

Issue Analysis

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First-Party Insurance Bad Faith Liability: Law, Theory, and Economic Consequences

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Executive Summary

The idea that insurers should be penalized for unfair claim settlement practices involving first-party insurance coverage is a relatively recent development in the long history of insurance law. Today, many states allow for recovery of consequential, or incidental, damages, attorney's fees, and prejudgment interest, as well as the benefit owed under the policy, in a first-party insurance bad faith case.

In theory, allowing policyholders to recover damages over and above the insurance benefit owed may provide insurers with added incentives to engage in fair and efficient claims settlement, enhancing the efficiency of contracting in insurance markets to the advantage of both policyholders and insurers. However, many observers have raised concerns that the development of the law of first-party bad faith and its implementation by the courts have not achieved uniformly desirable results. Critiques have centered on issues that arise from the expansion of bad faith actions into the area of tort law. A majority of states that recognize insurance first-party bad faith liability allow actions under tort law rather than contract law despite the existence of a contract, and without requiring the policyholder to allege a traditional tort such as fraud or intentional infliction of emotional distress. This increases both potential damages and the uncertainty of judgments, and changes the dynamics of the bad faith litigation process. Moreover, the variation in state legal regimes increases the uncertainty and complexity of the legal environment in which insurance companies must settle claims.

This paper provides a discussion and analysis of first-party insurance bad faith liability. It traces the evolution of first-party insurance bad faith law, and identifies and discusses the various approaches that have been taken by the courts and state legislatures. The paper identifies a number of potential adverse effects of excessive or uncertain first-party bad faith liability claims for insurance markets, and analyzes insurance claims data to investigate the empirical importance of these effects. *The empirical evidence suggests that bad faith remedies function less than optimally in practice. Specifically, the evidence supports the idea that allowing tort liability for insurance bad faith results in reduced insurer incentives to challenge disputable claims, and in higher claims costs as a result.*

In light of these findings, the paper discusses and evaluates state legislative expansions of policyholder remedies for first-party bad faith that occurred in 2007 and 2008. *The paper concludes that certain features of recent legislation in several states will create incentive distortions that may lead to greater uncertainty and higher costs for insurers, higher levels of insurance fraud, and correspondingly higher insurance premiums for consumers.*

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Introduction

Origins of First-Party Bad Faith

Historically, insurers were not penalized under common law for unfair claim settlement practices including, for example, unnecessarily delaying the payment of a policy benefit or withholding payment of a rightful policy benefit. Pursuant to the nineteenth-century English common law rule articulated in *Hadley v. Baxendale*,¹ the policyholder was allowed to recover only those damages that were in the contemplation of the parties to the contract at the time the policy was purchased. This meant that damage awards could not exceed the amount specified in the insurance policy. Even if the breach of contract was intentional on the part of the insurer, the policyholder was not entitled to prejudgment interest on the amount due under the policy, legal expenses incurred in pursuing a breach of contract remedy, or consequential (incidental) damages for economic loss and mental distress. With perhaps the exception of large commercial insureds, the legal system provided little incentive for most policyholders to challenge an insurer over an unpaid claim.

In the early 1900s, state legislatures began to respond to this situation by enacting statutes that provided for the recovery of prejudgment interest and legal expenses in those cases where the insurer acted unreasonably in the processing of a claim. While enactment of these statutes constituted the first recognition that a problem existed, only about one-fourth of the states had enacted statutes providing for prejudgment interest and legal expenses as late as 1951.² However, by 1959, all states had adopted the Model Unfair Trade Practices Act developed and promulgated by the National Association of Insurance Commissioners (NAIC). This model act primarily addressed the marketing practices of insurers, and it was not until 1972 that an amendment pertaining to unfair claim settlement practices was incorporated into

the model legislation. Today, this model legislation, or some variant of it, has been adopted by all states.

The Unfair Trade Practices model legislation prohibits certain acts by an insurer only when committed flagrantly and in conscious disregard of the statute, or with such frequency as to indicate a general business practice. Prohibited acts include, for example, knowingly misrepresenting to insureds policy provisions relating to coverage at issue, failing to acknowledge promptly a communication from a policyholder relating to a claim, failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims, and not attempting in good faith to effectuate prompt, fair, and equitable settlement of submitted claims in which liability has become reasonably clear.³

The model legislation was silent as to whether it creates a private cause of action. This meant that the insured's only recourse was to file a complaint with the state insurance department. Given that the insured could not file a suit for money damages, hiring an attorney and compelling discovery to obtain proof that the insurer had "flagrantly, and in conscious disregard of the statute committed a prohibited act" was often not practical. In the absence of such proof, state insurance departments were unlikely to undertake remedial action unless numerous similar complaints were received that indicated the prohibited act was being committed by the insurer with such frequency as to indicate a general business practice.

To strengthen the position of insureds and further deter insurer misconduct, courts and state legislatures across the country began to allow the filing of private causes of action against insurers alleging unfair claim settlement practices. This move was based on the "private attorney general" concept, which holds that insureds are in the best position to police the insurance industry

with respect to unfair claim settlement practices. The ability of the insured to obtain compensatory damages (including consequential, or incidental, damages for economic loss and mental distress) created an incentive for policyholders who believed they were treated unfairly to bring lawsuits against insurers.

Specifically, courts and state legislatures across the country adopted three distinct procedures and standards to facilitate the filing of private causes alleging unfair claim settlement practices:

Tort Action Based Solely on Bad Faith

Today, a majority of jurisdictions permit a tort action based solely on breach of the implied covenant of utmost good faith (i.e., bad faith). Policyholders are not required to allege an independent tort such as fraud or intentional infliction of emotional distress in order to recover under the tort laws. The general rule of damages in tort is that the injured party may recover for all harm or injuries incurred, regardless of whether they could have been anticipated. Assuming that the conduct giving rise to liability was particularly egregious, punitive damages may be awarded.

Contract Action with Broad Definition of Damages

At least nine states confine the good faith/bad faith inquiry to the realm of contract, but broadly define damages to include both general damages (i.e., those following naturally from the breach) and consequential, or incidental, damages (i.e., those reasonably within the contemplation of, or reasonably foreseeable by, the parties at the time the contract was made).⁴ Consequential damages may reach beyond the strict contract terms and include prejudgment interest and legal expenses, and damages for economic loss and mental distress. An independent tort such as fraud or intentional infliction of emotional distress must be alleged in order to make a claim for punitive damages.

Statute

At least 25 states recognize the right to file a private cause of action alleging bad faith based on a statute and judicial recognition of an implied, private cause of action under an Unfair Trade Practices Act that includes an unfair claim settlement practices provision.⁵ Damages may include prejudgment interest and legal expenses, consequential, or incidental, damages for economic loss and mental distress, and, in some instances, punitive damages.

Legal Development of Tort Action Based Solely on Bad Faith

Among jurisdictions that permit a tort action based solely on bad faith, at least 10 have adopted a “negligence” standard for determining whether an insurer has acted in bad faith; at least 15 jurisdictions have adopted an “intentional tort” standard; and one (Arkansas) has adopted a “quasi-criminal” standard. We discuss each of these standards as they relate to first-party bad faith claims.

Negligence Standard

A “negligence” standard was first adopted in a third-party liability insurance case in California.⁶ Courts following this approach have reasoned that insurers must be held to a very high standard because of their disproportionate ability to influence the acceptance or rejection of a settlement offer made by a claimant. In particular, the standard demands that an insurer consider the insured’s interest in addition to its own in deciding whether to accept or reject the settlement offer.⁷

Because claim-handling practices that are arguably unreasonable can extend beyond third-party claims to first-party claims, plaintiffs’ attorneys soon asserted that first-party insureds also should be permitted to file a tort action based solely on bad faith. Insurers countered that breach of contract should be the exclusive cause of action for first-party insurance bad faith actions because the relationship between an insurer and a policyholder in a first-party context differs

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In adopting the negligence standard, the court reasoned that insurers have “a duty not to withhold unreasonable payments due under a policy.”

from that in a third-party context. In a first-party context, the relationship might lead to a dispute that could be characterized as “adversarial” (i.e., first-party cases simply involve disputes over the terms of coverage, whether a loss occurred, or the value of the loss). On the other hand, the relationship between an insurer and a policyholder in a third-party context could be characterized as “fiduciary” (i.e., the policy agreement transfers from the insured to the insurer the authority to accept or reject on behalf of the insured a settlement offer presented by a claimant; this transfer of authority and the attendant possibility of a judgment that exceeds the policy limits create a fiduciary relationship between the insurer and the policyholder).

