Pace Law Review

Volume 12
Issue 3 *Fall 1992*

Article 2

September 1992

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Recommended Citation

Joan B. Lefkowitz, *New York Third Party Bad Faith: Is It a Plaintiff's Dream or a Defendant's Nightmare?*, 12 Pace L. Rev. 543 (1992)

DOI: https://doi.org/10.58948/2331-3528.1439

Available at: https://digitalcommons.pace.edu/plr/vol12/iss3/2

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

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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.[1] To the contrary, New York has been slow in providing clear definitions of what evidences bad faith[2] and

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† 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).

A first-party bad faith claim is brought by an insured who "seeks to recover a claim for coverage under its own insurance policy." Samovar of Russia Jewelry Antique Corp. v. Generali, 102 A.D.2d 279, 280, 476 N.Y.S.2d 869, 871 (1st Dep't 1984). New York's standard of third-party bad faith liability as set forth in Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 285 N.E.2d 849, 334 N.Y.S.2d 601, *cert. denied*, 410 U.S. 942 (1972), "does not apply to an action involving a first party claim by an insured against its own insurer." *Samovar*, 102 A.D.2d at 280, 476 N.Y.S.2d at 871. First-party bad faith is beyond the scope of this Comment. For a discussion of first-party bad faith, see Phyllis Savage, Note, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims-An Emerging Trend*, 45 FORDHAM L. REV. 164 (1976). Third-party bad faith in the context of excess insurers versus primary insurers is also beyond the scope of this Comment.

2. DiBlasi v. Aetna Life and Cas. Ins. Co., 147 A.D.2d 93, 98-99, 542 N.Y.S.2d 187, 191 (2d Dep't 1989). *See also* Knobloch v. Royal Globe Ins. Co., 38 N.Y.2d 471, 476, 344

what measure of damages is applicable[3] once bad faith has been proven. Consequently, in many instances New York insurers have escaped punishment for bad faith conduct. Given the inexorable increase in the size of personal injury verdicts[4] and the absence of a concomitant increase in the amount of automobile liability coverage[5] that people carry,[6] 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[7] 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. Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 440, 285 N.E.2d 849, 856, 334 N.Y.S.2d 601, 611, *cert. denied*, 410 U.S. 942 (1972) (Fuld, J., concurring).

4. Michael Hoenig, *Random Thoughts on Damage Issues*, N.Y.L.J., Dec. 9, 1991, at 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 suffered paraplegic injuries and a $20.7 million verdict awarded by a Bronx jury to a diabetic 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 REPORTER, Issue 18, Nov. 1991.

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 insurance 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 occurrence 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[8] 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.[9] They should be able to reasonably expect that the insurer will take no action that will burden them "with the crippling jeopardy of a[n] 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,[12] by bring-

liability he may incur to third parties." ASHLEY, *supra* note 5, at § 1:06.

8. Dennis E. Murray & Kirk J. Delli Bovi, *Prosecuting Bad Faith Claims, in* PROSECUTING AND DEFENDING INSURANCE CLAIMS 439, 443, 445 (Robert F. Cushman et al. 1989).

9. Thomas J. Scannell, Comment, *Excess Liability of Insurers for Bad Faith Refusal to Settle: A Boon to the Individual Insured that Works to the Detriment of Consumers*, 18 SUFFOLK U. L. REV. 377, 382 (1984). *See also* Guarantee Ins. Co. v. City of Long Beach, 106 A.D.2d 428, 482 N.Y.S.2d 522 (2d Dep't 1984) (ruling that insurer "must exercise good faith and fair dealing when [engaging] in settlement negotiations of liability claims) (citing Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 334 N.E.2d 849, 334 N.Y.S.2d 60, *cert. denied*, 410 U.S. 931 (1972)).

10. Henegan v. Merchants Mut. Ins. Co., 31 A.D.2d 12, 13, 294 N.Y.S.2d 547, 548 (1st Dep't 1968).

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,[13] may be the only way to deter insurer misconduct and fill the gaps created by regulatory oversight.[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* Oppel 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).

