strong.

2. Statutory Standard

New York Insurance Law section 2601 defines “unfair claim settlement practices” and requires insurers to attempt “in good faith to effectuate prompt, fair and equitable settlements of claims submitted in which liability has become reasonably clear . . . .” Another provision of the New York Insurance Law authorizes a monetary penalty of $500.00 for each violation.

New York courts have refused to entertain private causes of action for violations of section 2601. In Cohen v. New York Property Insurance Underwriting Association, the First Department ruled that section 2601 “does not create a private right of action but rather affords a public right of redress by the Insurance Department . . . .” In other words, violations are

70. 2 NEW YORK PATTERN JURY INSTRUCTIONS — CIVIL 4:67 (Supp. 1992). The instruction also lists factors to be considered by the jury in deciding whether bad faith occurred in the underlying case, including: the probability of a plaintiff’s verdict on liability, the probability of an excess verdict due to the severity of the injuries, and whether there had been any attempts by the insurer to settle the claim and if so, at what point such attempts were made.

71. Id.

72. Id. In the Comment following PJI 4:67, the authors took the phrase “grossly disregarded” from Gordon, a case that they interpreted to concern “bad faith in refusal to defend rather than in failure to settle . . . .” Id. at 348. The authors believe that “gross disregard” may be too strong a term for failure to settle cases. Id.

73. N.Y. INS. LAW § 2601(a)(4) (McKinney 1985).

74. N.Y. INS. LAW § 109(c)(1), § 2601(c) (McKinney 1985).

75. 65 A.D.2d 71, 410 N.Y.S.2d 597 (1st Dep’t 1978).

76. Id. at 79, 410 N.Y.S.2d at 602.
"within the province and jurisdiction of the State Superintendent of Insurance" and do not give rise to private bad faith claims, because they are labelled as wrongs against the public at large. Both the Second and Fourth Departments have adopted the First Department's position and have refused to authorize a private cause of action brought pursuant to section 2601.

Despite its rejection of private causes of action that are based on section 2601 violations, the First Department recently identified a role that section 2601 violations can play in common law bad faith actions. In Belco Petroleum Corp. v. AIG Oil Rig, Inc., the First Department suggested that insureds use evidence of section 2601 violations to press claims for punitive damages, as follows: "Now, an insured aggrieved by an unfair claim settlement practice can take his grievance to the Superintendent of Insurance; if the grievance has merit, the Superintendent will presumably take it up and investigate; the insured, he of modest means or substantial, should then be able to use the results of that investigation in pressing a claim for punitive damages.

B. Measure of Damages in New York Bad Faith Claims

Twenty-four years ago, New York adopted the rule that an insured can bring a bad faith claim against his insurer before paying an excess judgment. In Henegan v. Merchants Mutual Insurance Co., the First Department unanimously reversed nisi prius and ruled that it would "join with the majority of jurisdictions in this country in concluding that an insured is damaged, that he has suffered a loss or injury, upon entry of the

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81. Id. at 565, N.Y.S.2d at 781. For a discussion of Roldan and Belco, see Harry H. Lipsig, Bad-Faith Failure to Settle, N.Y.L.J., Feb. 28, 1991, at 3.
82. 31 A.D.2d 12, 294 N.Y.S.2d 547 (1st Dep't 1968).
excess final judgment in the [underlying] case."\(^9\) Although the term "judgment rule" does not appear within the opinion, *Henegan* is widely cited\(^4\) as the New York decision that adopted the judgment rule in theory if not in name, except for the rare circumstance when the insured is "insolvent before the rendition of the judgment and, furthermore, [is] discharged in bankruptcy from paying [it]."\(^8\)

In accordance with *Henegan*, the Second Circuit shortly thereafter in *Young v. American Casualty Co.*,\(^8\) awarded the amount of the excess judgment as damages in a bad faith action, despite the fact that the formerly solvent insured's debt had been relieved in bankruptcy.\(^7\) In the words of the *Young* court, "the fact that [the insured] ha[s] been discharged from future liability on [the excess] judgment does not inure to the benefit of [the insurer]."\(^8\)

The dissenting opinion in *Gordon v. Nationwide Mutual Insurance Co.*\(^9\) advocates a retreat from compliance with the judgment rule in favor of a convoluted three-part rule.\(^90\) Under