In the landmark *Gruenberg v. Aetna Insurance Company* decision,⁸ the California Supreme Court rejected an insurer’s argument that third-party cases are different from first-party cases, extending the bad faith tort to first-party insurance coverage disputes. In *Gruenberg*, the policyholder’s business was destroyed in a fire. The claim representative informed the fire department investigator that excessive coverage was in place, suggesting that the policyholder intentionally caused the loss. Shortly thereafter, the policyholder was charged with arson. Based on the advice of defense counsel, the policyholder initially declined to submit to an examination under oath, which was requested by the insurer shortly after the fire pursuant to the “Your Duties After Loss” provision contained in its policy. At a preliminary hearing concerning the criminal matter, charges were dismissed for lack of probable cause. Shortly after disposal of the criminal matter, the policyholder informed the insurer that he was now prepared to submit to an examination under oath. The insurer declined to depose the policyholder based on its contention that because the policyholder had previously breached a condition in the policy requiring the insured to submit to an examination under oath, the coverage was void.

Arguing that his insurer had unreasonably suggested that he intentionally caused the loss, the policyholder sought both compensatory and punitive damages. In adopting the negligence standard in this first-party case, the court reasoned that the third-party context cannot be distinguished from the first-party context. In third-party claims, the insurer has a “duty to accept reasonable settlements,” whereas in a first-party claim, the insurer has a “duty not to withhold unreasonably payments due under a policy.”⁹ The court observed that “these are merely two different aspects of the same duty.”¹⁰ When an insurer “[refuses], without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.”¹¹ At least 11 states have followed California’s lead by adopting the negligence standard for first-party bad faith claims.¹²

Intentional Tort Standard

An “intentional tort” standard was first adopted in *Anderson v. Continental Insurance Company*, a first-party homeowner’s insurance case in Wisconsin in 1978.¹³ Like the California Supreme Court in *Gruenberg*, the Supreme Court of Wisconsin ruled that the theoretical underpinnings of the bad faith tort in the third-party claim context apply equally in the first-party claim context. Most importantly, however, the Wisconsin Supreme Court departed from the California legal precedent, ruling that “the tort of bad faith is not a tortious breach of contract. It is a separate intentional wrong, which results from a breach of duty imposed as a consequence of the relationship established by contract.”¹⁴

This subtle distinction is the foundation of the intentional tort standard: the denial of a claim may constitute a breach of contract, but not constitute bad faith. In other words, an insurer is entitled to contest a claim so long as it has a reasonable basis grounded in law or fact. Whether the insurer ultimately is correct in its position is of no consequence

in resolving the bad faith issue. Denying a claim's validity as "fairly debatable" does not necessarily constitute bad faith. Rather, the issue is first, whether the insurer undertook a proper investigation, and second, whether the results of the investigation are subjected to a reasonable evaluation and review. If neither of these conditions is met, the insurer will have failed to establish that its denial of the claim was reasonably grounded in law or fact.

Because the intentional tort standard is more stringent than the negligence standard, insurers are more likely to be successful in pretrial pleadings. Judges are more likely to dismiss as a matter of law an allegation of bad faith that involves nothing more than an insurance coverage dispute.

Moreover, the Wisconsin court ruled that "there must be a showing of an evil intent deserving of punishment or of something in the nature of special ill-will or wanton disregard of duty or gross or outrageous conduct" in order to recover punitive damages.¹⁵ The court added, "[An insurer] must not only intentionally have breached [its] duty of good faith, but in addition must have been guilty of oppression, fraud, or malice"¹⁶ This heightened standard means that only a small subset of bad faith claims will warrant punitive damages. Direct proof must be presented establishing either that the misconduct was extreme or that the misconduct was the result of a deliberate company-wide practice of underpaying claims.

At least 15 jurisdictions have followed Wisconsin's lead by adopting the intentional tort standard for first-party bad faith claims.¹⁷

Quasi-Criminal Standard

In 1984, the Arkansas Supreme Court overturned a jury verdict that seemed to epitomize the extreme result that can occur if stringent standards of conduct and proof are not required to support an award of

punitive damages in a first-party bad faith case.¹⁸ The policyholder in the case, *Aetna Casualty and Surety v. Broadway Arms*, alleged bad faith in the handling of a fire insurance claim. The only evidence presented to the jury to support a finding of intentional oppressive conduct was the claim representative's statement to the policyholder that he might be asked by the Internal Revenue Service (IRS) to explain why the insurance carrier would pay \$75,000 for loss of inventory when the policyholder's financial statement showed an inventory valued at only \$23,000. Apparently convinced that the claim representative had made a thinly-veiled threat to report him to the IRS if the policyholder refused a reduced settlement offer, the jury awarded the policyholder \$5 million in punitive damages. The judgment was reversed on appeal, and the case was remanded for a new trial based on a "quasi-criminal" standard of conduct.

In adopting this standard, the court declared that "evidence of bad faith must be sufficient to show affirmative misconduct of a nature which is malicious, dishonest, or oppressive."¹⁹ As articulated by the court, the quasi-criminal standard has three elements. First, the court noted that a single violation of the Arkansas Trade Practices Act does not necessarily constitute bad faith. At minimum, there must be multiple violations in the handling of the claim. Alternatively, a pattern of institutional misconduct (e.g., a company-wide practice of deliberately underpaying claims) would constitute bad faith. Assuming multiple violations in the handling of the claim, or institutional misconduct, an inference can be made that the evidence is "sufficient to show affirmative misconduct of a nature which is malicious, dishonest, or oppressive."²⁰ Second, the court ruled that the purpose of the tort of bad faith is not to address the situation where the insurance carrier simply refuses or fails, through nonfeasance, to pay an insurance claim. In cases of this sort, breach of contract damages should include incidental damages for economic loss, mental distress, prejudgment interest, and legal expenses. Third, the court reasoned that the

In adopting the intentional tort standard, the court ruled that "there must be a showing of an evil intent deserving of punishment or of something in the nature of special ill-will or wanton disregard of duty or gross or outrageous conduct."

Some states have declined to adopt the tort of bad faith in order to avoid the unforeseen consequences to the law of contracts and “the analytical straining necessitated by the tort approach.”

public interest demands that the tort of bad faith, which includes a substantial punitive damages exposure, be carefully confined to extreme cases of misconduct. Otherwise, insurers will be inappropriately discouraged from questioning false, suspicious, or inflated claims – a result that will increase insurers’ claim costs and raise policyholders’ premiums.

While no other state has followed Arkansas’ lead in adopting a quasi-criminal standard for first-party bad faith claims, this decision is significant in that the court demonstrated that rigorous standards are available to limit the tort of bad faith to extreme cases of misconduct. The court suggested that alternative remedies should be used to assure that policyholders are appropriately compensated in those cases where an insurer simply refuses or fails to pay a valid insurance claim.