13. *DiBlasi*, 147 A.D.2d at 94, 542 N.Y.S.2d at 188-89.

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.[15] Because an insurer has complete control in responding to settlement offers within policy limits,[16] 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.[17]

15. STEPHEN S. ASHLEY, BAD FAITH LIABILITY: A STATE-BY-STATE REVIEW 10 (1987).

16. Kulak v. Nationwide Mut. Ins. Co., 47 A.D.2d 418, 419, 366 N.Y.S.2d 927, 928 (4th Dep't 1975), *rev'd on other grounds*, 40 N.Y.2d 140, 351 N.E.2d 735, 386 N.Y.S.2d 87 (1976).

17. JOHN APPLEMAN, 7C APPLEMAN'S INSURANCE LAW AND PRACTICE § 4713 (Berdal ed. 1979). *E.g.*, Home Ins. Co. v. North River Ins. Co., 385 S.E.2d 736, 741 (Ga. Ct. App. 1989) (reiterating that under Georgia law, "recovery is permitted for a negligent refusal to settle"); Surdyka v. DeWitt, 784 P.2d 819, 822 (Colo. Ct. App. 1989), *cert. denied*, (Dec. 18, 1989) (affirming trial court's use of the negligence standard for bad faith liability after insurer denied claim); Spray v. Continental Cas. Co., 739 P.2d 40, 42 (Or. Ct. App.), *review denied*, 743 P.2d 735 (Or. 1987) (affirming jury verdict of bad faith for insurer's negligence in failing to attempt to settle wrongful death claim); McNally v. Nationwide Ins. Co., 815 F.2d 254, 259 (3d Cir. 1987) (applying Delaware law) (noting that insurer must act like a "reasonable and prudent man with the obligation to pay all of the recoverable damages"); Ranger County Mut. Ins. Co. v. Guin, 723 S.W.2d 656, 659 (Tex. 1987) (affirming jury verdict of bad faith because insurer, in handling claims, failed to exercise "that degree of care and diligence which an ordinary prudent person would exercise in the management of his own business"); Allstate Ins. Co. v. Reserve Ins. Co.,

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.[18] 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."[19] 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.[20]

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.

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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.[21] 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."[22]

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.*,[23] the Supreme Court of Michigan reasoned that "bad faith should not be used interchangeably with either negligence or fraud."[24] Instead, the Michigan court ruled that to be liable, an insurer must have engaged in conduct that was "arbitrary, reckless, [or] indifferent"[25] 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.[26] If the

21. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 117 (1987).

22. Centennial Ins. Co. v. Liberty Mut. Ins. Co., 404 N.E.2d 759, 762 (Ohio 1980) (quoting Slater v. Motorists Mut. Ins. Co., 187 N.E.2d 45, 48 (1962)). *See also* Stevenson v. Union Std. Ins. Co., 746 S.W.2d 39, 41 (Ark. 1988) (requiring insurer conduct that is dishonest, malicious, or oppressive for bad faith cause of action to stand).

23. 393 N.W.2d 161 (Mich. 1986).

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 Court*[31] a decade earlier. For instance, it surveyed nineteen[32] jurisdictions that had also considered the issue, noting that seventeen had refused to authorize private causes of action.[33] 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."[34] Instead, the statute had been created to provide for ad-

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gation, in PROSECUTING AND DEFENDING INSURANCE CLAIMS 465, 471 (Robert F. Cushman et al. eds. 1989). *See also* Hartford Acc. & Indem. Co. v. Foster, 528 So. 2d 255, 264 (Miss. 1988).

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.

28. *E.g.*, Lough v. Insurance Co. of N. Am., 789 P.2d 576 (Mont. 1990); Robinson v. Continental Cas. Co., 406 S.E.2d 470 (W. Va. 1991).

29. 758 P.2d 58 (Cal. 1988), *rev'g* Royal Globe Ins. Co. v. Superior Court, 592 P.2d 329 (Cal. 1979).