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83. *Id.* at 13, 294 N.Y.S.2d at 548.
85. *Henegan*, 31 A.D.2d at 14, 294 N.Y.S.2d at 549 (citing *Harris v. Standard Acc. & Ins. Co.*, 297 F.2d 627 (2d Cir. 1961), *cert. denied*, 369 U.S. 843 (1962)). In *Harris*, the insured was insolvent at the time of the personal injury trial and was forced into bankruptcy after the excess judgment was entered against him. *Harris*, 297 F.2d at 629. In the bad faith action that followed, a district court's award of the excess judgment to the insured's bankruptcy trustee, was reversed on appeal. *Id.* at 636.
87. *Id.* at 912.
88. *Id.* at 908.
90. *Id.* at 442, 285 N.E.2d at 857, 334 N.Y.S.2d at 613 (Breitel, J., dissenting). The trial court in *Gordon* had charged "that if liability is found the damages are measured as a matter of law by the amount of the excess judgment[]." *Gordon*, 30 N.Y.2d at 442, 285 N.E.2d at 857, 334 N.Y.S.2d at 613 (Breitel, J., dissenting). In *Knobloch v. Royal Globe Ins. Co.*, 38 N.Y.2d 471, 344 N.E.2d 364, 381 N.Y.S.2d 433 (1976), the excess verdict had been paid by the insured and a co-defendant prior to institution of the bad faith action, so upon finding bad faith, the court ordered the insurer to pay the excess judgment. *Id.* at 476, 344 N.E.2d at 367, 381 N.Y.S.2d at 436. In *St. Paul Fire and Marine Ins. Co. v. United States Fid. and Guar. Co.*, 43 N.Y.2d 977, 375 N.E.2d 733, 404 N.Y.S.2d 552 (1978), the excess verdict had been paid by the excess insurer, so upon finding bad faith,
the proposed rule, the measure of bad faith damages would depend on whether the insured is solvent, insolvent, or impecunious — "of such meager means that a judgment [would be] worth less than the full amount of the excess verdict." Judge Breitel, writing for the three dissenting judges, advocated that when the insured is either insolvent or impecunious, factors such as his "age, economic status, economic prospects, skills, health, and any other matters presently existing which would be reasonably predictive of [his] economic future," should influence what measure of damages is applied once bad faith has been proven. 92

Thirteen years ago, this approach was embraced by a New York trial court, and was credited with providing "the only guidance available . . . [on] how damages should be evaluated where the assured is judgment proof or impecunious." 93 In Levantino v. Insurance Co. of North American, 94 a bad faith claim was instituted after an excess judgment was obtained against an impecunious insured. 95 The jury found bad faith liability and awarded the plaintiff the amount of the excess judgment plus interest. 96 The insurer moved to set aside the verdict after discovering that the insured had filed for bankruptcy before the bad faith trial. 97

The Levantino court refused to set aside the verdict, unconvinced that knowledge by the jury of the bankruptcy filing would have altered the award. 98 The court set forth concisely the minority three-part rule as follows:

1) where the assured pays part of the judgment or is solvent


94. Id.
95. Id. at 78, 422 N.Y.S.2d at 997.
96. Id. at 79, 422 N.Y.S.2d at 998.
97. Id.
98. Id. at 88, 422 N.Y.S.2d at 1003.
enough to do so at the time of the excess judgment, the judgment rule applies and he is entitled to the full amount of the excess as his damages; 2) where he was insolvent before the judgment and obtained a bankruptcy discharge after it, he is not damaged and may not recover for it; and 3) where he was insolvent or nearly insolvent prior to the judgment the jury must consider his past, his prospects, and other economic factors and assess his damages.\(^9\)

Nevertheless, in accord with the *Gordon* minority opinion, the Comment following New York Pattern Jury Instruction 4:67 cites *Gordon* for the proposition that with regard to bad faith damages, the judgment rule applies if the insured is solvent.\(^{100}\) When the insured is insolvent or impecunious, PJI 4:67 remarks that “damages recoverable . . . are not clear.”\(^{101}\) Thus, while use of the *Gordon* dissenters’ opinion in a jury charge is recommended by PJI 4:67, it is not acknowledged as being “the law in New York.”\(^{102}\)

Recent case law reveals that such an approach is meeting with resistance. In *DiBlasi v. Aetna Life and Casualty Insurance Co.*,\(^{103}\) the Second Department appeared to reject the three-pronged rule and espoused consistent application of the judgment rule, noting that “[r]egardless of the insured’s financial responsibility most courts automatically adopt the excess judgment as the measure of damages.”\(^{104}\) The *DiBlasi* court found support for its ruling in *Reifenstein v. Allstate Insurance Co.*,\(^{105}\) a case in which the Fourth Department had defined the

