A Punitive Damage Award as the Consequential Damages in the Insured's Bad Faith Case

By Tom Hershewe[1]

In many cases, an insurance company's failure to settle the insured's case may result in the victim suing the insured for punitive damages. If the court enters judgment against the insured and awards punitive damages to the victim, should the court allow the insured to claim the punitive damage award against him or her as part the consequential damages in the bad faith case?

Yes. In most jurisdictions, a bad faith case is a tort action.[2] The overarching goal of the tort system is to place the injured person as nearly as possible in the condition that he or she would have occupied if the wrong had not occurred.[3] A bad faith case can accomplish this goal only if the insured is allowed to claim all damages—even punitive damages—arising from the insurance company's bad faith.

Bad faith law

An insurance company owes a fiduciary duty to its insured to act in good faith to resolve any claims against the insured.[4] If the insurance company fails to act in good faith, the insured may institute a bad faith case against it.[5] In most states, the insured's bad faith case against the

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[2] *Shobe v. Kelly*, 279 S.W.3d 203, 212 (Mo. App. 2009). The author relies primarily on Missouri law for many general propositions. For the most part, the author believes that Missouri law is consistent with the law in other states. Of course, a lawyer should verify that his or her state follows the same general propositions as Missouri.

[3] *Ingram Barge Company v. Lewis & Clark, Inc.*, 504 F. Supp. 2d 665, 678 (E.D. Mo. 2007).

[4] *Duncan v. Andrew Cnty. Mut. Ins. Co.*, 665 S.W.2d 13, 18 (Mo. App. 1983); see also generally Stephen Ashley, Bad Faith Actions Liability & Damages § 2:4 (2d ed.).

[5] *Johnson v. Allstate Ins. Co*., 262 S.W.3d 655, 662 (Mo. App. 2008).

insurance company is a tort action and not a contract action.[6] Thus, the insured's bad faith case is governed by the traditional tort law concepts of duty, breach, causation, and damages.[7]

To prove causation, the plaintiff must show both causation in fact and proximate cause.[8] A defendant's conduct is the cause in fact of a plaintiff's injuries where the injuries would not have occurred but for that conduct.[9] The defendant's conduct is the proximate cause of the plaintiff's injury when the injury is the natural and probable consequence of the defendant's negligence."[10] The court determines proximate cause by determining whether or not the plaintiff's injury was reasonably foreseeable.[11]

Based on these tort standards, it seems obvious that an insured should be able to claim an outstanding punitive damage award as a part of his or her compensatory damages in a bad faith case. The punitive damage award meets both the test for "but for" causation and proximate cause. After all, "but for" the insurance company's bad faith in refusing to defend or settle the insured's lawsuit, the insured would not be subject to a punitive damage verdict. Furthermore, it is reasonably foreseeable that the insurance company's failure to settle the case could expose the insured to a punitive damage award. So , if the goal of the tort system generally is to place the injured person as nearly as possible in the condition that he or she would have occupied if the wrong had not occurred[12] then the insured should be able to claim the punitive damage award as part of his or her compensatory damages.

The 8th Circuit has used these general tort law principles to reach this exact conclusion:

> In the present case, [the insured] cannot be made whole unless she is given the opportunity to recover the entire amount of the judgments obtained against her in

[6] Ashley, Bad Faith Actions Liability & Damages § 2:4-2:5.
[7] *Shobe*, 279 S.W.3d at 212.
[8] *Robinson v. Missouri State Highway & Transp. Comm'n*, 24 S.W.3d 67, 77-78 (Mo. App. 2000).
[9] *Id.*
[10] *Id*.
[11] *Id.*
[12] *Shobe*, 279 S.W.3d at 212; (quoting *Truck Ins. Exch.,* 162 S.W.3d at 93.

