

# verdict

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## Were it only this simple...

### Are Tort Damages Available for Breach of an Insurance Contract Without Proof of Bad Faith?

by Michael M. Pollak

It would seem clear to most attorneys that in order to recover tort damages against an insurance carrier, an insured must prove that the carrier acted in bad faith. Bad faith (technically known as breach of the implied covenant of good faith and fair dealing) requires more than a breach of contract. It requires unfair or unreasonable conduct, not just mistaken judgment. *Waters v. United Services Auto. Assn.* (1996) 41 Cal.App.4th 1063, 1069-1070; *California Shoppers, Inc. v. Royal Globe Ins. Co.* (1985) 175 Cal.App.3d 1, 54-55. Since there is a large body of law discussing bad faith, it would seem obvious that an insured cannot recover tort damages against an insurance carrier without proof of bad faith. Why else would the tort exist? If a plaintiff could get tort damages for a simple breach of contract, there would be no need for bad faith law. The question discussed in this article is important because, in many cases, a plaintiff can prove a breach of contract but not bad faith.

The answer is complicated. Language in several opinions implies, but does not expressly state, that tort damages are recoverable only if the insured proves that his or her insurance carrier committed the tort of

bad faith. One such example is in the recent California Supreme Court case of *PPG Industries, Inc. v. Transamerica Ins. Co.* (1999) 20 Cal.4th 310:

“An insurer’s breach of the implied covenant of good faith and fair dealing ‘will provide the basis for an action in tort.’ (citation) Because breach of the implied covenant is actionable as a tort, the measure of damages for tort actions applies, and the insurance company generally is liable for ‘any damages which are the proximate result of that breach.’ (Citations.)” *Id.* at 315.

Typically, the plaintiff practitioner – like the courts – does not even realize there is an issue. The issue usually comes to light when it is time to request jury instructions. If the case is in state court, the plaintiff’s attorney often will request BAJI 10.90 and 10.92. BAJI 10.90 allows a jury to award all damages for breach of contract that will compensate the plaintiff for all detriment caused by the breach. The instruction, taken from Civil Code section 3300, does not limit contract damages to unpaid amounts under the insurance contract but instead allows the jury to award damages that were foreseeable at the time the contract

was formed. BAJI 10.90 leaves it up to the jury to determine what contract damages were foreseeable. BAJI 10.90 is a product of *Hadley v. Baxendale* (1884 Ex.) 156 Eng.Rep. 145, a case familiar to anyone who went to law school.

BAJI 10.92 allows a jury to award special damages when “special circumstances exist which cause some unusual injury to plaintiff.” The comment to BAJI 10.92 does not state whether the instruction should be given in insurance bad faith cases.

The question of whether tort damages are recoverable without proof of bad faith appears to be answered in another portion of BAJI, the comment to BAJI 12.92, concerning damages for bad faith. The comment states in part, “Without evidence of bad faith on [the] part of [the] insurer there can be no consequential damages, nor malice to base punitive damages. *Blake v. Aetna Life Ins. Co.* (1979) 99 Cal.App.3d 901, 918, 160 Cal.Rptr. 528, 538.” Were it only this simple. In reality, *Blake* does not say this at all. (Are you reading this, members of the BAJI Committee?)

Ordinarily, as a matter of law, emotional distress damages are not



recoverable for breach of contract. *Applied Equipment Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 Cal.4th 503. In *Applied Equipment*, the California Supreme Court, in holding that damages for emotional distress are generally not compensable in contract actions, emphasized the distinction between contract law and tort law: contract law exists to enforce legally binding agreements between parties; tort law is designed to vindicate social policy. A breach of contract becomes tortious only when that conduct violates an independent duty arising from principles of tort law. Contract damages are limited to those foreseeable at the outset. Tort damages are awarded to compensate a plaintiff for injuries suffered. *Id.* at 514-516. In other cases, exceptions were made for contracts that directly affect the comfort, happiness, or personal welfare of the non-breaching party, such as mortuary contracts (*Chelini v. Nieri* (1948) 32 Cal.2d 480, 482) and a contract to entrust jewelry of sentimental value (*Windeler v. Scheers Jewelers* (1970) 8 Cal.App.3d 844).

### State Farm v. Allstate

*State Farm Mut. Auto Ins. Co. v. Allstate Ins. Co.* (1970) 9 Cal.App.3d 508, 527-528 allowed tort damages for breach of an insurance contract. *State Farm* involved the obligations of five insurance companies for the payment of judgments against a common insured. The appeal also concerned damages to the insured for breach of an insurance carrier's duty to defend. Although the action was filed by State Farm, the portion of the appeal relevant here concerned the insured's cross-complaint against Allstate. The trial court awarded the insured emotional distress damages for breach of contract. On appeal,

Allstate argued that, because it merely breached a contract and did not act in bad faith, it should not be liable for the insured's emotional distress damages arising from its failure to defend. The court of appeal held that the award for emotional distress damages was proper under a breach of contract theory. Quoting from *Chelini v. Nieri, supra*, the court stated: "Whenever the terms of a contract relate to matters which concern directly the comfort, happiness, or personal welfare of one of the parties, he may recover damages for physical suffering caused by its breach." *Id.* at 527-528. The court then relied on *Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 434, for the proposition that a liability insurance policy is such a contract.

