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INSURANCE LAW - BAD FAITH

The Top 10 Decisions From 25 Years of Bad-Faith Law

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July 1 marked the 25th anniversary of the effective date of Pennsylvania's insurance bad-faith statute, 42 Pa. C.S.A. Section 8371. For attorneys who litigate in the insurance field, this statute—which allowed insureds to sue their insurers for bad-faith conduct and, if successful, recover punitive damages, attorney fees, interest and costs—has had a tremendous impact. With a nod to another recent milestone, the recent retirement of longtime late-night host David Letterman, here is a “Top Ten List,” in chronological order, of the groundbreaking federal and state court decisions from the last 25 years addressing Section 8371.

‘Lombardo’

In *Lombardo v. State Farm Mutual Automobile Insurance*, 800 F. Supp. 208, 213 (E.D. Pa. 1992), an early question was whether the bad-faith statute created an independent cause of action, or simply provided for additional damages to supplement the traditional breach of contract action. The late Judge Daniel Huyett concluded that Section 8371 “create[d] a new cause of action for bad-faith conduct.” Subsequent courts would echo that analysis, and it became the accepted view that Section 8371 created an independent cause of action.

‘Strutz’

The statute provides that “an insured” may bring a bad-faith action. Questions soon arose as to who was included in



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the class of potential plaintiffs. *Strutz v. State Farm*, 609 A.2d 569 (Pa. Super. 1992), held that a plaintiff in a personal-injury action could not assert a bad-faith action against the defendant’s insurer under Section 8371, because there was no contractual relationship between the plaintiff and the defendant’s insurer. Similar limiting rulings followed,

including a decision that a treating physician could not sue an insurer under Section 8371 as a result of a denial of a first-party medical benefit claim.

‘Polselli’

Via six district court and three appellate court opinions, *Polselli v. Nationwide Mutual Fire Insurance*, 23 F.3d 747 (3d Cir. Pa. 1994), demonstrated the plethora of issues spawned by Section 8371. Although the statute failed to define “bad faith,” the U.S. Court of Appeals for the Third Circuit held that “in the insurance context, the term ‘bad faith’ has acquired a peculiar and universally acknowledged meaning.” Relying upon older common-law bad-faith cases, that court also held that an insured would have to prove Section 8371 bad faith by the “clear and convincing evidence” standard. And in a later proceeding, the Third Circuit ruled that a successful plaintiff under Section 8371 could recover attorney fees not only for the prosecution of the underlying contract claim but also for litigating the bad-faith claim itself.

‘Romano’

Pennsylvania’s Unfair Insurance Practices Act and related regulations do not afford an insured a private right of action, but in *Romano v. Nationwide Mutual Fire Insurance*, 646 A.2d 1228 (Pa. Super. 1994), the Superior Court held that a trial court may “consider, either sua sponte or upon the request of a party, the alleged conduct constituting violations of the UIPA or the regulations in determining whether an insurer ... acted in ‘bad faith.’” In later years, many

federal courts would come to question whether the UIPA is relevant in a bad-faith case, such as in *Dinner v. United Services Automobile Association*, 29 F. App'x 823, 827 (3d Cir. 2002).

'Terletsky'

Borrowing from Pennsylvania common-law precedent as well as various federal court opinions, the Superior Court in *Terletsky v. Prudential Property and Casualty Insurance*, 649 A.2d 680 (Pa. Super. 1994), succinctly set forth the burden of proof, standard of proof and definition of bad faith for purposes of a Section 8371 action: An insured must prove, by clear and convincing evidence, that the insurer "did not have a reasonable basis for denying benefits under the policy" and "knew or recklessly disregarded its lack of a reasonable basis in denying the claim."