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99. *Id.* at 87, 422 N.Y.S.2d at 1002.
100. 2 *New York Pattern Jury Instructions — Civil* 4:67 Comment, at 357 (Supp. 1992). Interest accrues on a tort judgment from the date it is obtained, so the judgment rule includes interest on the excess judgment. *Id.* (citing *DiBlasi v. Aetna Life & Cas. Ins. Co.*, 147 A.D.2d 93, 542 N.Y.S.2d 187 (2d Dep’t 1989)).
101. *Id.*
103. 147 A.D.2d 93, 542 N.Y.S.2d 187 (2d Dep’t 1989).
104. *DiBlasi v. Aetna Life & Cas. Ins. Co.*, 147 A.D.2d 93, 101, 542 N.Y.S.2d 187, 193 (2d Dep’t 1989). The *DiBlasi* court did admit, however, that the insured was solvent, so distinctions between solvency, insolvency, and impecuniosity were not in issue. *Id.* at 103, 542 N.Y.S.2d at 194.
105. 92 A.D.2d 715, 461 N.Y.S.2d 104 (4th Dep’t 1983). In *Reifenstein*, the insurer initially offered $9,500 of the insured’s $10,000 policy limits on a wrongful death liability claim and refused for ten months to increase the offer to policy limits. *Id.* at 715, 461
bad faith cause of action as one brought by an insured "to recover the excess judgment"\(^{106}\) after losing "an actual opportunity to settle the negligence claim against him within the coverage limits of his policy by reason of the insurer's purported 'bad faith.' "\(^{107}\)

In 1990, a Kings County jury in Pavia v. State Farm Mutual Automobile Insurance Co.\(^{108}\) applied the judgment rule in a bad faith case, ordering State Farm to pay the excess judgment of $3.7 million.\(^{109}\) In October 1992, the Second Department affirmed the decision of the Supreme Court, Kings County, ordering State Farm to pay an excess judgment of 3.7 million dollars.\(^{110}\) On appeal, State Farm had argued that since the insureds were "insolvent" and unable to pay any significant portion of the underlying personal injury judgment, in effect they did not sustain any legally compensable damages and thus the entire judgment should be vacated. The Second Department declined to adopt this view, holding that it "is settled in New York that with respect to a solvent insured, the measure of damages in a bad faith case is the amount by which the judgment in the underlying tort action exceeds the insured's policy coverage."\(^{111}\)

The appellate court found that although the insured's lacked the resources to pay any significant portion of the judgment, they were not financially "insolvent" to the extent that they would suffer no harm by virtue of the judgment. In fact, citing Henegan v. Merchants Mut. Ins. Co.,\(^{112}\) the court adopted the view that the very imposition of such a large judgment causes harm to the judgment debtor. "The judgment increases his debts, it damages his credit, it subjects his property to the

N.Y.S.2d at 105.

106. Reifenstein, 92 A.D.2d at 716, 461 N.Y.S.2d at 106 (emphasis added).

107. Id.

108. Insurer Liable for $3.7 Million Award, N.Y.L.J., Dec. 5, 1990, at 2, col. 5. For a discussion of Pavia and the question of how long after discovery an insurer can wait to offer limits before the plaintiff can refuse and pursue bad faith, see Francis J. Seahill, Bad Faith Litigation: A Window Period on the Horizon, N.Y.S.B.J., Nov. 1991, at 31; Lipsig, supra note 81, at 3.


111. Id. at 200, 589 N.Y.S.2d at 517.

112. 31 A.D.2d 12, 13, 294 N.Y.S.2d 547, 548 (1st Dep't 1971).
liens of the ubiquitous judgment." 113

In addition, from a public policy standpoint, the court refused to permit a "faithless carrier" to "shackle[] its insured with a massive excess judgment" and avoid liability by arguing that its "insured's assets have not been sufficiently damaged by the judgment". 114 To adopt such a standard would only serve to reward an insurer who acts in bad faith, since, in the case of an "impecunious insured, the carrier's liability in any 'bad faith' case would be governed not by the amount of the resulting excess judgment, but rather by the measure of its insured's limited economic worth." 115

III. New York Should Adopt The Negligence Standard For Liability And Apply The Judgment Rule As The Measure Of Damages

A. Reasons for Adopting the Negligence Standard

1. The Insurer is a Fiduciary with Absolute Control over the Insured's Financial Future

When an insurer handles a liability claim brought against its insured, the insurer acts as a fiduciary. 116 The insured places his trust and confidence in the insurer, and relies upon the insurer to guard him against financial harm. 117 "In defending a claim, an insurer is obligated to act with undivided loyalty; it may not place its own interests above those of its assured." 118

When an offer to settle the case within limits is made, the insurer has absolute control in deciding whether to accept it or try the case, thereby exposing the insured to an excess judg-

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114. Id.
115. Id.
117. Murray & Delli Bovi, supra note 8, at 441.
A conflict of interest arises because while it is always in the insured's best financial interest to settle the case within limits, it is in the insurer's financial interest to settle only "when the relationship between [the] settlement offer and policy limits is mathematically favorable in the light of the probabilities of winning or losing the suit." This conflict creates an obligation on the part of the insurer "to protect the interests of the assured equally with its own."