The problem is that it is not clear that *Crisci* says that. In *Crisci*, an insurance carrier failed to settle within policy limits, even though there was considerable evidence that the third party claimant likely would recover a judgment in excess of those limits. After the excess judgment, the insured suffered financial and emotional distress, including suicide attempts. The insured then sued for breach of contract and bad faith. *Crisci* must be read carefully. In *Crisci*, the California Supreme Court, citing *Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, stated that an insurance carrier breaches the implied covenant of good faith and fair dealing (i.e., commits the tort of bad faith) when it fails to accept a reasonable settlement offer. *Crisci, supra*, 66 Cal.2d at 430. The court noted that an amicus curiae had argued that, whenever an insurance carrier receives an offer to settle within the policy limits and rejects it, the carrier should be held liable for the amount of any final judgment in excess of the policy limits (i.e.,

whether or not the carrier acted in bad faith). *Id.* at 430. The Supreme Court stated that it need not decide whether to adopt the rule, because the evidence showed that the insurance carrier was unreasonable by not considering the insured's interests in the proposed settlement (i.e., it acted in bad faith). Again citing *Comunale*, the *Crisci* court stated that wrongful refusal to settle has generally been treated as a tort. *Id.* at 432-433.

The *Crisci* court made it very clear that the insured could recover emotional distress damages because the insurance carrier had committed a tort, not because of a mere breach of contract:

"The general rule of damages in tort is that the injured party may recover for all detriment caused whether it could have been anticipated or not . . . . The commonest example of the award of damages for mental suffering in addition to other damages is probably where the plaintiff suffers personal injuries in addition to mental distress as a result of either negligent or intentional misconduct by the defendant.

....

We are satisfied that a plaintiff who as a result of a defendant's tortious conduct loses his property and suffers mental distress may recover not only for the pecuniary loss but also for his mental distress." *Id.* at 433-434.

After having held that the plaintiff's emotional distress damages were recoverable because of the insurance carrier's tort, and after having expressly left open the proposed rule that an insurance carrier that does not settle within policy limits should automatically be held liable for an excess judgment, the *Crisci* court concluded with a cryptic statement:

"Recovery of damages for mental suffering in the instant case does not mean that in every case of breach of contract the injured party may recover

such damages. Here the breach also constitutes a tort. Moreover, plaintiff did not seek by the contract involved here to obtain a commercial advantage but to protect herself against the risks of accidental losses, including the mental distress which might follow from the losses. Among the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental loss, and recovery of damages for mental suffering has been permitted for breach of contracts which directly concern the comfort, happiness or personal esteem of one of the parties. (*Chelini v. Nieri*, 32 Cal.2d 480, 482.)” *Id.* at 434.

This closing comment in *Crisci* is confusing in light of the court’s clear discussion beforehand, because the closing comment can be read in isolation to mean that tort damages are recoverable for breach of an insurance contract. It was this language that apparently led the court in *State Farm v. Allstate* to have allowed tort damages for breach of an insurance contract.

*State Farm v. Allstate* was cited in dicta in *Aero-Crete, Inc. v. Superior Court* (1993) 21 Cal.App.4th 203, 212, fn. 4, for the proposition that emotional distress damages are recoverable against an insurance company that wrongfully refuses to defend regardless of whether the action sounds in tort or contract.

The question left open in *Crisci* appears to have been resolved: An insurance carrier who fails to accept a policy limit demand is liable for the excess portion of the judgment and tort damages only if the insurance carrier acts unreasonably, that is, in bad faith. In *Walbrook Ins. Co., Ltd. v. Liberty Mutual Ins. Co.* (1992) 5 Cal.App.4th 1445, the court stated:

“The Supreme Court has never gone so far as to hold that the insurer’s duty of good faith imposes ‘a categorical obligation on a carrier to accept a settlement demand regardless of cost.’ (citation) In

fact, the court has twice declined to adopt what in effect would be a rule of strict liability for insurers who refuse settlement offers within policy limits. (See *Johansen v. California State Auto. Assn. Inter-Ins. Bureau*, *supra*, 15 Cal.3d 9 at p. 17, fn. 6; *Crisci v. Security Ins. Co.*, *supra*, 66 Cal.2d 425 at pp. 430-431.)” *Id.* at 1459.

(There is an exception where the carrier denies coverage. In that instance it “acts at its own risk.” *Samson v. Transamerica Ins. Co.* (1981) 30 Cal.3d 220, 237.)

Other cases have held that a carrier is liable for tort damages when it breaches its implied covenant of good faith and fair dealing by unreasonably refusing to accept a settlement offer within policy limits. As such, those cases impliedly state that a carrier is liable for tort damages only when it acts in bad faith. *Commercial Union Assur. Cos. v. Safeway Stores, Inc.* (1980) 26 Cal.3d 912, 916-917; *California Shoppers, Inc. v. Royal Globe Ins. Co.*, *supra*, 175 Cal.App.3d 1.

