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Underinsured Motorist Coverage: Legislative Solutions to Settlement Difficulties

The automobile accident is perhaps the most pervasive tragedy of the twentieth century.¹ Unfortunately, economic hardship often compounds the human cost of an automobile accident. Although the presence of automobile insurance has eased the economic burden caused by accidents,² many accident victims are forced to do battle with one or more insurance companies to obtain compensation for their injuries.³ When an accident involves an underinsured motorist,⁴ the problems associated with settlement are exacerbated by uncertainty regarding the obligations of the parties involved.⁵

In an effort to resolve settlement conflicts arising from accidents involving underinsured motorist coverage, the North Carolina General Assembly recently passed a statutory amendment clarifying the rights and duties of insureds and insurers.⁶ Among the problems addressed by the 1985 amendment are subrogation, "stacking,"⁷ and the insurer's duty to defend. This Note explains the significance of these problems, analyzes the solutions prescribed by the general assembly, and discusses the potential problems still ahead both for insureds and insurers.

Most states, including North Carolina, have long required all automobile owners to carry a minimum amount of liability insurance.⁸ Nevertheless, every

1. Although the United States has the lowest motor vehicle fatality rate in the world, HIGHWAY USERS FEDERATION & AUTOMOTIVE SAFETY FOUNDATION, THE SAFETY BELT PROPONENT'S GUIDE 2 (1984) (available in the Library of the Highway Safety Research Center, University of North Carolina at Chapel Hill) [hereinafter cited as PROPONENT'S GUIDE], 38,899 fatal accidents occurred in 1982. UNITED STATES DEPT. OF TRANSPORTATION, NATIONAL HIGHWAY TRAFFIC SAFETY ADMINISTRATION, NATIONAL CENTER FOR STATISTICS AND ANALYSIS, FATAL ACCIDENT REPORTING SYSTEM 1982, ii (n.d.) (available in the Library of the Highway Safety Research Center, University of North Carolina at Chapel Hill). Of the 56,190 vehicles involved in fatal accidents, 33,955 were passenger cars. *Id.*

2. In most cases private insurance companies pay the cost of injuries and fatalities due to motor vehicle accidents. These companies pass this cost on to their insureds in the form of increased premiums. PROPONENT'S GUIDE, *supra* note 1, at 35. The national expense of traffic accidents exceeds \$45 billion annually. *Id.*

3. Gallagher & German, *Resolution of Settlement Conflicts Among Insureds, Primary Insurers, and Excess Insurers: Analysis of the Current State of the Law and Suggested Guidelines for the Future*, 61 NEB. L. REV. 284 (1982) (discussing conflicts in the area of liability coverage).

4. An "underinsured motorist" is the owner of "a highway vehicle with respect to . . . which, the sum of the limits of liability under all bodily injury bonds and insurance policies applicable at the time of the accident is less than the applicable limits of liability under the owner's policy." N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985). An underinsured motorist, in other words, is a tortfeasor who has less liability insurance coverage than his or her victim's underinsured motorist coverage. Underinsurance only becomes significant when the victim's damages exceed the tortfeasor's liability coverage.

5. See Note, *No-Fault Insurance—Subrogation in Underinsured Motorist Settlement Proceedings*—Schmidt v. Clothier, 11 WM. MITCHELL L. REV. 585, 586 (1985) (discussing the uncertainty of obligations in underinsurance subrogation).

6. Act of July 31, 1985, ch. 666, § 74, 1985 N.C. Sess. Laws 862, 862-64 (codified at N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985)).

7. See *infra* notes 46-70 and accompanying text for a discussion of "stacking."

8. N.C. GEN. STAT. § 20-279.21(b)(3) (Supp. 1985) requires minimum coverage of "twenty-five thousand dollars (\$25,000) because of bodily injury to or death of one person in any one accident

motorist still faces the possibility of being injured in an accident caused by an uninsured driver. Consequently, most states require that all automobile liability insurance policies contain uninsured motorist coverage.⁹ Since 1961¹⁰ North Carolina has required that all automobile insurance policies contain uninsured motorist coverage unless such coverage is specifically rejected by the insured.¹¹ This coverage compensates the insured when the tortfeasor has no insurance or when the tortfeasor's insurance company is bankrupt.¹²