In theory, the insurer should be able to satisfy the obligation to protect the insured's interests equally with its own. In practice, however, whether insurers actually do satisfy the obligation is highly debateable. Adopting the negligence standard for bad faith liability would prompt insurers to be more cognizant of their obligation, and more careful when making choices on whether to settle. It would force them to think of their insured's interest equally with their own, every step of the way through settlement negotiations. This rationale was set forth concisely in Certain Underwriters of Lloyd's v. General Accident Insurance Company of America, in which the court stated:

When a claim exceeds policy limits, a rational insured, having purchased protection against liability, would seek to settle... within policy limits. Typically, however, the insurer has full control over... the decision to settle. Absent a duty to settle, the insurer would consider only its monetary interests in deciding whether... to settle, ignoring the risk of an excess verdict which would be borne entirely by the insured. The duty of due care... remedies that situation, forcing the insurer "to view the situation as if there were no policy limits applicable to the claim, and to give equal consideration to the financial exposure of the insured."

120. For a succinct discussion of the conflict of interest situation the insurer assumes under the liability policy, see Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 784 (N.H. 1971).
123. 909 F.2d 228 (7th Cir. 1990) (applying Indiana law).
124. Id. at 232 (citing Continental Cas. Co. v. Reserve Ins. Co., 238 N.W.2d 862, 864
Some jurisdictions maintain that when an insurer handles the defense of a claim brought against its insured, the insured's interest is not to be considered equally, but instead "must necessarily come first."\(^{125}\) Jurisdictions espousing this view believe that "the interests of the insured are paramount to those of the insurer, and that the insurer may not gamble with the funds and resources of its policyholders."\(^{126}\) An argument for adoption of the negligence standard for bad faith liability is even more persuasive given this reasoning.

2. *The Negligence Standard is a Fair Compromise between a Strict Liability Standard and a Dishonesty Standard*

Although no court to date has held an insurer strictly liable in bad faith for failure to settle a liability claim within policy limits, the use of strict liability as an ideal way to balance the interests of the insured and the insurer has long been advocated by some jurisdictions.\(^{127}\) "The strongest argument on the side of strict liability appears to be that [because] the [insured's] interests generally dictate settlement within the policy limits, the insurer having control of settlement should be held to assume the risks of its acts against the insured's interests."\(^{128}\)

In a landmark decision, the Supreme Court of West Virginia recently adopted a "hybrid negligence-strict liability" standard for use in future bad faith actions. The impact of the ruling in that case, *Shamblin v. Nationwide Mut. Insurance Co.*,\(^{129}\) is not yet known, but could be vast indeed. In *Shamblin*, the trial court had applied a negligence standard and the insurer had

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130. *Id.*
been found liable in bad faith for failure to settle the underlying tort action brought against its insured.\textsuperscript{131} Nationwide appealed, arguing that negligence was too lenient a standard for the imposition of bad faith liability.\textsuperscript{132} In reaching its decision, the Shamblin court analyzed the various standards for bad faith liability and concluded that not only is the negligence standard appropriate, but it is best applied in conjunction with a strict liability component.\textsuperscript{133} In the words of the court:

"wherever there is a failure on the part of the insurer to settle within policy limits . . . [and] there exists the opportunity to so settle[,] and where such settlement within policy limits would release the insured from any and all personal liability, . . . the insurer has prima facie failed to act in its insured's best interest and . . . such failure to so settle prima facie constitutes bad faith towards its insured."\textsuperscript{134}

In West Virginia, it is now the insurer's burden to prove, by clear and convincing evidence, that it attempted in good faith to settle; that failure to settle when the opportunity to do so existed, "was based on reasonable and substantial grounds," and; that it "accorded the interests and rights of the insured at least as great a respect as its own."\textsuperscript{135}

The strict liability standard has come under fire as one which might benefit individual insureds, but will more likely "precipitate an increase in insurance rates and adversely affect insureds as a group,"\textsuperscript{136} because it arguably "writes unlimited

\textsuperscript{131} Id. at 771, 773. In the underlying tort action, a woman sued Shamblin after being struck head-on by a truck Shamblin owned. Two other Shamblin trucks were also involved in the collision, which occurred when the latter two drivers signaled to the first that it was clear to pass another truck. Shamblin had $100,000 per person and $300,000 per occurrence bodily injury liability limits. The woman sought $100,000 for each Shamblin vehicle because she contended all three drivers were negligent. Nationwide contended the entire accident was a single occurrence so only $100,000 in coverage was available. The woman offered to settle for whatever the policy limits were judicially determined to be. Nationwide refused and instead offered $100,000 plus $30,000 from Shamblin's own pocket. The jury awarded the woman $775,000.