Legal Development of Contract Action with a Broad Definition of Damages

A number of jurisdictions have declined to embrace the tort of bad faith in the first-party claim context, reasoning that “[a]lthough the policy limits define the amount for which the insurer may be held responsible in performing the contract, they do not define the amount for which it may be liable upon a breach.”²¹ Confinement of the good faith/bad faith inquiry to the realm of contract assures appropriate compensation in the situation where the insurance carrier fails to pay an insurance claim but forecloses the possibility of a punitive damages award in the absence of proof that an independent tort such as fraud or intentional infliction of emotional distress occurred. Indeed, courts have reasoned that “the practical end of providing a strong incentive for insurers to fulfill their contractual obligations can be accomplished ... through a contract cause of action, without the analytical straining necessitated by the tort approach and with far less potential for unforeseen consequences to the law of contracts.”²² Nine states have confined

the good faith/bad faith inquiry to the realm of contract.²³

Legal Development of Private Cause of Action Based on Statute

In a majority of states, a private cause of action is not statutorily or judicially permitted under the state’s Unfair Trade Practices Act. In a small number of states, however, either the state legislature has amended the law to permit a private cause of action or a court has recognized an implied private cause of action under the law. For example, the Connecticut statute identifies specific types of conduct that constitute bad faith, sets forth the burden of proof, and specifies the damages that can be recovered.²⁴ Furthermore, in many states where the courts have failed to recognize a common law cause of action for first-party bad faith, the state legislatures have responded by enacting a statute that permits a private cause of action for the first-party bad faith. Typically, these statutes identify the standard of conduct, the burden of proof, and the damages that can be recovered in a first-party bad faith action.²⁵

There is considerable variation among statutes with respect to the standard of conduct, burden of proof, and damages that can be recovered. Some statutes only allow for limited recovery of damages (e.g., prejudgment interest and attorney fees).²⁶ Other statutes have been broadly construed by courts to permit unlimited punitive damages in those cases where the insurer has engaged in more than one listed prohibited practice with respect to the processing of a single claim.²⁷

Economic Perspective

Potential Unintended Effects of First-Party Bad Faith Actions

Allowing the courts to impose extra-contractual liability on insurers in cases of intentional or unintentional bad faith denial of claims serves the obvious purpose of compensating policyholders for their unwarranted losses. However, while tort

actions to address insurer bad faith in claims settlement may be beneficial in theory, as in other liability settings their implementation in law has important implications for whether the system is in fact producing those benefits. If the standards applied in the courts for a finding of insurer bad faith are too lax and/or if damage awards are too high relative to the actual costs incurred by policyholders whose claims have been denied, substantial incentive distortions may arise.

A major concern is the increased pressure on insurers to pay disputable claims (Abraham, 1986). We have discussed the possibility that litigation for bad faith may be part of an efficient system (coupled with insurer payment strategies) to screen for fraudulent claims and to reduce fraud incentives. Insurers balance the benefits of reduced fraud costs with the expected costs of litigation. If, however, the expected damage awards in litigation exceed the expected costs to policyholders associated with the claim denials, the expected cost of litigation will exceed the benefits of reducing fraud costs and insurers will have too little incentive to employ these screening and deterrence strategies. The costs of fraud will increase as a result, and these costs will be borne by all insurance consumers.

Claims investigations are another important tool that insurers have for preventing excessive claim payments or payment of illegitimate claims. An investigation can benefit the insurer if it results in claim denial or a reduction in claim payment, but the investigation process itself may lead to claim delays and other insurer actions that bring accusations of bad faith. Because investigating claims is costly, insurers will balance the expected gains from investigation against the costs, including the expected costs of litigation. Excessive liability will raise the costs of investigation and reduce investigations below what they should be. This will raise the costs of fraud in both the immediate

term because fewer fraudulent claims will be detected, and over the longer term because of reduced deterrence. This latter point is important because the deterrence objectives of investigative activities are often overlooked. By reducing insurer resistance to fraudulent claims and by increasing the payoffs from litigation, excessive liability for insurer bad faith will increase consumers' incentives to engage in claims fraud and exaggeration. Another potential moral hazard is the increased incentive for policyholders to engage in litigation against insurers for bad faith handling of a claim even if the policyholder knows that the claim is invalid (Abraham, 1986).

If, in addition, the standard for a finding of insurer bad faith is unclear, changing, or prone to error, this can lead insurers to over-invest in avoidance of claim disputes (Shavell, 1987). This will lead to further pressures on insurers to pay disputable claims, with the resulting increase in consumer incentives for claims fraud described above. It may also lead to excessive investments in claims processing bureaucracy, procedures or technology, raising insurers' costs. This will also drive up the cost of insurance to consumers.

The extent of uncertainty facing (most) insurers is exacerbated by the fact that laws vary across states. Insurers operating in more than one state must be cognizant of these varying standards and must adopt procedures and policies that can account for the variation. This seems likely to lead to additional resource expenditure and perhaps excessive caution if insurers adopt behaviors that are tailored to the most stringent state(s) in which they operate.

Empirical Evidence

Assignment of excessive liability to insurers for bad faith in claims settlement may create significant distortions to the behavior of insurers and create unwarranted costs for society. These costs may be manifested as higher claims costs due to insurers' reluctance

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to challenge disputable claims out of fear of liability. Insurer expenses may also increase due to increased investments in internal monitoring and in legal expertise. If first-party bad faith laws have these consequences, they will contribute to inefficiencies in insurance markets and their benefits for insurance consumers are lessened.

Evidence from Existing Studies

While the impact of bad faith law has not been extensively studied, there is substantial anecdotal evidence from case law that tort liability standards are too lax and/or damage awards are too high in some cases. Noted legal scholar Alan Sykes (1996) discusses a variety of cases in which, by his assessment, the courts have made substantial errors. These include cases in which the courts found insurer bad faith even when claim disputes arose as a result of the insurer's reasonable suspicion of claims fraud;²⁸ cases in which the intentional tort standard is misapplied to a finding of insurer bad faith for reasonably debatable claims;²⁹ cases in which the size of punitive damage awards appear to be disproportionate to the offense of the insurer;³⁰ and cases in which insurers' strict reading of contractual provisions led to findings of bad faith.³¹

Sykes concludes from his research that "the remedy may be worse than the problem, as the courts seem to find bad faith on the part of insurers who have genuine and reasonable disputes with their policyholders" (p.405) and that "the ability of the courts to identify opportunistic behavior ... is very much in doubt" (p.443). These concerns are echoed in the writings of William Powers, Jr. (1994), who argues that "careful examination of the details of bad faith insurance litigation ... suggests that it was a mistake to turn to tort law to solve the problem of insurance bad faith in the first place" (p. 1571).

In addition, formal empirical analysis of insurance claims data has demonstrated that tort liability for insurer bad faith is associated with higher claims payments.

Browne, Pryor, and Puelz (2004) analyze a large dataset of first-party automobile insurance claims settled in 38 different states in 1992.³² They find that even after controlling for a wide array of claim characteristics and for other features of states' legal and claims environments, claim payments are significantly higher in states that allow tort actions for insurer bad faith in claims settlement.

If higher claims payments are occurring because insurers are paying unwarranted amounts or paying illegitimate claims in order to avoid potential bad faith liability, this should be a source of concern to policymakers. We are not aware of any studies that consider this effect or evaluate the implications of first-party bad faith laws for insurer behavior. Therefore, we undertake our own analysis of insurers' claims payment practices to begin to explore this issue.

Bad Faith Liability and Insurer Claims Handling

One difficulty in researching the effects of bad faith liability on insurer claims handling practices is obtaining appropriate data. First, such a study requires data on individual first-party insurance claims, rather than aggregate data for the insurance industry, which, in and of itself, can be difficult to come by. Moreover, the study requires data from more than one state (in order to examine the effects of different legal regimes); from more than one insurer (to be certain that observed effects reflect more than just the practices of a single firm); and from a large number of claims (in order to adjust for claim-specific circumstances).