30. CAL. INS. CODE § 790.03(h) (West Supp. 1992).

31. 592 P.2d 329 (Cal. 1979).

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-

ministrative 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

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key, *Bad Faith in California: Its History, Development and Current Status*, 26 TORT & INS. L.J. 561, 581-88 (1991).

35. *Moradi*, 758 P.2d at 62.

36. Van Dyke v. St. Paul Fire and Marine Ins. Co., 448 N.E.2d 357, 360 (Mass. 1983); DiMarzo v. American Mut. Ins. Co., 449 N.E.2d 1189, 1194 (Mass. 1983). *See also* Milazzo v. Sentry Ins., 691 F. Supp. 517 (D. Mass. 1987), *aff'd*, 856 F.2d 321 (1st Cir. 1988) (acknowledging accident victim's right to sue for violation of statute but granting insurer's summary judgment motion because it had not wrongfully refused to settle or defend case).

37. MASS. GEN. L. ch. 93A, § 1-11 (1991).

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 Indem. 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

40. Purdy v. Pacific Auto Ins. Co., 203 Cal. Rptr. 524, 532 (Cal. Ct. App. 1984).

41. State Farm Mut. Auto. Ins. Co. v. Schlossberg, 570 A.2d 328, 337 (Md. Ct. Spec. App.), *cert. denied*, 577 A.2d 50 (Md. 1990). Interest and costs are also recoverable. *Id.*

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.").

43. Carter v. Pioneer Mut. Cas. Co., 423 N.E.2d 188, 191 (Ohio 1981).

44. Murray & Delli Bovi, *supra* note 8, at 442.

45. This rule had early endorsement from Professor Keeton of Harvard Law School. *See* Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954).

46. Frankenmuth Mut. Ins. Co. v. Keeley, 447 N.W.2d 691, 709 (Mich. 1989) (Levin, J., dissenting), *later adopted in* Frankenmuth Mut. Ins. Co. v. Keeley, 461 N.W.2d 666 (Mich. 1990).

failure to settle.[47] 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.[48]

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.[49] Three years ago in *Roldan v. Allstate Insurance Co.*,[50] the Second Department reiterated a sixty-year-old precedent that "a plaintiff must show more than mere negligence on the part of the insurer"[51] to support a bad faith action.[52]

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.*[53] In *Gordon*, the Court of Appeals

47. Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 440, 285 N.E.2d 849, 856, 334 N.Y.S.2d 610, 611 (Fuld, J., concurring).

48. "If the [insurer] were to be obliged to pay more than the insured was capable of paying . . ., the [insurer] . . . would be charged punitive damages." *Gray*, 871 F.2d 1128 (citing Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 440, 285 N.E.2d 849, 856, 334 N.Y.S.2d 610, 611 (1972) (Fuld, J., concurring)). *See also* All State Vehicles v. Allstate Ins. Co., 620 F. Supp. 444, 447 (D.C.N.Y. 1985) (describing measure of damages in bad faith claim as punitive in nature).

49. Brown v. United States Fid. & Guar. Co., 314 F.2d 675, 677-78 (2d Cir. 1963) (construing New York law). According to *Brown*, "negligence alone is insufficient to render the insurer liable, [but] serious and recurrent negligence may be indicative of bad faith." *Brown*, 314 F.2d at 680.

50. 149 A.D.2d 20, 544 N.Y.S.2d 359 (2d Dep't 1989).

51. *Id.* at 37, 544 N.Y.S.2d at 369 (citing Best Bldg. Co. v. Employers' Liab. Assur. Corp., 247 N.Y. 451, 160 N.E. 911 (1928)).

52. *See, e.g.*, Shumalski v. Government Employees Ins. Co., 80 A.D.2d 975, 976, 438 N.Y.S.2d 609, 610 (3d Dep't), *aff'd*, 54 N.Y.2d 671, 425 N.E.2d 897, 442 N.Y.S.2d 508 (1981) (granting insurer's summary judgment motion to dismiss bad faith claim after plaintiff failed to list in her bill of particulars those actions by the insurer constituting more than mere negligence). One New York court explained that to apply the negligence standard would be to punish an insurer merely for taking a position that "is arguably correct at the time, [but] ultimately shown to be incorrect." Orion Ins. Co. v. General Electric Co., 129 Misc. 2d 466, 474, 493 N.Y.S.2d 397, 403 (Sup. Ct. Queens Cty. 1985).