\textsuperscript{132} Id. at 773.

\textsuperscript{133} Id. at 776.

\textsuperscript{134} Id.

\textsuperscript{135} Id.

\textsuperscript{136} Scannell, supra note 9, at 377, 397. Scannell believes that the trend toward strict liability, among other things:

create[s] a significant threat of bad faith liability and recovery in each claim set-
coverage into every policy that can be settled within its limits. Adoption of the negligence standard by New York would appease critics of the strict liability standard, yet simultaneously would increase the opportunity for insureds who are victims of bad faith to transfer the liability for excess judgments to their insurers without having to overcome the dishonesty standard hurdle.

3. **Combatting the Insurer's Defense that Refusing to Settle was not Bad Faith Because a Liability Argument Existed**

Precedent does exist to support the proposition that when the insurer has a valid liability argument in the underlying tort action, it has the right to try that issue before a jury without being subject to a bad faith claim. Indeed, New York Insurance Law § 2601, which regulates claim settlement practices, requires insurers to effectuate "settlement[] of claims submitted in which liability has become reasonably clear."

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139. See DiBlasi v. Aetna Life and Cas. Ins. Co., 147 A.D.2d 93, 98, 542 N.Y.S.2d 187, 191 (2d Dep't 1989) (ruling that "a bad faith case is established where the liability is clear and the potential recovery far exceeds the insurance coverage") (emphasis added); Pipoli v. United States Fid. and Guar. Co., 31 N.Y.2d 679, 289 N.E.2d 178, 337 N.Y.S.2d 257 (1972) (unanimously affirming appellate ruling of no bad faith when insurer refused to settle in reliance on insurer's version that his car had run out of gas on the highway and that he had taken "every possible precaution to make its presence known to the other driver"); Colbert v. Home Indem. Co., 35 A.D.2d 326, 315 N.Y.S.2d 949 (4th Dep't 1970) (affirming dismissal of insured's bad faith complaint because he claimed not to have been the driver in the single vehicle accident and was thus estopped from arguing that insurer should have disbelieved him and settled the liability claim against him); Brown v. United States Fid. and Guar. Co., 314 F.2d 675, 679 (2d Cir. 1963) (ruling that bad faith is most readily inferable when injuries are so severe that the verdict is likely to greatly exceed policy limits and when a defendant's verdict on the issue of liability is doubtful).
140. N.Y. Ins. Law § 2601 (McKinney 1985) (emphasis added).
Interestingly, however, this statutory language is not identical to that which appeared in the Governor’s Memorandum on the statute, a proposed bill at the time. The Memorandum remarked that the statute would require an insurer to effectuate “settlement of any claims in which its liability has become reasonably clear.” Moreover, language describing the statute in a Joint Legislative Committee Report is altogether different. The Committee noted that the statute would require insurers to “attempt good faith settlements of claims for which the company is clearly liable.” Use of the different language creates confusion as to the definition of the term “liability” in the statutory context.

Experts who have analyzed the insurer’s liability defense find it weak. They label it a vague and subjective defense that yields inconsistent and unpredictable results when applied “to real-world decisions to accept or reject settlement offers.” As one distinguished commentator has noted, the insurer’s argument that it can refuse to settle without fear of bad faith when it has a reasonable liability defense “suffer[s] from two main flaws” and states: “Does a ‘fair and reasonable’ prospect of success [on liability] mean a 51 percent chance of victory? A 75 percent chance? A 90 percent chance? Second, [the liability defense] focus[es] too much attention on one of the two factors that normally affect a decision to accept or reject a settlement offer. [It] place[s] all of [its] emphasis on the probability of winning and give[s] little weight to the amount the third party might recover if he wins his suit against the insured.”