We are fortunate to have access to a database with just these characteristics from the Insurance Research Council (IRC). As part of an analysis of automobile insurance claims, the IRC has compiled data on uninsured motorist (UM) claims. Uninsured motorist (UM) coverage is part of the automobile insurance policy and provides indemnification to the policyholder in

accidents in which the driver who is at fault does not carry liability insurance. In this case, the injured policyholder files a UM claim with his own insurer and may receive compensation for both economic and non-economic losses. Although UM claims may not be at the forefront of first-party insurance bad faith liability, UM insurance is a first-party insurance contract, and courts in a number of states have specifically upheld the applicability of first-party bad faith remedies in the UM context (see Browne, Pryor, and Puelz, 2004). Therefore, due to data availability, our analysis focuses on this claiming context.³³

The data are based on a national sampling of claims from insurance companies in 1997, the most recent year for which data are available. The original dataset includes nearly 6,000 uninsured motorist claims from 50 states, the District of Columbia, and the U.S. territories. The survey reports a wealth of information for each claim, including the amount claimed and the amount paid, injury severity and type of injury, injury treatments, and the insurer's handling of the claim. We combine these data on UM claims with data on each state's legal regime for insurer first-party bad faith to facilitate a comparison of outcomes among states with different bad faith regimes. The data on state laws is compiled from the GenRe (2008) report on state bad faith statutes.

Based on the discussion above, we are interested in three aspects of the claims: (1) the use of investigative techniques by the insurer; (2) characteristics of claims that may be indicative of fraud (so-called suspicion indicators or "red flags"); and (3) insurer payments for claims. We provide evidence on each of these areas in turn by comparing claim characteristics among states that have different legal regimes for first-party bad faith actions. We compare claims in states that allow tort-based causes of action for first-party bad faith to claims in states that do not allow tort-based causes

of action (but may allow contract-based or statute-based actions).³⁴ The states are grouped so that the important distinction between the two sets of states is whether the state allows unlimited punitive damage awards in bad faith actions.

Use of Investigative Techniques

Insurers have several methods at their disposal to investigate the validity of medical claims. One method is a medical audit, which entails having a medical professional (usually a nurse) review the medical treatment and bills submitted. The review will provide information from a medical perspective on whether the treatment and billed amounts are appropriate. The intensity and purpose of a medical audit can vary, however, from routine to investigative, and may be undertaken in-house or by an external professional. While procedures may vary among individual insurers and cannot be determined from the available data, internal medical audits are more likely to be routine than those undertaken external to the firm.

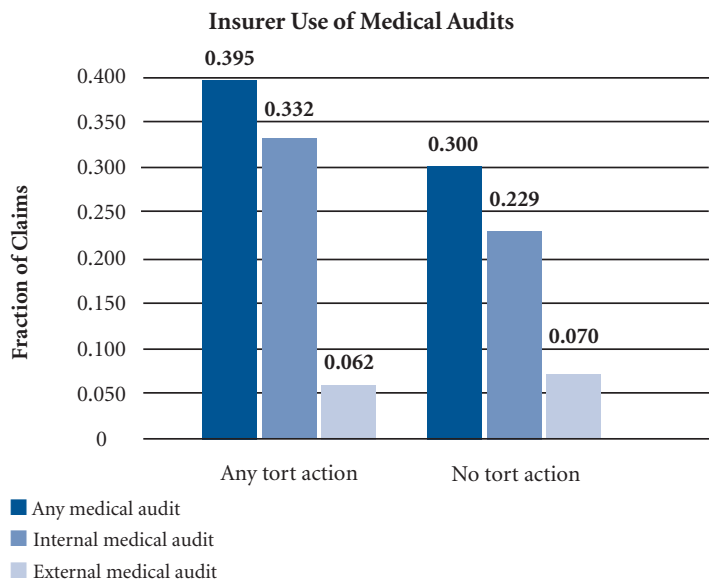
Another more costly and detailed investigative method is an independent medical exam (IME). An IME is an examination of the injured policyholder by a medical professional (usually a doctor) chosen by the insurance company. An IME provides a second medical opinion about the nature and severity of the injuries to the policyholder. An IME is more expensive than a medical audit and necessitates the cooperation and involvement of the policyholder.

The IRC claims database reports information for each claim on whether a medical audit or an IME was undertaken. Exhibits 1 and 2 compare insurers' use of medical audits and IMEs, respectively, in states that allow tort-based actions for bad faith and states that do not.

The comparisons in Exhibit 1 are suggestive of both larger resource investments in claims handling and smaller resource investments in fraud investigation by insurers in states that

Insurers have several methods at their disposal to investigate the validity of medical claims.

Exhibit 1
Medical Audits in States with Different Bad Faith Laws



Note: The difference across states in the fraction of claims receiving any medical audit or an internal medical audit is statistically significant, which means that we can be highly confident the difference is not due to random chance; the difference in the fraction of claims receiving an external medical audit is not statistically significant, indicating it may be due to random chance.

allow tort-based bad faith actions. Insurers faced with potential tort actions are more likely to conduct a medical audit (on 39.5 percent of claims versus 30.0 percent of claims in other states), but this is entirely due to a greater propensity to conduct in-house medical audits (33.2 percent versus 22.9 percent). These differences across states are statistically significant, meaning that we can have a high degree of confidence that there truly are differences.³⁵ Insurers in tort-action states are actually slightly less likely to invest in external medical audits (although the difference is not statistically significant, indicating that the difference may be due to random chance). This pattern suggests greater routine use of medical audits in states that allow tort-based bad faith actions, but no greater *investigative* use of medical audits, which may indicate an overinvestment in claims processing bureaucracy. This interpretation is reinforced by the fact that the prospect of a tort claim has the opposite effect on insurers' IME use, as seen in Exhibit 2.

Because an IME requires the notification and cooperation of the insured, insurers may be particularly reluctant to undertake this type of investigation when bad faith suits are decided under tort law. Consistent with this idea, insurers request an IME for only 4.1 percent of claims in states that allow tort-based bad faith actions, but for 14.8 percent of claims in states that do not allow tort-based bad faith. Similarly, an IME is performed for only 3.5 percent of claims in states that allow tort-based bad faith as compared to 13.8 percent of claims in states that do not. Statistical tests show that both of these differences are statistically significant.

Fraud Suspicion Indicators

Fraudulent and exaggerated claims are an important problem in the insurance industry and in automobile insurance in particular. As a result, there is growing empirical literature that analyzes the nature of claims fraud and how it is handled by insurance companies.³⁶ Particularly influential in this area are studies undertaken by Weisberg and Derrig (1991, 1998), in which insurance claims professionals were engaged to review actual closed claim files in order to gauge the likelihood that each claim was legitimate or fraudulent. In addition to providing a suspicion score for each file, the reviewers were asked to list specific elements of the claims that led to a higher or lower degree of suspicion. One outcome of these studies is a catalog of fraud *suspicion indicators*, defined as those elements of a claim that most claims professionals found to indicate potential fraud. The claim characteristics identified as suspicion indicators encompass a wide variety of characteristics of the insured, the accident, the injury, and the injury treatment. It should be emphasized, of course, that no single one of these characteristics is treated as evidence of fraud; instead, if enough of the characteristics are present in a claim, these “add up” to indicate a higher likelihood that the claim is fraudulent or exaggerated.

Several of the suspicion indicators are reported in the IRC claims survey. Because the IRC database includes only claims that are closed with some payment by the insurer, we can make use of these suspicion indicators to infer whether insurers handle suspicious claims differently in states that allow tort-based bad faith actions as compared to states that do not. Specifically, if paid claims are more likely to exhibit fraud suspicion indicators in states that allow tort-based bad faith, we may infer that insurers are less likely to deny suspicious claims in these states.

One fraud suspicion indicator is the *lack of a police report* for the accident that produced the claim. The thinking behind this is that in the normal course of an accident, the police will be called and a report will be filed. If there is no police report, it is more likely that the accident (and hence the injury) is fictitious. Another suspicion indicator is the *lack of a visible injury* at the scene of the accident. Although it is possible that the policyholder could realize his or her injuries only with some delay, if there was no injury apparent at the scene of the accident, it is more likely that the injury is fictitious or exaggerated.