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

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.[54] 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."[55]

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.*,[56] 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."[57]

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."[58]

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.*,[59] another insured with a $10,000 policy lost control of his car, injuring his passenger.[60] 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.[61]

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.[62]

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*,[63] 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

59. 38 N.Y.2d 471, 344 N.E.2d 364, 381 N.Y.S.2d 433 (1976).

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 436.

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.

63. 109 A.D.2d 935, 486 N.Y.S.2d 412 (3d Dep't 1985).

> 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."[70] 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."[71] 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.[72]

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 . . . ."[73] Another provision of the New York Insurance Law authorizes a monetary penalty of $500.00 for each violation.[74]

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*,[75] 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 . . . ."[76] 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"[77] and do not give rise to private bad faith claims, because they are labelled as wrongs against the public at large.[78] 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.[79]

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.*,[80] 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, be he of modest means or substantial, should then be able to use the results of that investigation in pressing a claim for punitive damages.[81]

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.*,[82] 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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77. *Id.* (quoting Frizzy Hairstylists, Inc. v. Eagle Star Ins. Co., 93 Misc. 2d 59, 403 N.Y.S.2d 389 (App. Term 2d & 11th Jud. Dists. 1977)).

78. Roldan v. Allstate Ins. Co., 149 A.D.2d 20, 43, 544 N.Y.S.2d 359, 374 (2d Dep't 1989).

79. Rein Monroe Ass'n v. Royal Ins. Co. of Am., 175 A.D.2d 582, 572 N.Y.S.2d 247 (4th Dep't 1991); Mavroudis v. State Wide Ins. Co., 121 A.D.2d 433, 503 N.Y.S.2d 133 (2d Dep't 1986); Kurrus v. CNA Ins. Co., 115 A.D.2d 593, 594, 496 N.Y.S.2d 255, 256 (2d Dep't 1985).

80. 164 A.D.2d 583, 565 N.Y.S.2d 776 (1st Dep't 1991).

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."[83] Although the term "judgment rule" does not appear within the opinion, *Henegan* is widely cited[84] 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]."[85]

In accordance with *Henegan*, the Second Circuit shortly thereafter in *Young v. American Casualty Co.*,[86] 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.[87] 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]."[88]

The dissenting opinion in *Gordon v. Nationwide Mutual Insurance Co.*[89] 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.

84. *See* Levantino v. Insurance Co. of N. Am., 102 Misc. 2d 77, 83, 422 N.Y.S.2d 995, 1000 (Sup. Ct. 1979); Gordon v. Nationwide Mut. Ins. Co., 37 A.D.2d 265, 270, 323 N.Y.S.2d 550, 555 (2d Dep't 1971), *rev'd on other grounds*, 30 N.Y.2d 427, 285 N.E.2d 849, 334 N.Y.S.2d 601 (1972); Young v. American Cas. Co. of Reading, Pa., 416 F.2d 906, 912 (2d Cir. 1969).

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.

86. 416 F.2d 906 (2d Cir. 1969), *cert. dismissed*, 396 U.S. 997 (1970).

87. *Id.* at 912.

88. *Id.* at 908.

89. 30 N.Y.2d 427, 441, 285 N.E.2d 849, 856, 334 N.Y.S.2d 601, 612, *cert. denied*, 410 U.S. 942 (1972).

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."[91] 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

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the court ordered the primary insurer to reimburse the excess insurer. In Kulak v. Nationwide Mut. Ins. Co., 47 A.D.2d 418, 366 N.Y.S.2d 927 (4th Dep't 1975), the Fourth Department followed *Gordon*, but that decision was reversed on other grounds when it reached the Court of Appeals. Kulak v. Nationwide Mut. Ins. Co., 40 N.Y.2d 140, 351 N.E.2d 735, 386 N.Y.S.2d 87 (1976).