Indeed, when the accident victim’s injury is severe and the special damages alone approach or exceed policy limits, the logic of the liability defense becomes strained. At times, the probable damages are so far above limits that even a finding of minimal negligence on the insured will result in an excess verdict. Preserving the logic of the liability defense in such cases is unwise,

143. Ashley, supra note 15, at 33-34.
144. Id.
145. Id.
both to those who have suffered catastrophic injuries and are being vastly undercompensated, and to the public who will likely be forced to bear the burden of care for the victim because he can no longer care for himself. At least one court faced with such a case has warned that even though an insurer believes it has "a genuine and reasonable issue as to its insured's liability," it cannot rely on this factor alone when deciding whether to settle.\textsuperscript{148} According to the West Virginia Supreme Court in that case, \textit{Shamblin v. Nationwide Mutual Insurance Co.}, "if the settlement offer can be considered fair when cast against the possibility of a substantial excess verdict against the insured, the liability issue in and of itself may not be sufficient grounds for the insurer not to settle."\textsuperscript{147}

Other commentators endorse the imposition of bad faith in cases of contested liability by referring to it as the price to pay for "ferreting out nonmeritorious claims."\textsuperscript{148} They reason that paying nonmeritorious claims, in which significant liability issues exist, drive up insurance rates for everyone.\textsuperscript{149} The better approach, it is argued, is to contest liability, but also to impose bad faith liability when claims are ultimately determined to be meritorious, as a simple expense of engaging in the business of insuring for risks.\textsuperscript{150} The risk involved "is simply that an [insurer] may erroneously regard a meritorious claim as a nonmeritorious claim and thereby subject its insured to a liability in excess of the policy limits. In that event, the insurance company merely satisfies the entire judgment, even though it exceeds the policy, as an incidental cost of the insurance business."\textsuperscript{151}

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\textsuperscript{147.} Id. at 777.
\textsuperscript{148.} Murray & Delli Bovi, supra note 9, at 444.
\textsuperscript{149.} Id.
\textsuperscript{150.} Id.
\textsuperscript{151.} Id.
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B. Reasons for Applying the Judgment Rule Regardless of the Insured's Solvency

1. Insurer Owes all Insureds the Same Duty to Settle Claims in Good Faith

The wealth or poverty of an insured is a poor measure of an insurer's duty. All insureds, regardless of wealth, are entitled to protection by insurers handling liability claims brought against them. An insurer with an insolvent insured should not be excused "from exercising the same good faith it would be expected to exercise, were the insured" solvent and capable of paying an excess judgment. Moreover, because the size of the excess verdict is not a function of the insured's economic status, it seems illogical to condition the payment of the judgment on his economic status.

The insurer's conduct may well have contributed to the insured's weakened financial condition. Therefore, especially in such instances, the insurer should be prohibited from capitalizing on the insured's financial frailty. The insurer should be held responsible for the excess judgment regardless of the fullness or emptiness of the insured's purse. Any other rule for measuring damages results in a windfall to insurers fortunate enough to insure impoverished individuals.

155. Id.
2. **Application of the Judgment Rule Promotes Improved Claims Handling**

Application of the judgment rule not only protects insureds but "promot[es] good faith in the conduct of settlement negotiations by a liability insurer" and fosters "the prompt and fair disposition of liability claims." 158 Rejecting the judgment rule "opens the door [for insurers to use] the shaky financial condition of an insured as a device for driving down settlements" 159 and encourages them to unreasonably refuse to settle, 160 playing "fast and loose with claims against their less affluent policyholders." 161 Even Judge Breitel, the author of the infamous Gordon dissent advocating the three-part bad faith damages rule, acknowledged that "most courts automatically adopt the excess judgment as the measure of damages . . . [because] [t]o permit otherwise . . . would allow insurers to benefit from the impecuniousness of an insured [and] encourage insurers to be less responsive to their contractual obligations . . . ." 162

3. **Insurer Should be Held to the Terms of its Policy**

Liability policies commonly include language that states "[b]ankruptcy or insolvency of the insured or of the insured's estate shall not relieve the Company of any of its obligations hereunder." 163 Courts have construed the term "obligations" comprehensively, finding that it refers not only to the maximum dollar amount of the policy liability limits, but also to other obligations of the insurer. 164 Thus, the insurer is barred from using the insured's insolvency as a defense against any of its obliga-

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159. Id. at 288 (Oakes, J., dissenting).
161. Moutsopoulos v. American Mut. Ins. Co., 607 F.2d 1185, 1189-90 (7th Cir. 1979) (citing Liberty Mut. Ins. Co. v. Davis, 412 F.2d 475, 485 (5th Cir. 1969)). In Moutsopoulos, the Seventh Circuit ruled, pursuant to Wisconsin law, that damages in a bad faith case are equal to the amount of the excess judgment as a matter of law. Id. at 1186.
164. Id. at 563 (relying on Maguire v. Allstate Ins. Co., 341 F. Supp. 866 (D. Del. 1972)).
tions, including those that flow from its bad faith conduct.\textsuperscript{165}

Because liability policies are contracts of adhesion, written solely by the insurer, questions with regard to the meaning of policy language must be resolved in favor of the insured.\textsuperscript{166} Therefore, courts should not accept an insurer's argument that the term "obligation" refers only to the maximum amount of the liability policy limits, because such reference "is not apparent from the language employed."\textsuperscript{167} If a narrow meaning of the term had been intended, the insurer should have used specific language to make the intention "clearly known"\textsuperscript{168} and to protect itself against allegations of ambiguity.