Exhibit 3 compares these characteristics of claims across states with different bad faith laws. We observe that police reports from the scene of the accident are less prevalent among claims in states that allow tort actions. In these states, 79.2 percent of claims have a police report from the scene of the accident, while 84.8 percent of claims in states that do not allow tort actions have an on-scene police report. In addition, we observe that claims involving no visible injury at the scene of the accident are more prevalent in states that allow tort-based bad faith (70.0 percent) than in states that do not (62.4 percent). Tests show that these differences are statistically significant. Thus, suspicion indicators from the scene of the accident are more prevalent among paid claims in states that allow tort-based

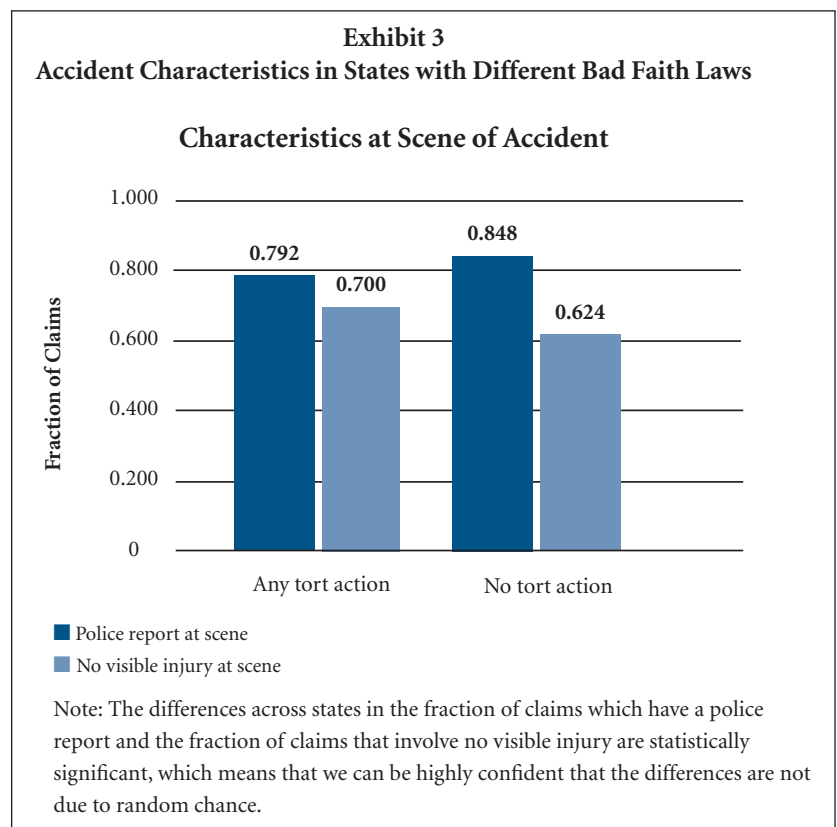
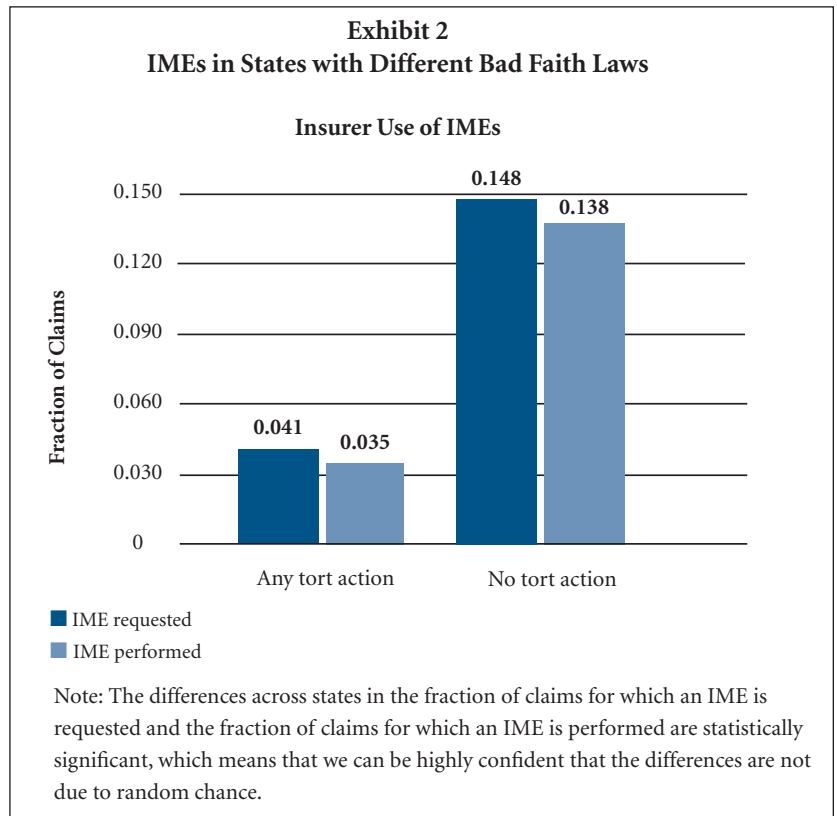
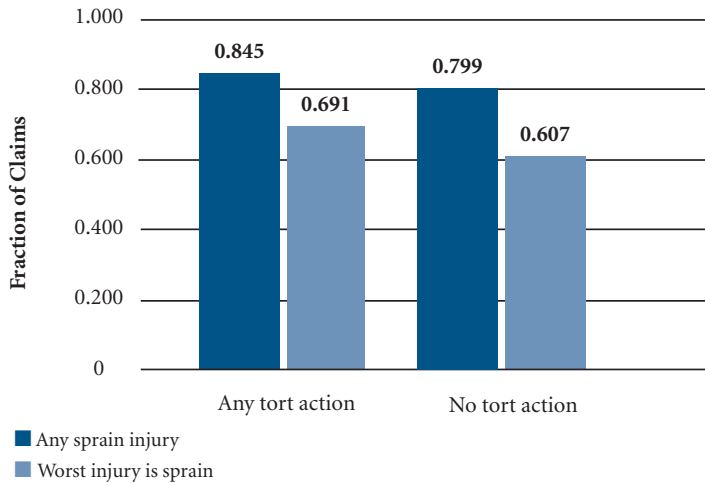


Exhibit 4
Characteristics of Injuries in States with Different Bad Faith Laws

Prevalence of Sprain Injuries



Note: The differences across states in the fraction of claims involving a sprain and in the fraction of claims for which a sprain is the worst injury are statistically significant, which means that we can be highly confident that the differences are not due to random chance.

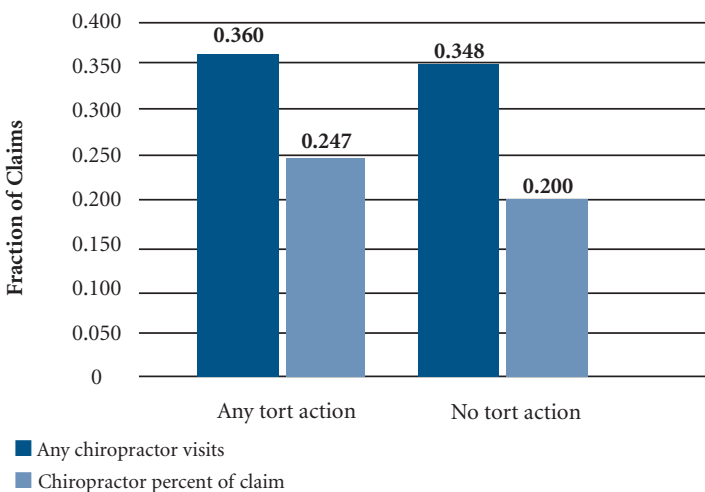
bad faith. This is consistent with the idea that insurers may be less likely to challenge disputable claims in states with these laws.

A second set of fraud suspicion indicators has to do with the nature of the injury. Soft tissue injuries such as sprains and strains are difficult to medically verify and therefore fall into the category of claims that may not lend themselves to discovery through investigations (Dionne and St-Michele, 1991). As a result, they are notorious for being prone to falsification and exaggeration, and a claim involving *only or primarily a sprain injury* is a fraud suspicion indicator for insurers.