Until recently, most courts rejected the applicability of uninsured motorist coverage when the tortfeasor had the minimum coverage required by law, even if the injured motorist's damages exceeded the liability limit of the tortfeasor's automobile insurance policy.¹³ Thus, in many instances a person was better off as the victim of an uninsured driver than a driver with only minimal coverage.¹⁴ This situation became known as the "underinsurance loophole."¹⁵ In 1979 the North Carolina General Assembly recognized the need to close this loophole and amended the uninsured motorist statute to provide coverage for the underinsured motorist.¹⁶ By including the underinsured motorist in the statutory definition of uninsured motorist, the general assembly sought to eliminate the underinsurance loophole and to protect motorists from financial loss due to inju-

and subject to said limit for one person, fifty thousand dollars (\$50,000) because of bodily injury to or death of two or more persons in any one accident."

9. E.g., N.C. GEN. STAT. § 20-279.21(b)(3) (Supp. 1985) (requiring automobile liability policies to provide coverage "for the protection of persons insured thereunder who are legally entitled to recover damages from owners or operators of uninsured motor vehicles and hit-and-run motor vehicles because of bodily injury, sickness or disease, including death, resulting therefrom."). For other examples of uninsured motorist coverage requirements, see OHIO REV. CODE ANN. 3937.18(A)(1) (Page Supp. 1985); OKLA. STAT. ANN., tit. 36, 3636(B) (West 1985).

10. Act of June 6, 1961, ch. 640, § 1(3), 1961 N.C. Sess. Laws 831, 832 (codified at N.C. GEN. STAT. § 20-279.21(b)(3) (Supp. 1985)).

11. N.C. GEN. STAT. § 20-279.21(b)(3) (Supp. 1985).

12. See *id.*; for the text of the statute, see *supra* note 8.

13. In 1979 the North Carolina Court of Appeals refused to allow an injured insured to recover on his own uninsured motorist policy even though his damages exceeded the tortfeasor's liability limit. *Tucker v. Peerless Ins. Co.*, 41 N.C. App. 302, 254 S.E.2d 656 (1979). The court reasoned that "[h]ad the legislature wished to make an underinsured motorist an exception to the general definition [of an uninsured motorist], it could have done so easily." *Id.* at 303, 254 S.E.2d at 657.

14. For example, consider an injured insured with bodily injury limits of \$50,000 per person and an equal amount of uninsured motorist coverage. If the insured had been injured by a motorist with no insurance, he or she could have recovered up to \$50,000. But if the tortfeasor had had a liability limit of \$25,000, the injured insured, under pre-1979 law could have recovered no more than \$25,000. Thus, the uninsured motorist provision of the injured insured's policy would have been of no value in this situation.

15. *James v. Michigan Mut. Ins. Co.*, 18 Ohio St. 3d 386, 389, 481 N.E.2d 272, 274 (1985).

16. The 1979 amendment provides in part:

an "uninsured motor vehicle," as described in subdivision (3) of this subsection, includes an "underinsured highway vehicle," which means a highway vehicle with respect to the ownership, maintenance, or use of which, the sum of the limits of liability under all bodily injury liability bonds and insurance policies applicable at the time of the accident is less than the applicable limits of liability under the owner's policy.

N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985).

Many other states have "[engrafted] underinsured motorist coverage into . . . [the existing definition of an] uninsured motorist." Phillips, *Underinsured Motorist Coverage in Mississippi*, 3 MISS. C. L. REV. 65, 72 (1982) (comprehensive survey of development of underinsured motorist coverage); see, e.g., IOWA CODE ANN. § 5-6A.1 (West Supp. 1985); N.M. STAT. ANN. § 66-5-301(B) (1984); S.D. CODIFIED LAWS ANN. § 58-11-9.4 (1985).

ries caused by a tortfeasor having only the minimum liability insurance coverage. Underinsured motorist coverage provides the injured insured a second source of recovery in the event the tortfeasor has insufficient liability coverage or assets to compensate the victim fully.