Even policies that do not include the above-mentioned clause usually do contain a clause that says the insurer "will pay damages for bodily injury or property damage for which any covered person becomes legally responsible because of an [] accident."\textsuperscript{169} Whether an insured intends, or is financially capable of paying a judgment, does not affect his legal responsibility for it. Thus, based on a fair reading of the policy language, the insurer is required to cover the excess judgment as bad faith damages, regardless of the insured's solvency, because the insured is legally liable for that judgment.

4. \textit{Even an Insolvent Insured is Damaged by an Excess Judgment}

An insured without assets "suffers injury when an excess judgment is obtained against him because [it will] potentially impair his credit, place a cloud on the title to his exempt estate, impair his ability to successfully apply for loans, diminish his reputation and future prospects, and the like."\textsuperscript{170} Indeed, ac-

\textsuperscript{165}. Id.


cording to Judge Breitel, author of the *Gordon* dissent, there may be "other tangible harms, such as the loss of the right to operate motor vehicles or to obtain employment or insurance."\(^{171}\)

Unpaid judgments have long been recognized to qualify as damages in a bad faith case.\(^{172}\) Thirty-one years ago, for instance, the Fourth Circuit in *Lee v. Nationwide Mutual Insurance Co.*,\(^{173}\) accepted the view that unpaid judgments are injuries in themselves, and should be the measure of damages in a bad faith case.\(^{174}\) In adopting this view, the court analogized unpaid judgments and unpaid medical expenses:

It would be the clearest kind of error for a . . . court to instruct a jury that they could not consider the element of damage consisting of medical, nursing and hospital expenses which had been incurred by the plaintiff but not paid. . . . [T]he analogy between that element of damage in a bodily injury suit, on the one hand, and the element of damage to the plaintiffs here, through suffering or 'incurring' this judgment, on the other hand, is so close as to be indistinguishable . . . .\(^{175}\)

Even when the excess judgment is discharged in bankruptcy, insurers who argue that insureds are not economically damaged ignore the negative impact that discharge has on the insured's "future financial dealings."\(^{176}\) Indeed, "the submission to bankruptcy to avoid the excess judgment may be a significant loss for those who are sensitive or for those who have a reasona-
ble likelihood of ever requiring credit."\textsuperscript{177}

5. The Public Interest in Spreading the Burden of Care

"[A] strong public interest [exists] in spreading the burden of caring for the injured."\textsuperscript{178} Our society has found it "desirable to utilize insurance as a means" to spread this burden, especially when the injured party is a victim of negligence.\textsuperscript{179}

When a negligence victim is injured catastrophically, to the point of requiring institutionalization, the need for spreading the burden of care is underscored. The cost of private institutionalized care rises significantly each year. Juries in negligence cases are free to award damages to cover the cost of private facility care as opposed to less expensive public facility care. Yet insurers sued for bad faith by insureds facing sizeable excess judgments argue that the judgments are inflated by private care cost figures. Insurers would prefer to use the public care cost figures.

Catastrophically injured victims should have the choice of where to obtain institutionalized care. Once a jury has assessed damages and an excess judgment is obtained against the insured, recovery of the excess judgment as damages in the subsequent bad faith action should not hinge on the insurer's argument that the medical expenses are inflated. It would be an injustice to force someone injured negligently by another to seek care at a public facility instead of a private facility merely because the insurer found in bad faith does not want to pay the full excess judgment. Moreover, it would be unfair to citizens to use public funds to support the incapacitated victim,\textsuperscript{180} when the burden should rest on the bad faith insurer.


\textsuperscript{179} Note, Direct-Action Statutes: Their Operational and Conflict-of-Law Problems, 74 Harv. L. Rev. 357 (1960).