Exhibit 4 compares the prevalence of sprain claims among states with different bad faith laws. The exhibit reveals that paid claims in states that allow tort-based bad faith are more likely to involve a sprain injury (84.5 percent in states that allow tort-based bad faith compared to 79.9 percent in states that do not), and more likely to involve a sprain as the most severe injury received by the policyholder (by 69.1 percent to 60.7 percent). Both of these differences are statistically significant.

Exhibit 5
Use of Chiropractors in States with Different Bad Faith Laws

Claimants' Use of Chiropractors



Note: The differences across states in the fraction of claims involving any chiropractor treatment is not statistically significant, however, the difference across states in the proportion of the total claim amount arising from chiropractor treatments is statistically significant, which means that we can be highly confident that the differences are not due to random chance.

Appropriate treatment of sprain injuries is also difficult to determine, providing an additional avenue for a policyholder to falsify the treatment or to exaggerate the amount of treatment. Because of this, *large numbers of visits to a chiropractor* for treatment of accident injuries is another fraud suspicion indicator in the eyes of insurance claims professionals. Exhibit 5 shows that the fraction of claims with any chiropractor treatments is about the same among states with different bad faith laws (36.0 percent in states that allow tort-based bad faith and 34.8 percent in states that do not), and the difference among the two sets of states is not statistically significant. However, the proportion of the total claimed amount that arises from chiropractor care is significantly larger in states that allow tort actions (24.7 percent) compared to states that do not (20.0

percent), and this difference is statistically significant. These differences in treatment patterns are suggestive of differences in insurers' handling of claims that involve suspicious treatment patterns.

In light of the greater prevalence of fraud suspicion indicators among claims in states that allow tort-based bad faith, we examine the likelihood that some portion of the claim costs are disallowed by the insurer. Exhibit 6 compares the proportion of paid claims for which any charges were disallowed by the insurer in states that allow tort-based bad faith and states that do not. There is no statistically significant difference in the rate of disallowances among the two sets of states. This lack of difference, even as fraud suspicion indicators are more prevalent in states with tort-based bad faith, may again suggest that insurers are more reluctant to challenge claims when faced with potential tort liability.

Overall, Exhibits 1 through 6 provide evidence of a disturbing pattern: Paid UM claims in states that allow tort actions for insurer bad faith are significantly more likely to contain characteristics associated with claims fraud, but insurers in these states are not more aggressive in investigating claims or in disallowing part of the claimed costs. This evidence suggests that insurers may be inhibited in challenging disputable claims due to concerns about bad faith liability.³⁷

Claim Payments

To investigate how these differences in claims handling affect insurance loss costs, we compare payment amounts for insurance claims in states that have different bad faith regimes. Because claims arise from many different types of accidents and have different characteristics that determine the severity of injury and losses incurred by the policyholder, we analyze claim payments using a multiple regression framework in which we control for a wide variety of characteristics of the accident, the injury, and the claimant. With these control variables included, the estimated

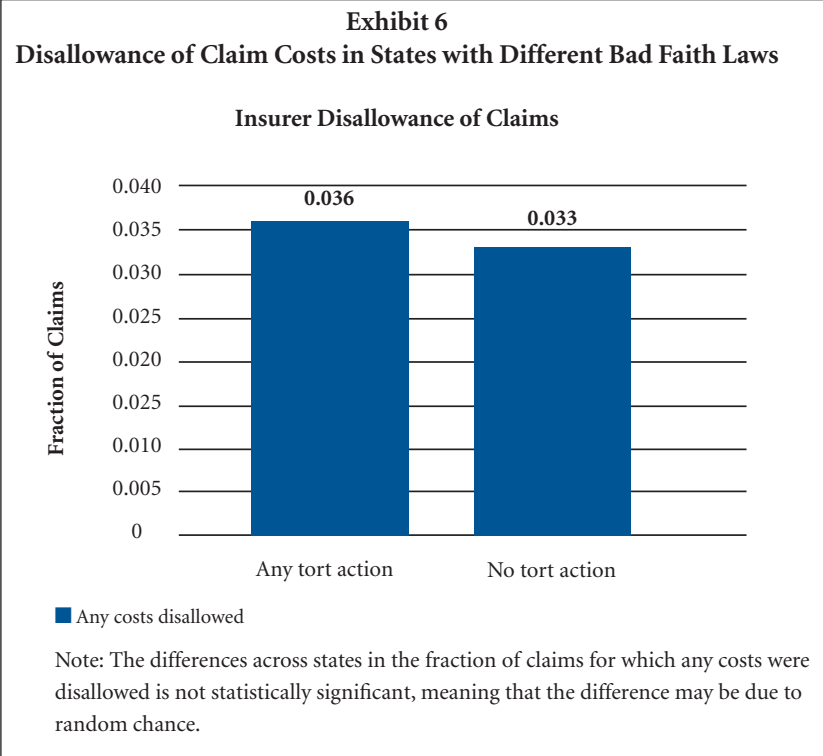


Exhibit 7
Predicted Impact of Tort Liability on UM Claims and Payments

	Claim Amount Estimated		Payment Amount Estimated	
	Effect	T-stat	Effect	T-stat
State allows tort action	-0.045	-1.10	0.124	3.599***

Note: Regression models include claimant age and age squared, sex, marital status and employment status; claimant fault, indicator for claimant receiving traffic citation, accident impact severity; injury severity, nature of worst injury, hospital treatment; an indicator of whether an attorney was hired, and accident year. Attorney is treated as endogenous and parameters are obtained from instrumental variables estimation. T-statistics are based on standard errors adjusted for arbitrary heteroskedasticity and clustering by state.
***Indicates statistically different from zero at the 1 percent confidence level, two-sided test.

Source: Authors' calculations from IRC survey data.

effects of tort-based bad faith reveals whether claim payments are higher in these states after controlling for other differences in the insurance claims. The predicted effects of tort-based bad faith laws on claimed amounts and payment amounts are reported in Exhibit 7.

Exhibit 7 indicates that claim payments are higher in states that allow tort-based

Tort liability for first-party insurance bad faith may not perform as well as theory suggests.

bad faith actions than in other states after controlling for claim characteristics, and this difference is statistically significant. Our estimates suggest that, all else being equal, claim payments are 12.4 percent higher in states that allow tort-based bad faith actions. Because the estimates also show that there is no statistically significant difference in claim amounts in these states (see left-hand column of Exhibit 7), the difference in payment amounts should not be attributed to differences in claimed amounts. This finding is consistent with the findings of previous studies of first-party insurance bad faith (Browne, Pryor, and Puelz, 2004) that tort liability leads to higher claim payments.

Examination of Current First-Party Bad Faith Law

An Evaluation of the Different Approaches to First-Party Bad Faith

The preceding discussion indicates that in evaluating the different approaches to first-party bad faith, it is important to keep in mind both theoretical and practical considerations. Tort liability for first-party insurance bad faith may not perform as well as theory suggests, either in protecting policyholders from insurer bad faith by providing clear standards for insurer behavior or in facilitating efficient claims settlement in insurance markets.

One important consideration is the amount of damages awarded in relation to the loss of the insured. If damage awards are sufficient to create a “windfall” for the insured, this may encourage insureds to file illegitimate claims. Excessive damage awards will in addition discourage insurers from questioning claims that may be potentially illegitimate. Alternatively, some insurers may become determined to meet the twin goals of paying only legitimate claims, while at the same time keeping the exposure to bad faith lawsuits at a minimum. These insurers will over-invest in claims processing bureaucracy, procedures, or technology. In both cases, the result will be unwarranted increases in

claim costs that are ultimately distributed to the insuring public in the form of higher insurance premiums.

A second issue is the potential flexibility of the standard applied by the courts in finding insurer bad faith. There is substantial anecdotal evidence from case law (some of it cited in previous sections of this paper) that tort liability standards are too lax and/or damages awards are too high in some cases (Sykes, 1996). The variation across cases and jurisdictions means that insurers face substantial uncertainty regarding their duties of good faith dealings in claims settlement. Uncertain bad faith standards for insurers will undermine the benefits of the bad faith remedy, reducing its effectiveness in deterring insurer misconduct. Uncertain bad faith standards will also create additional costs by distorting insurers’ claims settlement practices and policyholders’ claim filing incentives.