Because the 1979 amendment, through a definitional change, encompassed the underinsured motorist, the "established rules of construction for uninsured motorist coverage [applied] also to underinsured motorist coverage."¹⁷ The established rules of construction for uninsured motorist coverage, however, were inadequate to deal with the problems that soon surfaced with underinsured motorist coverage.¹⁸

In 1985 the North Carolina General Assembly amended the underinsured motorist statute, prescribing solutions to certain problems that are not encountered with uninsured motorist insurance but that have plagued underinsured motorist insurance since its inception.¹⁹

I. DEFINING THE RIGHTS OF INSURER AND INSURED

Subrogation is a tool of equity that allows an insurer to "step into the shoes of the party whom [it] has compensated and sue any party who the compensated party could have sued."²⁰ Thus, in the event of an accident with an uninsured tortfeasor, an injured party may receive compensation under his or her own uninsured motorist policy. The uninsured motorist insurance carrier then is entitled to pursue the injured party's claim against the tortfeasor to the extent of the payment made to its insured.²¹

When an underinsured tortfeasor is involved, however, the process of subrogation is complicated by the presence of a second insurance company—the underinsured tortfeasor's liability insurer. Insurance carriers representing the injured party and the tortfeasor have conflicting goals. The tortfeasor's liability carrier seeks to fulfill its duty to "defend and indemnify" by paying the policy limits and obtaining a release for its insured.²² The underinsurance carrier, on the other hand, desires to preserve its subrogation rights. Because the release the tortfeasor's liability carrier seeks would destroy the subrogation rights that

17. Phillips, *supra* note 16, at 76.

18. See generally Hentemann, *Underinsured Motorist Coverage: A New Coverage With New Problems*, 1983 INS. COUNS. J. 365 (analyzing the problems arising from the competing interests of the underinsurance carrier, the injured insured, and the tortfeasor's insurance carrier).

19. Act of July 31, 1985, ch. 666, § 74, 1985 N.C. Sess. Laws 862, 862-64 (codified at N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985)).

20. BLACK'S LAW DICTIONARY 1279 (5th ed. 1979).

21. N.C. GEN. STAT. § 20-279.21(b)(3) (Supp. 1985) provides:

In the event of payment to any person under the coverage required by this section and subject to the terms and conditions of such coverage, the insurer making such payment shall, to the extent thereof, be entitled to the proceeds of any settlement for judgment resulting from the exercise of any limits of recovery of such person against any person or organization legally responsible for the bodily injury for which such payment is made, including the proceeds recoverable from the assets of the insolvent insurer.

22. See Hentemann, *supra* note 18, at 371.

the underinsurance carrier wishes to retain,²³ the two carriers may find themselves at an impasse.

To protect their subrogation rights, insurers often include a "consent-to-settlement" clause in their insurance policies.²⁴ Such a clause requires the insured to obtain consent from his or her insurer before executing a release of the tortfeasor.²⁵ The insured's failure to obtain consent for a release may relieve the insurer of any obligation to pay on the underinsurance policy claim.²⁶ The consent-to-settlement clause also can impede the efficient processing of a policyholder's claim on his or her underinsured motorist coverage.²⁷

A tortfeasor's liability carrier may be willing to settle a claim by paying the policy limits on the condition that its insured obtain a release from the injured party. The underinsurance carrier, however, may oppose the settlement on the ground that the release of the tortfeasor from further liability would destroy its subrogation rights. This conflict presents a dilemma for the injured party. The injured party cannot collect underinsured motorist benefits from its insurer without first exhausting the tortfeasor's coverage²⁸ and may be unable to settle with the tortfeasor because the underinsurance carrier will not consent to the destruction of its subrogation rights that would result from a release of the tortfeasor's liability.²⁹

In some states the courts have taken the lead in attempting to resolve this dilemma.³⁰ In *Prudential Property and Casualty Co. v. Nayerahamadi*³¹ a federal district court in Pennsylvania held that an insurance company could not withhold its consent when a reasonable settlement was proposed.³² The prob-

23. See *Doyle v. Liberty Mut. Ins. Co.*, 546 F. Supp. 532 (E.D. La. 1982); *Frey v. Independence Fire and Casualty Co.*, 698 P.2d 17 (Okla. 1985).

24. See *March v. Mountain States Mut. Casualty Co.*, 101 N.M. 689, 693, 687 P.2d 1040, 1044 (1984) (an insured's settlement with the tortfeasor's insurance company without the consent of the underinsurance carrier was in violation of the consent-to-settlement provision of the policy and, therefore, relieved the underinsurance carrier of its obligation to the insured).

25. See *id.* at 691, 687 P.2d at 1042.

26. *Id.*

27. See Note, *supra* note 5, at 595-96; see also Thomas, *No-Consent-to-Settlement Clauses and Uninsured Motorist Coverage*, 35 FED'N. INS. COUNS. Q. 71, 71-76 (1984) (discussing consent-to-settlement clauses in the context of uninsured motorist coverage).