\textsuperscript{180} Note, supra note 179, at 379.
6. **Judgment Rule Without Regard to Solvency is not Excessive: Many States Award Additional Compensatory and Punitive Damages**

Unlike most states, which view a breach of the implied covenant to settle claims in good faith as a tort\(^{181}\) as well as a breach of contract,\(^{182}\) New York views it as the latter only.\(^{183}\) Damages awarded in breach of contract cases are compensatory in nature. Plaintiffs in jurisdictions that label bad faith a tort and a breach of contract, however, have a wider range of damages available to them,\(^{184}\) including consequential damages,\(^{185}\) damages for mental anguish,\(^{186}\) and in some cases, punitive damages.\(^{187}\)

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181. Comunale v. Traders & General Ins. Co., 328 P.2d 198, 203 (Cal. 1958) (holding that breach of the good faith covenant to settle claims "sounds in both contract and tort"). For a discussion of Comunale, see Croskey, *supra* note 34, at 563.


185. For a discussion of consequential damages that can be awarded for the breach of an insurance contract, see Bob G. Freeman, Jr., *Reasonable and Forseeable Damages for Breach of an Insurance Contract, 21 TORT & INS. L.J. 108* (1986).


In Massachusetts, where a bad faith cause of action may be based upon a violation of that state's unfair claim settlement practices act, one award rendered by the state supreme court consisted of twice the amount of the excess judgment plus interest, costs, and attorney's fees.\(^{188}\) Thus, application of the judgment rule in all cases is actually a conservative approach to damages, when one considers the host of damages in addition to the excess judgment that are awarded in some jurisdictions.

7. Accident Victims Must be Fairly Compensated

An accident victim is “entitled to recover, as nearly as possible, compensation for the damages he suffers.”\(^{189}\) Depriving insureds of adequate compensation for bad faith damages simultaneously deprives accident victims of adequate compensation for their damages. Application of the Gordon solvency rule would deprive an accident victim of any real possibility of collecting on his judgment in instances when the insured happens to be insolvent or impecunious. Even critics of extra-contractual bad faith damages such as punitive damages and emotional suffering damages admit that liability for the amount of the excess judgment is fair compensation for insureds,\(^{190}\) and thus is fair compensation for accident victims.

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\(^{188}\) DiMarzo v. American Mut. Ins. Co., 449 N.E.2d 1189, 1202 (Mass. 1983) (awarding $20,000 policy limits plus interest with costs, $129,068 plus interest, doubled, $2,392 in costs, and $71,962 in attorney's fees, in case where excess judgment had been $149,068). Chief Judge Hennessey, who concurred in the opinion, remarked regretfully that the award was “anti-consumer” because the accident victim recovered almost four times the amount of the excess judgment, at the expense of other consumers insured by the defendant mutual insurance company. \(\text{Id. at 1204 (Hennessey, C.J., concurring). A mutual insurance company is “organized as an association; its members are the insureds who purchase the association’s policies. Historically, if a mutual company made a profit or suffered a loss, that profit or loss belonged to or was borne by the members . . . .”}\)


\(^{190}\) Scannell, \(\text{supra}\) note 9, at 379, 398.
Judge Breitel, in his Gordon dissent, cautions that situations exist in which the "magnitude of the [bad faith] excess judgment may be so great as to make unjust [the imposition of] liability up to its full amount." 191 Judge Breitel was apparently referring to the possibility that some bad faith verdicts will be too large to expect the insurer to cover. He omitted mention, however, of the appellate division's power to reduce bad faith verdicts it finds excessive. 192 If the verdict is left intact on appeal, no reason exists why the judgment rule should not be applied.

8. The Three-Part Rule Proposed in the Gordon Dissent is Complex and Impossible to Apply Fairly

Imposition of the Gordon dissent's three-part rule for bad faith damages is impractical. Jury trials, evidence, and charges are difficult enough for lay persons to fully comprehend without being assaulted by all of the variations that the three-part doctrine would require to be considered.

IV. Conclusion

New York should adopt the negligence standard for bad faith liability and the judgment rule for bad faith damages, regardless of the insured's solvency. In lieu thereof, the state legislature should improve the regulation of the insurance industry so that the public is protected. Legislation that would provide for these standards would be most helpful. Significantly, however, it should be recalled that the Appellate Division, Second Department recently adopted the judgment rule for measure of bad faith damages in Pavia v. State Mut. Auto Ins. Co. 193

192. See, e.g., Grimaldi v. Finch, 99 A.D.2d 920, 922, 473 N.Y.S.2d 45, 47 (3d Dep't 1984) (stating that appellate division has "discretionary power to overturn a jury verdict upon the ground that it is inadequate or excessive... where [it] is so disproportionate as to shock the conscience of the court."); Jandt v. Abele, 116 A.D.2d 699, 498 N.Y.S.2d 17 (2d Dep't 1986) (finding verdict excessive and granting new trial on issue of damages unless plaintiff consented to reduction in damages from $100,000 to $65,000).
193. See discussion supra notes 110-15.