> the underlying state court action, including the punitive damages awards. . . . The jury found that, because of [the insurance company's] bad faith and negligence in failing to settle, [the insured] was exposed not only to compensatory damages in excess of the policy limits but also to punitive damages.[13]

Despite what appears to be a fairly straightforward application of general tort law, the supreme courts in California, Colorado, and New York have held that an insured may not include the underlying punitive damage award as part of his or her compensatory damages in the bad faith case.[14] These courts seem to concede that the insurance company's failure to settle the underlying lawsuit was the cause in fact of the punitive damage award against the insured[15] and was also reasonably foreseeable.[16]

Despite these concessions, these courts have held that public policy rationales prevent them from allowing an insured to claim the punitive damage award as part of the compensatory damages in the bad faith case.[17] These public policy rationales include: 1) a prohibition against allowing the insured to shift the cost of a punitive damage award to his or her insurance company when such damages are expressly excluded by the insurance policy;[18] (2) a fear that allowing an insured to claim those damages would defeat the purposes of punitive damages, which are to punish and deter the wrongdoer; and (3) an assumption that a contrary rule would violate the state's public policy against indemnification for punitive damages.[19] None of these public policy rationales justify the courts' holdings.

An insurance company's bad faith should subject it to extra-contractual damages regardless of whether or not the insurance policy expressly excludes those damages

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[13] *Carpenter v. Auto. Club Interinsurance Exch.*, 58 F.3d 1296, 1302-03 (8th Cir. 1995).
[14] *PPG Industries, Inc. v. Transamerica Insurance Company*, 20 Cal. 4th 310 (1999); *Lira v. Shelter Insurance Company*, 913 P.2d 514 (1996); *Soto v. State Farm Insurance Company*, 83 N.Y.2d 718 (1994).
[15] *Id*.
[16] *Soto*, 83 N.Y.2d at 723-724.
[17] *PPG*, 20 Cal. 4th 310; *Lira*, 913 P.2d 514; *Soto*, 83 N.Y.2d 718.
[18] *Lira*, 913 P.2d 517.
[19] *PPG*, 20 Cal. 4th 310; *Lira*, 913 P.2d 514; *Soto*, 83 N.Y.2d 718.

In *Lira*, the Colorado Supreme Court prohibited the insured from claiming the punitive damages award as part of his compensatory damages in a bad faith case because the insurance policy expressly excluded coverage for punitive damages.[20] The court held that "[t]he insured may not later utilize the tort of bad faith to effectively shift the cost of punitive damages to his insurer when such damages are expressly precluded by the underlying insurance contract."[21]

Colorado Supreme Court's reasoning, however, ignores the fact that in most jurisdictions the claim against an insurance company for bad faith is a tort action and not a contact action.[22] So, in a bad faith action, the insured is not suing to enforce the contract or receive the benefit of the contract. Rather the insured sues to recoup the extra-contractual damages that he or she incurred because of the insurance company's bad faith. By definition, extra-contractual damages are damages that are in addition to or outside the scope of the insurance policy.

For example, all insurance policies have a policy limit that exclude coverage or indemnification above that limit. No court would allow an insurance company to defend a bad faith case with an excess judgment by arguing that it was not liable for the difference between the policy limits and the judgment because the excess judgment was not covered by the policy. And, in fact, courts have consistently held that the insurance company is liable for the entirety of the insured's judgment (and interest on the judgment) including the excess judgment over the policy limits.[23] Courts have also held that the insured's damages can include reimbursement for any out of pocket attorney's fees, economic losses in credit, interest rates, and insurance, and even other intangible losses such as fears of bankruptcy.[24]

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[20] *Lira*, 913 P.2d at 514.
[21] *Id.* at 517.
[22] *Shobe*, 279 S.W.3d at 212; *Lira*, 913 P.2d at 519-520 (Lohr, J. dissenting).
[23] Ashley, Bad Faith Actions Liability & Damages § 8:3; *Shobe*, 279 S.W.3d at 212.
[24] *Shobe*, 279 S.W.3d at 212*; Rinehart v. Shelter Gen. Ins. Co.,* 261 S.W.3d 583, 590 (Mo. App. 2008) (stating that plaintiff testified to the emotional distress of having an excess judgment against him); Ashley, Bad Faith Actions

These losses are un-indemnified liabilities that would not otherwise be covered by an insurance policy. And, they are all liabilities that the insured faces only when the insurance company breaches it duty to settle a claim within policy limits. But no court would allow an insurance company to defend itself against those damages by arguing that the insurance policy does not cover them.