91. DiBlasi v. Aetna Life & Cas. Ins. Co., 147 A.D.2d 93, 103, 542 N.Y.S.2d 187, 194 (2d Dep't 1989).

92. *Gordon*, 30 N.Y.2d at 451, 285 N.E.2d at 863, 334 N.Y.S.2d at 620 (Breitel, J., dissenting).

93. Levantino v. Insurance Co. of N. Am., 102 Misc. 2d 77, 85, 422 N.Y.S.2d 995, 1001 (N.Y. Sup. Ct. 1979).

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.[99]

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

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.*

102. 2 New York Pattern Jury Instructions — Civil 4:67 Comment, at 358 (Supp. 1992).

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. Scahill, *Bad Faith Litigation: A Window Period on the Horizon*, N.Y.S.B.J., Nov. 1991, at 31; Lipsig, *supra* note 81, at 3.

109. *Insurer Liable*, *supra* note 108.

110. Pavia v. State Farm Mut. Aut. Ins. Co., 183 A.D.2d 189, 589 N.Y.S.2d 510 (2d Dept. 1992).

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).

lien 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-

113. *Pavia*, 183 A.D.2d at 201, 589 N.Y.S.2d at 517 (quoting *Henegan v. Merchants Mut. Ins. Co.*, 31 A.D.2d 12, 13, 294 N.Y.S.2d 547, 548 (1st Dep't 1968).

114. *Id.*

115. *Id.*

116. Hartford Acc. and Indem. Co. v. Michigan Mut. Ins. Co., 92 A.D.2d 337, 340, 462 N.Y.S.2d 175, 178 (1st Dep't 1983), *aff'd*, 61 N.Y.2d 569, 463 N.E.2d 608, 475 N.Y.S.2d 267 (1984). *See also* discussion of the fiduciary standard of insurer conduct in ROBERT F. CUSHMAN ET AL., PROSECUTING AND DEFENDING INSURANCE CLAIMS § 17.9 (1989). *But see* William T. Barker et al., *Is an Insurer a Fiduciary to its Insureds?*, 25 TORT & INS. L.J. 1 (1989) (focusing on California law).

117. Murray & Delli Bovi, *supra* note 8, at 441.

118. *Hartford*, 92 A.D.2d at 340, 462 N.Y.S.2d at 178.

ment.[119] A conflict of interest[120] 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."[121] This conflict creates an obligation on the part of the insurer "to protect the interests of the assured equally with its own."[122]

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*,[123] 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."[124]

119. Hartford Acc. & Indem. Co. v. Foster, 528 So. 2d 255, 263 (Miss. 1988).

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).

121. *Hartford*, 528 So. 2d at 263 (citing Merritt v. Reserve Ins. Co., 110 Cal. Rptr. 511, 518-19 (1974)).

122. *Merritt*, 110 Cal. Rptr. at 518-19; Brown v. United States Fid. and Guar. Co., 314 F.2d 675, 678 (2d Cir. 1963) (construing New York law).

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"[129] standard for use in future bad faith actions. The impact of the ruling in that case, *Shamblin v. Nationwide Mut. Insurance Co.*[130] 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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(7th Cir. 1976)).

125. Hartford Acc. & Indem. Co. v. Foster, 528 So. 2d 255, 264 (Miss. 1988) (citing Lieberman v. Employers Ins. of Wausau, 419 A.2d 417, 422-23 (N.J. 1980)).

126. *Hartford*, 528 So. 2d at 265 (citing Cousins v. State Farm Mut. Auto. Ins. Co., 294 So.2d 272, 275 (La. Ct. App. 1974)). *Contra* Barker, *supra* note 118, at 2 (stating that insurer is required to give only equal, not paramount, consideration to insured's interests).

127. Scannell, *supra* note 9, at 385 (citing Rova Farms Resort, Inc. v. Investors Ins. Co. of Am., 323 A.2d 495, 509-10 (N.J. 1974) and Crisci v. Security Ins. Co., 426 P.2d 173, 177 (Cal. 1967)).

128. Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 784 (N.H. 1971).

129. Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990).

130. *Id.*

been found liable in bad faith for failure to settle the underlying tort action brought against its insured.[131] Nationwide appealed, arguing that negligence was too lenient a standard for the imposition of bad faith liability.[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.[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."[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."[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,"[136] because it arguably "writes unlimited

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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.

132. *Id.* at 773.

133. *Id.* at 776.

134. *Id.*

135. *Id.*

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."[137] 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[138] without being subject to a bad faith claim.[139] 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.*"[140]

> tlement situation. Conscious of potential bad faith liability and the ensuing award, and determined to avoid a finding of unreasonableness, an insurer may voluntarily place a higher value on each claim. This course of action may in turn lead to more claim settlements and a concomitant increase in the exposure of insurers, because settlement precludes a determination of no liability. Increased exposure through settlement, therefore, will cause insurers to increase liability insurance rates.

Id. at 397.

137. Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 784 (N.H. 1971).

138. St. Paul Fire and Marine Ins. Co. v. United States Fid. and Guar. Co., 43 N.Y.2d 977, 978, 375 N.E.2d 733, 404 N.Y.S.2d 552, 553 (1978).

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 insured'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."[141] 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."[142] 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."[143] 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"[144] 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."[145]

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,

141. New York State Legislative Annual 305 (New York Legislative Service, Inc. 1970).

142. IV New York Legislative Document Series, 1919-1976, No. 18, Joint Legislative Committee on Consumer Protection (5th annual report, March 31, 1970).

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.[146] According to the West Virginia Supreme Court in that case, *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."[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."[148] They reason that paying nonmeritorious claims, in which significant liability issues exist, drive up insurance rates for everyone.[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.[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."[151]

146. Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990).
147. *Id.* at 777.
148. Murray & Delli Bovi, *supra* note 9, at 444.
149. *Id.*
150. *Id.*
151. *Id.*

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.[152] 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.[153] 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.[154] Therefore, especially in such instances, the insurer should be prohibited from capitalizing on the insured's financial frailty.[155] The insurer should be held responsible for the excess judgment regardless of the fullness or emptiness of the insured's purse.[156] Any other rule for measuring damages results in a windfall to insurers fortunate enough to insure impoverished individuals.[157]

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152. Bourget v. Government Employees Ins. Co., 456 F.2d 282, 289 (2d Cir. 1972) (Oakes, J., dissenting).

153. Farmers Ins. Exchange v. Schropp, 567 P.2d 1359, 1369 (Kan. 1977).

154. Purdy v. Pacific Auto Ins. Co., 203 Cal. Rptr. 524, 532 (Cal. App. 1984). *See, e.g.*, State Farm v. Schlossberg, 570 A.2d 328, 329 (Md. Ct. Spec. App.), *cert. denied*, 577 A.2d 50 (Md. 1990), (insured filed for bankruptcy because he was unable to pay the excess judgment); Young v. American Cas. Co. of Reading, Pa., 416 F.2d 906 (2d Cir. 1969), *cert. denied*, 396 U.S. 99 (1970) (ruling that insured's paying part of excess judgment and filing bankruptcy will not inure to the benefit of the insurer).

155. *Id.*

156. Carter v. Pioneer Mut. Cas. Co., 423 N.E.2d 188, 191 (Ohio 1981) (citing Wolfberg v. Prudence Mut. Cas. Co., 240 N.E.2d 176, 176 (Ill. App. Ct. 1968)).

157. Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 782 (N.H. 1971), *overruling* Dumas v. Hartford Acc. & Indem. Co., 26 A.2d 361 (N.H. 1942).

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-

158. Bourget v. Government Employees Ins. Co., 456 F.2d 282, 288 (2d Cir. 1972) (Oakes, J., dissenting).

159. *Id.* at 288 (Oakes, J., dissenting).