A final and related consideration is the standard for assessing punitive damages against an insurer. Punitive damages can be justified only if needed to create a sufficient incentive for the insurer not to engage in misconduct. This suggests that punitive damages may play a useful role in cases involving extreme, intentional bad faith, particularly in cases involving institutional misconduct.³⁹ In institutional misconduct cases, a punitive damage award that disgorges profits derived from a company-wide policy of underpaying claims serves to deter future similar conduct by eliminating any profit incentive. Punitive damage awards serve no meaningful role, however, in cases involving unintentional bad faith. If the standard for awarding punitive damages is not sufficiently strict to confine punitive damages to cases involving extreme, intentional bad faith, the result will be excessive and uncertain damages awards, with the attendant effects discussed above.

With these considerations in mind, we examine first-party insurance bad faith in four states in 2007 and 2008:

Minnesota

This legislation³⁹ creates a new private cause of action for first-party insurance bad faith where one previously did not exist. The statute codifies the intentional tort standard, providing for damages if the insured can show (1) the absence of a reasonable basis for denying the benefits of the insurance policy, and (2) that the insurer knew or acted in reckless disregard of the lack of a reasonable basis for denying the benefits of the insurance policy. The law allows policyholders to be awarded up to \$250,000 in “taxable costs” if an insurer is found to be acting in bad faith and up to \$100,000 in attorney’s fees, but specifically precludes the possibility of punitive damages in the absence of an independent tort such as fraud or intentional infliction of emotional distress. Nevertheless, the fact that the statute utilizes tort law to adjudicate these issues creates incentives for fraudulent or exaggerated claim filing and potentially inhibits insurers from conducting appropriate claim investigations. These effects could have been avoided or minimized if the statute had adopted the contract approach with a broad definition of damages.

Colorado

This legislation⁴⁰ lowered the legal standard for asserting a first-party bad faith claim and increased the penalties levied against an insurer, relative to existing common law. The new legislation adopts the negligence standard, whereas the intentional tort standard applies under common law. In addition, under common law, consequential, or incidental, damages for economic loss and mental distress can be recovered, but the cost of litigation cannot be recovered. The new legislation allows for the recovery of the cost of litigation and two times the policy benefit that was unreasonably denied. Moreover, the new legislation imposes a special penalty on health insurers that unreasonably delay the payment of the policy benefit (i.e., the penalty is 20 percent of the policy benefit, the payment of

which was delayed 90 days or longer past the submission of the claim).

The Colorado law places a cap on the damages awards, reducing incentives for claim fraud and reducing insurer uncertainty about damages amounts. However, like the Minnesota law, the Colorado statute utilizes tort law to adjudicate bad faith issues. Here again, adoption of the contract approach to adjudication probably would have been a more effective means of realizing the goals of full compensation with minimal incentive distortions.

Particularly noteworthy is the law’s creation of the 90-day deadline for payment of a health insurance claim. Not only is this an extremely narrow time frame for resolving a medical claim, but the placement of any arbitrary fixed time may deter insurers from engaging in legitimate claims investigations and may encourage strategic behaviors by policyholders or their attorneys.

Maryland

This legislation⁴¹ applies exclusively to property/casualty insurance policies and allows insureds to initiate first-party bad faith claims through the Maryland Insurance Administration (MIA), the state agency responsible for enforcing Maryland’s insurance laws. The new law adopts the negligence standard and caps damages the insured can recover at the policy limit. In addition, it provides for recovery of pre-judgment interest and allows recovery of attorney’s fees, but limits the recoverable amount to one-third of the actual damages. The law further provides that claims falling within the small-claims jurisdiction of district courts, as well as those involving commercial insurance policies with liability limits exceeding \$1 million, need not be initiated through the MIA process.

Previously, an insured could recover only the amount of actual damages, subject to the policy’s limits. Such actions could be pursued either through the MIA or as a civil action for breach of contract, but neither avenue allowed recovery of litigation expenses.

The Minnesota law codifies the intentional tort standard, but nevertheless creates incentives for fraud or exaggerated claim filing and may inhibit insurers from investigating claims.

The Maryland approach would appear to minimize the uncertainty and potential incentive distortions associated with tort-based actions without sacrificing the goal of full compensation for policyholders.

Three features of the new legislation would appear to reduce the potential for judicial misapplication and incentive distortions. First, by excluding cases involving large, sophisticated commercial insureds, the law is effectively confined to those cases in which policyholders might otherwise find it difficult to effectively contest an unpaid claim. Second, in contrast to Minnesota's law, which allows for recovery of as much as \$100,000 in attorney fees, Maryland's limit on recoverable attorney fees to one-third of the actual damages reduces the potential for speculative bad faith lawsuits motivated chiefly by attorney self-interest. Finally, the law does not allow punitive damages. Hence, relative to other approaches discussed in previous sections of this paper, the Maryland approach would appear to minimize the uncertainty and potential incentive distortions associated with tort-based actions without sacrificing the goal of full compensation for policyholders.

Washington

This legislation⁴² was adopted to expand the definition of first-party insurance bad faith and to increase the damage awards available to policyholders in cases alleging insurer bad faith. The remedies specified in the act are separate and distinct from the remedies provided under common law as well as those prescribed in the state's Consumer Protection Act. Washington common law provides for the tort of bad faith with a negligence standard, and the Consumer Protection Act provides for recovery of actual damages sustained, the cost of litigation, and treble damages, subject to a cap of \$10,000, in the event the insurer violates a claims handling regulation.

The new legislation provides for a private cause of action in the event an insurer "unreasonably" denies or delays payment of a policy benefit or commits a specified unfair claims settlement practice; recovery of "actual damages sustained"; recovery of the cost of reasonable attorney's fees; and treble actual damages sustained, at the

discretion of the trial judge. The specific unfair claims settlement practices covered by the legislation include misrepresentation of policy provisions; failure to acknowledge pertinent communications; failure to meet standards for prompt investigation of claims; and failure to meet standards for prompt, fair, and equitable settlements applicable to all insurers.

Washington's law contains a number of features that may create incentive distortions. First, unlike the vast majority of states that have adopted the tort of bad faith, this legislation does not expressly require a showing of malice, intent, or recklessness to award punitive damages. Second, the standards for liability are unusually broad (including all "unreasonable" acts and a variety of vaguely defined statutory failings), and the definition of damages is unusually vague ("actual damages sustained" is not defined, but arguably could include consequential damages for economic loss and mental distress, as well as the policy benefit itself). Third, the provision of treble actual damages means that the total damage award potentially available under the statute is extraordinarily high, thus creating the prospect of enormous "jackpot" verdicts for policyholders and their lawyers. Finally, because liability for punitive damages is based on a statute as opposed to common law, any tort reform measures (e.g., an enhanced burden of proof such as clear and convincing evidence as opposed to a preponderance of the evidence, or a dollar cap on a punitive damages award) enacted for the purpose of constraining punitive damages awards are inapplicable. As a result, the potential for excessive and uncertain damages awards, along with the attendant effects discussed above, is virtually unlimited.

Conclusion

This paper has examined first-party insurance bad faith remedies under common law and the recent legislative expansion of such remedies. Theory predicts that

allowing policyholders to recover damages over and above the value of the insurance benefit owed will provide insurers with added incentives to engage in fair claims settlement, and that this may enhance the efficiency of contracting in insurance markets. However, theory also predicts that uncertain bad faith standards for insurers and excessive damage awards for policyholders will undermine the benefits of the bad faith remedy, distorting insurers' claims settlement practices and policyholders' claim filing incentives in ways that will lead to more borderline (or even fraudulent) claims and unwarranted increases in insurance costs.