A punitive damage award is no different than any of these other losses, and the court should not treat it differently. The mere fact that a policy would exclude a certain type of damage like punitive damages should have no bearing on whether or not a court allows an insured to claim the damages as part of his or her consequential damages in the bad faith case.

Allowing an insured to seek compensation for a punitive damage award will not decrease the deterrence value of punitive damages

Next, these courts have also held that allowing an insured to claim the punitive damages as compensatory damages in a bad faith case would defeat the state's rationale for punitive damages, which is to punish the defendant and deter future misconduct.[25] These courts believe that if they allowed the insured to claim the punitive damage award in a bad faith case, the insured would be essentially "shifting" responsibility for the insured's morally culpable behavior to the insurance company.

This is speculative at best. It is virtually impossible to envision a situation where an insured would engage in punitive behavior on the off-hand chance that his or her insurance company would deny coverage or refuse to settle his or her case in bad faith simply so that the

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Liability & Damages § 8:3 (stating that a plaintiff's compensatory damages may include "lost profits, loss of a business, lost rents, loss of credit reputation, loss of property, and loss of use of property.").

[25] *PPG*, 20 Cal. 4th 310; *Lira*, 913 P.2d 514; *Soto*, 83 N.Y.2d 718.

insured could shift liability for his or her behavior to the insurance company.[26] And, in fact, even one of the courts in favor of the rule (New York) has acknowledged that "the deterrent value of the rule against indemnification may be somewhat attenuated in this context."[27]

The New York court attempted to deal with this concession by claiming that while the deterrent goal of punitive was attenuated in this context, the rule would still preserve the goals of condemnation and retribution.[28] The New York court's rationale, however, makes little sense because the tort system very clearly allows an insured to avoid a punitive damage award by having his or her insurance company settle the tort case before the jury awards punitive damages.

If that insured is allowed to avoid a punitive damage award when an insurance company acts in good faith—despite the condemnation and retribution goals—then an insured who has been subjected to a bad faith by the insurance company should have the same right.

The New York court seemed to acknowledge this discrepancy when it noted that:

> Our system of civil justice may be organized so as to allow a wrongdoer to escape the punitive consequences of his own malfeasance in order that the injured plaintiff may enjoy the advantages of a swift and certain pretrial settlement. However, the benefit that a morally culpable wrongdoer obtains as a result of this system, i.e., being released from exposure to liability for punitive damages, is no more than a necessary incident of the process. It is certainly not a *right* whose loss need be made subject to compensation when a favorable pretrial settlement offer has been wasted by a reckless or faithless insurer.[29]

Of course, the New York court is correct that a defendant does not have an absolute right to settle his or her lawsuit. Obviously, neither the court system nor the defendant can force the plaintiff to make a settlement offer. But, the rest of the court's reasoning is just wrong. Once the plaintiff does make a settlement offer (or multiple offers), the insured does have a right to have his or her insurance company engage in good faith in determining whether or not to accept the

[26] *PPG*, 20 Cal. 4th at 324 (Mosk, J. dissenting).
[27] *Soto*, 83 N.Y.2d at 724.
[28] *Id*.
[29] *Id.* at 725.

settlement. The entire point of bad faith litigation is to hold the insurance company accountable for the natural and probable consequences of its bad faith failure to settle the case.

A state public policy regarding the insurability of punitive damages is not relevant to a person's damages in a bad faith case

The courts have justified their decision on the basis that the state's public policy prohibits insurance coverage for punitive damages.[30] In those courts' view, classifying punitive damages as consequential damages in a bad faith case violates their state laws prohibiting indemnification of punitive damages.[31] This rationale, however, is not useful to other states for a couple of reasons.