160. *Carter*, 423 N.E.2d at 191 (quoting Wolfberg v. Prudence Mut. Cas. Co., 240 N.E.2d 176, 176 (Ill. App. 1968)).

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.

162. *Gordon*, 30 N.Y.2d at 448-49, 285 N.E.2d at 861, 334 N.Y.S.2d at 618-19 (Breitel, J., dissenting).

163. Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 563 (Mo. App. 1990).

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.[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.[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."[167] If a narrow meaning of the term had been intended, the insurer should have used specific language to make the intention "clearly known"[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."[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. *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."[170] Indeed, ac-

165. *Id.*

166. Ruder & Finn Inc. v. Seaboard Surety Co., 52 N.Y.2d 663, 671, 422 N.E.2d 518, 522, 439 N.Y.S.2d 858, 862 (1981).

167. Miller v. Continental Ins. Co., 40 N.Y.2d 675, 677, 358 N.E.2d 258, 260, 389 N.Y.S.2d 565, 567 (1976) (construing word "accident" in life insurance policy).

168. Sperling v. Great Am. Indem. Co., 7 N.Y.2d 442, 447, 166 N.E.2d 482, 485, 199 N.Y.S.2d 465, 469 (1960).

169. Gray v. Grain Dealers Mut. Ins. Co., 871 F.2d 1128, 1132 (D.C. Cir. 1989).

170. Carter v. Pioneer Mut. Ins. Co., 423 N.E.2d 188, 191 (Ohio 1981). For a succinct discussion of bad faith damages sustained by insolvent insureds, see Dumas v. State Farm Mut. Auto. Ins. Co., 274 A.2d 781, 782-83 (N.H. 1971). In *Dumas*, the New Hampshire Supreme Court overruled a 25-year-old precedent and authorized insureds to bring

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-

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bad faith claims without prior payment of the excess judgment or proof of the ability to pay it. *Id.* at 783. *See also* Lee v. Nationwide Mut. Ins. Co., 286 F.2d 295, 295 (4th Cir. 1961) ("even insolvent, the outstanding judgments, as constant and life-long threats to [the insured's] financial security and rating, . . . caused him almost immeasurable damages").

171. *Gordon*, 30 N.Y.2d at 451, 285 N.E.2d at 863, 334 N.Y.S.2d at 621 (Breitel, J., dissenting).

172. Wolfberg v. Prudence Mutual Cas. Co. of Chicago, 240 N.E.2d 176, 180 (Ill. App. 1968). According to the court in *Wolfberg*, "[t]he rule of damages is that incurrence is equivalent to outlay." *Id.* Thus, "the very fact of the entry of judgment itself constitutes damage and harm sufficient to permit recovery." *Id.* "[T]he proposition that the [insured's] assets [are] relevant or material has been specifically rejected." *Id.*

173. 286 F.2d 295 (4th Cir. 1961).

174. *Id.* at 298.

175. *Id.* (quoting Wessing v. American Indem. Co., 127 F. Supp. 775, 781 (D.C.W.D. Mo. 1955)).

176. Purdy v. Pacific Auto. Ins. Co., 203 Cal. Rptr. 524, 532 (Cal. Ct. App. 1984).

ble likelihood of ever requiring credit."[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."[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.[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,[180] when the burden should rest on the bad faith insurer.

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177. Gordon v. Nationwide Mut. Ins. Co., 30 N.Y.2d 427, 450, 285 N.E.2d 849, 862 N.Y.S.2d 601, 620 (1972) (Breitel, J., dissenting). Of course, declaration of bankruptcy prior to the tort trial is distinguishable from declaration afterwards. *See, e.g.*, Camp v. St. Paul Fire and Marine Ins. Co., 127 B.R. 879 (N.D. Fla. 1991) (relieving insurer of potential liability for bad faith failure to settle where insured doctor's debts were discharged in bankruptcy prior to his medical malpractice trial).

178. Bourget v. Government Employees Ins. Co., 456 F.2d 282, 288 (2d Cir. 1972) (Oakes, J., dissenting).

179. Note, *Direct-Action Statutes: Their Operational and Conflict-of-Law Problems*, 74 HARV. L. REV. 357 (1960).

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.