Empirical evidence from case law and from insurance claims data suggests that bad faith remedies function less than optimally in practice. Prior studies have found that the legal standards employed to determine insurer bad faith under tort law are imprecisely applied (Sykes, 1996) and that tort-based standards for insurer bad faith are associated with higher insurance claims costs (Brown, Pryor, and Puelz, 2004). This paper presents new evidence that tort liability for first-party bad faith reduces insurers' incentives to monitor claims for fraud, leading to less intensive use of investigative techniques and to more paid claims containing characteristics often associated with fraud. The analysis also confirms that claims payments are higher in these states. These findings are consistent with the predictions of theory when liability is uncertain and/or excessive.

In view of this evidence, an examination of recent state legislation expanding first-party insurance bad faith liability suggests that the acts passed in most states are likely to create substantial negative side effects for insurance markets. In particular, we note that the Washington law combines two features – lax standards for proving bad faith and excessive damage awards – that are likely to produce negative consequences for insurers and policyholders. The states

should carefully consider whether the benefits of expanded bad faith liability outweigh the costs of added uncertainty to insurers and the increased costs of insurance to consumers (Abraham, 2004). As well, if it is true as Sykes (1996) argues that the courts cannot accurately identify bad faith behavior by insurers, the states must consider the possibility that the benefits from insurer bad faith law (in terms of deterring insurer misconduct) are themselves small.

Endnotes

¹ See *Hadley v. Baxendale*, 156 Eng. Rep. 145 (Ex. 1854).

² William R. Vance, *Handbook on the Law of Insurance*, 3rd ed., St. Paul, MN: West Publishing Company, 1951.

³ For an identification of all 14 of the prohibited acts, see e.g., Laureen Regan and Paul M. Rettinger, "Private Rights of Action Under State Unfair Claims Settlement Practices Acts," *Journal of Insurance Regulation*, Spring 1998, pp. 296, 297.

⁴ The nine states include Delaware, Maine, Maryland, New Hampshire, New Jersey, New York, Oregon, Utah, and Virginia.

⁵ The 25 states include Alabama, Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Tennessee, Texas, West Virginia, and Washington.

⁶ See *Comunale v. Traders and General Insurance Company*, 50 Cal 2d. 654, 328 P. 2d 198 (1958).

⁷ *Id.*

⁸ See *Gruenberg v. Aetna Insurance Company*, 510 P. 2d 1032 (Cal. 1973).

⁹ *Id.*, at 1037.

¹⁰ *Id.*

¹¹ *Id.*

¹² See Jeffrey W. Stempel, *Stempel on Insurance Contracts*, 3rd edition, New York: Aspen Publishers,

This paper presents new evidence that tort liability for first-party bad faith reduces insurers' incentives to monitor claims for fraud, leading to less intensive use of investigative techniques and to more paid claims containing characteristics often associated with fraud.

2006. According to Stempel, “[t]o appreciate the differences across the states concerning insurer bad faith, one must pay attention to the nuances of precedent and doctrine, which tend to be glossed over in any classification....” *Id.*, at 10-87. For this reason, legal scholars are bound to disagree on occasion over whether a particular state has adopted the negligence standard or the intentional tort standard in first-party claim cases. In any event, legal scholars agree that a minimum of 11 states have followed California’s lead by adopting the negligence standard for first-party bad faith claims. They include Alaska, Connecticut, Hawaii, Nevada, North Carolina, North Dakota, Ohio, Oklahoma, South Carolina, Texas, and Washington.

The California court did address the issue pertaining to recovery for mental distress. Given that the policyholder alleged substantial economic losses (e.g., loss of earnings, loss associated with bankruptcy) apart from damages for mental distress, the policyholder was entitled to make a claim for mental distress. In the absence of extreme circumstances (e.g., see *Crisci v. Security Insurance Company*, 426 P. 2d 173 Cal. (1967), holding that the insurer’s failure to settle a third-party claim within the policy limit resulted in a judgment in excess of the policy limits that left the insured destitute and suicidal), damages for mental distress are likely to be minimal. To be sure, some mental distress will almost always accompany the denial of a claim. In the vast majority of first-party bad faith cases, the courts have not been particularly sympathetic to claims for mental distress. For whatever reason, the court did not address the issue pertaining to recovery for punitive damages.

¹³ See *Anderson v. Continental Insurance Company*, 85 Wis. 2d 675, 691, 271 N.W. 2d 368 (1978).

¹⁴ *Id.*, at 374.

¹⁵ *Id.*, at 379.

¹⁶ *Id.*

¹⁷ The 16 jurisdictions include Alabama, Colorado, Idaho, Indiana, Iowa, Kentucky, Mississippi, Nebraska, New Mexico, Puerto Rico, Rhode Island, South Dakota, Vermont, Virgin Islands, Wisconsin, and Wyoming.

¹⁸ See *Aetna Casualty and Surety v. Broadway Arms*, 281 Ark. 128, 664 S.W. 2d 463 (1984).

¹⁹ *Id.*, at 467.

²⁰ *Id.*

²¹ See *Beck v. Farmers Insurance Exchange*, 701 P. 2d 795, 801-02 (Utah 1985).

²² *Id.*, at 799.

²³ The nine states include Delaware, Maine, Maryland, New Hampshire, New Jersey, New York, Oregon, Utah, and Virginia.

²⁴ See Conn. Gen Stat. Section 38a – 816 and Conn. Gen Stat Section 42-1106 – 42 – 110q.

²⁵ See e.g., Fla. Stat. Section 624, 155 (1) (b) (1) (2007).

²⁶ See e.g., MCL 500.3148 (1) Section 6.29 and 6.30 (Michigan).

²⁷ See e.g., *Maher v. Continental Casualty Company*, 76 F. 3d 535 (4th Cir. 1999). (Applying West Virginia law)

²⁸ See *T.D.S. Inc. v. Shelby Mutual Insurance Co.*, 760 F. 2d 1520 (1985); *Capstick v. Allstate Insurance Co.*, 1993 10CIR 779, 998 F. 2d 810 (1993).

²⁹ See *Aetna Life Insurance Co. v. Lavioe*, 475 U.S. 813 (1986).

³⁰ See *Aetna Life Insurance Co. v. Lavioe*, 475 U.S. 813 (1986); *Nationwide Mutual Ins. Co. v. Clay*, 525 So. 2d 1339 (Ala. 1989).

³¹ See *Silberg v. California Life Insurance Co.*, 11 Cal 3d 452, 113 Cal Rptr 711, 521 P. 2d 1103 (1974); *Sparks v. Republic National Life Insurance Co.*, 132 Ariz. 529, 647 P 2d 1127 (1982).

³² These authors study uninsured and underinsured motorist claims using data compiled by the Insurance Research Council from a survey of closed claims obtained from insurance companies.

³³ First-party underinsured motorist (UIM) claims were also separately analyzed, and the results were similar. Thus, the problems created by tort-based, first-party bad faith liability are present in that claiming context as well.

³⁴ Although not shown here, results from comparing the two sets of states with the most disparate legal regimes (i.e., those that allow negligence-based torts versus those that disallow all private actions) also reveal principally the same patterns.

³⁵ The statistical test employed is a t-test of differences in means across the two groups of states. Statistical significance depends on both the differences in the means and in the variability of outcomes within each group of states.

³⁶ See Cummins and Tennyson (1992) and Abrahamse and Carroll (1999) for evidence of the extent of the fraud problem in automobile insurance. Tennyson and Salsas-Forn (2002), Crocker and Tennyson (2002), and Loughran (2004) analyze claims handling by insurers.

³⁷ Because we recognize that claims characteristics may differ for small versus large claims and that insurers may handle claims differently if they are of different size, we also undertook the comparisons shown in Exhibit 1 – Exhibit 6 for claims of roughly the same size (in the same quarter of the claims distribution). Results are comparable to those shown here.

³⁸ See e.g., *Hawkins v. Allstate Insurance Company*, 733 P. 2d 1073 (Ariz. 1987).

³⁹ 2008 Minn. Laws § 604.18.

⁴⁰ Colorado Rev. Stat. Aon. § 10-3-1113 (2008).

⁴¹ 2007 Md. Laws § 27-1001 (e) (2) (i) – (ii).

⁴² Wash. Rev Code § 48.30.010 (2007).

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