First, very few states have a complete prohibition against the indemnification of punitive damages. In fact, a sharp split between the states exists regarding whether or not insurance may cover liability for punitive damages.[32] A recent Texas Supreme Court opinion summarizes the states' split on the issue.[33] The court determined that the highest courts in 45 states or their legislatures had addressed the insurability of punitive damages in some manner.[34] Of those 45 states, 25 states have held that their public policy does not prohibit insurance coverage for punitive damages.[35] On the other hand, eight states have adopted a broad prohibition against insuring punitive damages.[36] 12 other states have addressed the issue in limited circumstances and many of these states allow insurance coverage in certain circumstances.[37] Thus, based on

[30] *PPG*, 20 Cal. 4th at 317.
[31] *Id.* at 318.
[32] *City Products Corp. v. Globe Indem. Co.,* 88 Cal. App. 3d 31, 39 (Ct. App. 1979).
[33] *Fairfield Ins. Co. v. Stephens Martin Paving, LP*, 246 S.W.3d 653, 662 (Tex. 2008).
[34] *Id.*
[35] *Id.*
[36] *Id.*
[37] *Id.*

these findings, the courts' public policy rationale would not necessarily apply in certain contexts in most states.

Furthermore, even if a court were to conclude that the state's public policy prohibited coverage for punitive damages, the court should not take the next step by holding that the state's public policy prohibits an insured from claiming those as consequential damages in a bad faith case. For the most part, those states have held that it is against public policy to cover punitive damages because punitive damages are designed to punish the wrongdoer and deter future wanton conduct.[38] In other words, the court's public policy rationale is simply a regurgitation of its deterrence rationale. Of course, if classifying the punitive damage award as consequential damages in the bad faith case does not defeat the deterrence value of punitive damages then it cannot violate the state's public policy.

Finally, the court's public policy analysis confuses compensation with indemnification. The insurance company's payment to its insured in the bad faith case is not indemnification since the insurance company's duty to pay does not necessarily arise under the insurance policy's terms. Rather, the insured's payment to its insured in the bad faith case constitutes compensation for damages compelled under tort law.

Other policy considerations support allowing an insured to claim the punitive damages as consequential damages

There are also public policy reasons why a court should allow an insured to claim the punitive damage award as his or her compensatory damages. In the underlying action, the insurance company controls the defense and has the obligation to give consideration to both its

[38] *City Products,* 88 Cal. App. 3d at 39.

financial interests and its insured's financial interest.[39] A court's refusal to recognize the insurance company's liability to its insured for punitive damages would give an insurance company an incentive to breach its duty to settle when the victim's claims expose the insured to a small sum in compensatory damages, but a relatively large sum of punitive damages.[40] A rule that does not force the insurance company to bear the entire burden of failing to settle a case invites the insurance company to act to preserve its own self-interest at the expense of its insured's financial interests.[41] And, since the insurance company controls the defense, it could potentially force the insured to go to trial at unreasonably grave risk as for punitive damages.[42] Yet, the insurance company would know that the insured—and not it—runs the risk of paying the judgment because the insured cannot hold the insurance company liable for those damages in a bad faith case. In those cases, the insurance company would receive real premiums in consideration for an empty promise and would also avoid any payment in settlement.[43] And, in those cases, the insured would pay premiums in exchange for such a promise, but would have to pay a judgment that a settlement would have prevented.[44]

Conclusion

The overarching goal of the tort system is to place the injured person as nearly as possible in the condition that he or she would have occupied if the wrong had not occurred. To uphold that principle, the court should allow an insured to claim the underlying punitive damage award as part of his or her compensatory damages. If not, even after the bad faith case, the insured will

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[39] Ashley, Bad Faith Actions Liability & Damages § 3:15-3:23 (discussing the various rules among the jurisdictions).
[40] *PPG,* 20 Cal. 4th at 325 (1999) (Mosk, J., dissenting).
[41] *Id.*
[42] *Id.*
[43] *Id.*
[44] *Id.*

be in a worse position than he or she would have been in if the insurance company would have settled the case.