182. "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Kenneth E. Keller et al., *Emerging Trends in Non-Insurance Bad Faith Litigation, in* BAD FAITH LITIGATION AND INSURER VS. INSURER DISPUTES 1989 219, 222 (Practicing Law Institute 1989) (citing RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981)).

183. *Gordon*, 30 N.Y.2d at 437, 285 N.E.2d at 854, 334 N.Y.S.2d at 608-09. *See also DiBlasi*, 147 A.D.2d at 101, 542 N.Y.S.2d at 193 (stating "[t]he contractual, rather than tortious, foundation of a bad faith case was discussed in *Gordon*"). *Contra* Harris v. Standard Acc. and Ins. Co., 297 F.2d 627, 631-32 (2d Cir. 1961), *cert. denied,* 369 U.S. 843 (1962), in which Judge Lumbard considered the bad faith action to be a tort.

184. ROBERT H. JERRY II, UNDERSTANDING INSURANCE LAW 120 (1987). According to the Second Department, "no appellate decision in New York [] has affirmed . . . any damages other than the amount of the judgment in the underlying action in excess of the policy limits, plus interest." DiBlasi v. Aetna Life and Cas. Ins. Co., 147 A.D.2d 93, 100, 542 N.Y.S.2d 187, 192 (2d Dep't 1989).

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

186. *See* Crisci v. Security Ins. Co., 426 P.2d 173 (Cal. 1967) (allowing recovery for emotional distress damages); *contra* DiBlasi v. Aetna Life and Cas. Ins. Co., 147 A.D.2d 93, 542 N.Y.S.2d 187 (2d Dep't 1989) (noting that no New York authority exists for awarding emotional distress damages in a bad faith case, and declining to extend the law to do so).

187. Jerry, *supra* note 184, at 120 (1987). *Contra* Roldan v. Allstate Ins. Co., 149 A.D.2d 20, 54, 544 N.Y.S.2d 359, 374 (2d Dep't 1989) (striking cause of action for punitive damages in bad faith claim); AFIA v. Continental Ins. Co., 140 A.D.2d 167, 168, 527 N.Y.S.2d 420, 421 (1st Dep't 1988) (finding no authority in New York "for the thesis that an allegation of bad faith by an insurer in failing to settle, without more, gives rise to a claim for punitive damages"); Kulak v. Nationwide Mut. Ins. Co., 47 A.D.2d 418, 421, 366 N.Y.S.2d 927, 929-30 (4th Dep't 1975), *rev'd on other grounds,* 40 N.Y.2d 140, 351 N.E.2d 735, 386 N.Y.S.2d 87 (1976) (ruling that trial court had erred in permitting the jury to award punitive damages without evidence that insurer had acted with malice or

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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intent to harm the insured). *But see* Belco Petroleum Corp. v. AIG Oil Rig, Inc., 164 A.D.2d 583, 587, 565 N.Y.S.2d 776, 780 (1st Dep't 1991), *on subsequent appeal,* 579 N.Y.S.2d 24, 179 A.D.2d 516 (1st Dep't 1992) (rejecting *Roldan* and finding that New York Insurance Law § 2601 does not abolish the common law right to seek punitive damages for bad faith); Jolicouer v. American Transit Ins. Co., 159 A.D.2d 236, 237, 552 N.Y.S.2d 215, 216 (1st Dep't 1990) (affirming denial of summary judgment when question of fact existed as to whether bad faith "constituted a criminal indifference to civil obligations warranting punitive damages").

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. *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 . . . ." Ashley, *supra* note 5, at § 1:04.

189. Hernandez v. Great Am. Ins. Co. of N.Y., 464 S.W.2d 91, 94 (Tex. 1971).

190. Scannell, *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]

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191. *Gordon*, 30 N.Y.2d at 427, 285 N.E.2d at 844, 334 N.Y.S.2d at 620 (Breitel, J., dissenting).

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.