### **Cases Denying Tort Recovery For Breach of An Insurance Contract**

*California Shoppers, Inc. v. Royal Globe Ins. Co.*, *supra*, 175 Cal.App.3d 1 and *Ray v. Farmers Ins. Exchange* (1988) 200 Cal.App.3d 1411 both denied recovery for breach of contract for any damages beyond amounts owed under the contract. In *California Shoppers*, a third party case, the insured contended that as a result of his carrier’s breach of the duty to defend, it had to sell its business for much less than it was worth. At trial, the jury awarded \$3 million as compensation for the value of the lost business. The court of appeal held that the award could not be sustained as consequential damages for breach of contract. The court stated that the measure of damages in tort (Civil Code sec-

tion 3333) is broader than that in contract (Civil Code section 3300). The *California Shoppers* court stated:

“[T]he rule clearly applicable is that measuring the scope of recoverable damages in breach of contract cases must be restricted to such damages as were actually contemplated by or within the reasonable contemplation of the parties at the time they entered into the contract. Moreover, this measure, i.e., ‘within the reasonable contemplation of the parties,’ (citation) is something much more limited in scope than that applied in tort cases where the fiction of foreseeability of the risk is one of many factors woven into the complicated fabric which finally is labeled proximate cause in such cases.” *Id.* at 59. (See also *Pacific Union Club v. Commercial Union Assur. Co.* (1910) 12 Cal.App. 503, 508.)

The *California Shoppers* court stated that, to bring an award of \$3 million of consequential damages within that rule, it would be necessary to hold that the parties contemplated, at the time the insurance was purchased, that the insured would engage in the conduct complained of in the underlying action; that the insured would be sued for that conduct; that the carrier would decline coverage; that the insured would be forced to sell its business in order to pay attorney’s fees; and that the carrier was aware of the insured’s long-range plan to sell the business at a later date after it had greatly appreciated in value. *Id.* at 60. The court stated that there was no evidence that a breach of the contractual duty to defend contemplated that the insured would lose \$3 million under the insured’s theory of how it suffered an economic loss. Accordingly, the court of appeal reversed the award for economic loss.

*Ray v. Farmers*, *supra*, also explained the difference between damages recoverable for a breach of contract and damages recoverable in tort. In *Ray*, the insured submitted a first party auto col-

lision claim. The carrier paid the insured for the cost of repairing his car but not for the decline in market value of his car because of its status as a wrecked vehicle. The insured sued for breach of contract only. The court of appeal held that the insurance carrier owed only for the costs of repairing the vehicle and that, on his breach of contract action, the insured could not recover for any tort damages:

“Ray’s reliance on *Merchant, Etc. Assn. v. Kellogg E. & D. Co.* (1946) 28 Cal.2d 594, at page 600, for the proposition that Farmers is liable for diminution in market value of a repaired car is misplaced. *Merchant, Etc. Assn.* involved liability for damages in tort, not in contract. Rules applicable to recovery in tort do not apply to an action on a contract of insurance. (6 Appleman, *Insurance Law And Practice* (1972) §3881, p. 360, fn. 5.45.)” 200 Cal.App.3d at 1417.

*California Shoppers* and *Ray* thus stand for the proposition that tort damages are not recoverable for breach of an insurance contract.

## Reconciling Conflicting Authority

*Crisci* held that insurance carrier committed the tort of bad faith; and damages were awarded based on tort. The confusing statement at the end of the *Crisci* opinion that apparently led the *State Farm v. Allstate* court astray was therefore mere dicta. Also, because the question left open in *Crisci* – whether a carrier that failed to accept a policy limit demand was automatically liable for the excess portion of the judgment – has been resolved in favor of the carriers, the

dicta at the end of the *Crisci* opinion should be ignored. Thus this author believes that *State Farm v. Allstate* was wrongly decided.

The rule of *California Shoppers* and *Ray* – that an insurance carrier that breaches its contract but does not act in bad faith is liable only for contract damages – is fair. It not only gives effect to an entire body of bad faith law that has taken for granted that tort damages are not recoverable without proof of bad faith, but more importantly prevents an insurance carrier from being penalized when it does not act unreasonably. Insurance premiums are based on the risk insured, not on an insured’s susceptibility to financial or emotional distress. If the rule were otherwise, so that, for example, a carrier issuing collision coverage had to pay damages for emotional and financial harm every time it was found to have underpaid the collision claim, carriers would have to either determine premiums by calculating the insureds’ vulnerability to emotional and financial harm, or else they would have to overpay claims in order to avoid those damages. In either instance, the cost of insurance would needlessly rise.

On causes of action for breach of an insurance contract, BAJI 10.90 should be modified to state that the jury is not permitted to award tort damages. BAJI 10.92 should not be given concerning causes of action for breach of an insurance contract. ▼

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