'Birth Center'

Pennsylvania has long recognized a common-law bad-faith action, whereby a liability insurer refusing in bad faith to settle a suit against its insured within applicable policy limits could be liable for a verdict in excess of the policy limits. In *Birth Center v. St. Paul*, 787 A.2d 376 (Pa. 2001), a medical malpractice insurer agreed to pay a multimillion-dollar excess verdict against its insured. In the subsequent bad-faith action, the insurer argued that by paying the full verdict, it could not be found liable for bad faith. The Supreme Court disagreed, and upheld a jury award in favor of Birth Center for \$700,000 for lost profits and damaged reputation. Applying a traditional contract theory of liability, the court majority concluded that the insurer was "liable for the known and/or foreseeable compensatory damages of its insured that reasonably flow from the bad faith conduct of the insurer." This controversial opinion continues to resonate today on the subject of what damages may be recoverable in a bad-faith action.

'Mishoe'

Section 8371 says "if the court finds that the insurer acted in bad faith toward

the insured, the court may" award punitive damages and assess interest, attorney fees and costs. The Pennsylvania Supreme Court decided that for actions brought in state court, "the court" meant a judge, not a jury, so that the judge alone decides bad faith and whether to award punitive, attorney fees, costs and interest. Oddly, *Mishoe v. Erie Insurance*, 824 A.2d 1153 (Pa. 2003), does not govern the federal courts, where the Seventh Amendment requires that a jury decides issues of bad faith and punitive damages, as in *Klinger v. State Farm Mutual Automobile Insurance*, 115 F.3d 230 (3d Cir. 1997).

'Hollock'

Hollock v. Erie Insurance Exchange, 842 A.2d 409 (Pa. Super. 2004), was one of the earliest big punitive damage verdicts under Section 8371. Arising out of an underinsured motorist claim, the case was tried nonjury in Luzerne County, where the trial judge rendered a \$3 million verdict in favor of the plaintiff, which included a punitive damages award of \$2.8 million. The trial court's very detailed credibility and factual findings doomed the insurer's appeal, resulting in an en banc affirmation by the Superior Court, with the Supreme Court declining allocatur. Also noteworthy was the Superior Court's ruling that a plaintiff need not prove aggravating circumstances in order to obtain punitive damages under Section 8371; all that a plaintiff need show is that the insurer acted in bad faith.

'Toy'

Toy v. Metropolitan Life Insurance, 593 Pa. 20 (Pa. 2007), revealed a clash in opinions over the scope of Section 8371 among Supreme Court jurists. The plaintiffs alleged that Metropolitan Life had engaged in a scheme to market and sell life-insurance policies to consumers as retirement plans. The court majority agreed that there was no bad faith under Section 8371 because the alleged misdeeds occurred prior to the formation of the insurance contract, the existence of which is necessary for a bad-faith action. However, the late Chief Justice Ralph Cappy opined that "bad faith"

should only apply within the context of an insurer's denial of benefits under a policy, and thus would not apply to other types of misconduct, including post-litigation conduct of the insurer. Justice J. Michael Eakin, on the other hand, did not think Section 8371 was necessarily limited to claim denials, opining that the statute applied to "any act that would injure the insured's right to receive the benefit of the contract," possibly including post-litigation conduct. This issue remains unresolved today.

'Jurinko'

As decided by the landmark U.S. Supreme Court decisions in *Gore v. BMW*, 517 U.S. 559 (1996), and *State Farm v. Campbell*, 538 U.S. 408 (2003), the U.S. Constitution imposes limits upon punitive damage awards. *Jurinko v. Medical Protective*, 305 F. App'x 13 (3d Cir. 2008), was one of the first opinions to apply those standards to reduce a bad-faith punitive damages award. The jury found that the plaintiff's insurer violated Section 8371, and awarded \$1.7 million in compensatory damages and \$6.25 million in punitive damages. The Third Circuit ruled that the award was unconstitutionally excessive, and reduced the punitive award to approximately \$2 million—the amount of the excess verdict plus attorney fees.

For attorneys who handle bad-faith cases, whether for the policyholder or the insurance carrier, it has been an eventful quarter-century. While many issues involving Section 8371 have been resolved over that time period, as the above court decisions attest, numerous legal questions remain, and new ones seem to crop up with regularity. Thus practitioners and the courts are likely to find that the next 25 years will prove as action-packed as the last.