28. N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985), provides:

Underinsured Motorist coverage shall be deemed to apply when, by reason of payments of judgment or settlement, all liability bonds or insurance policies providing coverage for bodily injury caused by the ownership, maintenance, or use of the underinsured highway vehicle have been exhausted. *Exhaustion of such liability coverage for purpose of any single claim presented for underinsured motorist coverage shall be deemed to occur when either (a) the limits of liability per claim have been paid upon such claim, or (b) by reason of multiple claims, the aggregate per occurrence limit of liability has been paid.* Underinsured motorist coverage shall be deemed to apply to the first dollar of an underinsured motorist coverage claim beyond amounts paid to the claimant pursuant to the exhausted liability policy. [emphasis added.]

29. See Hentemann, *supra* note 18, at 371.

30. See *infra* notes 31-34 and accompanying text.

31. 593 F. Supp. 216 (E.D. Penn. 1984) (mem.).

32. *Id.* at 218 (citing 12A G. COUCH, CYCLOPEDIA OF INSURANCE LAW § 45:645, at 187-88 (2d rev. ed. 1981)).

lem with this solution is that it is likely to require a judicial determination of the proposed settlement's reasonableness.

An alternate approach proposed by the Minnesota Supreme Court in *Schmidt v. Clothier*³³ establishes specific procedural guidelines for settlement and subrogation.³⁴ The North Carolina General Assembly adopted this approach in the 1985 amendment to North Carolina General Statutes section 20-279.21(b)(4).³⁵ Under this approach, an injured party first obtains a proposed settlement from the tortfeasor's liability carrier. The injured party then submits this proposal to the underinsurance carrier, which has thirty days to consider the proposed settlement and can either substitute its own check in the amount of the proposed settlement and preserve its subrogation rights, or allow the settlement and release to take place and waive its subrogation rights.³⁶

This provision of the 1985 amendment has several desirable consequences for both insurers and insureds.³⁷ First, the adoption of a clearly defined settlement and subrogation procedure lessens the likelihood of litigation. When the parties involved are aware of their rights and obligations, there is less room for disagreement and a diminished need for judicial intervention in the settlement process. Second, the procedure shortens the delay in payment to the insured. Because the procedure requires the underinsurance carrier to make payment or allow a settlement within thirty days of receiving the tortfeasor's proposed settlement, the insured will receive compensation without unreasonable delay. Last, it gives the underinsurance carrier an opportunity to protect its subrogation rights.

The amendment, however, does not resolve the problems caused by a release executed without the consent of the underinsurance carrier. This may occur when a policyholder releases the tortfeasor without first ascertaining whether a claim may be filed under an underinsured motorist coverage provision and later discovers that the settlement amount is insufficient to cover all the damages. The injured party then may attempt to collect on the underinsured motorist coverage. The generally accepted rule in this situation is that a release executed without the insurer's consent relieves the insurer of its obligation to

33. 338 N.W.2d 256 (Minn. 1983).

34. *Id.* at 262-63.

35. See N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985) which provides in part:

No insurer shall exercise any right of subrogation or any right to approve settlement with the original owner, operator, or maintainer of the underinsured highway vehicle under a policy providing coverage against an underinsured motorist where the insurer has been provided with written notice in advance of a settlement between its insured and the underinsured motorist and the insurer fails to advance a payment to the insured in an amount equal to the tentative settlement within 30 days following receipt of such notice. Further, the insurer shall have the right, at its election, to pursue its claim by assignment or subrogation in the name of the claimant, and the insurer shall not be denominated as a party in its own name except upon its own election.

36. *Id.*

37. See *Schmidt v. Clothier*, 338 N.W. 2d 256, 260-61 (Minn.1983) (enumerating the problems alleviated by the settlement procedure). The procedure adopted by the Minnesota Supreme Court, *id.* at 262-63, is virtually identical to the 1985 amendment to N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985).

pay.³⁸ The insurer will be relieved of its obligation, however, only if it can show that substantial prejudice to its rights under the policy resulted from the release. The test for substantial prejudice focuses on the value of the subrogation right lost as a result of the release.³⁹ Prejudice may be found if the insurer shows that it could have recovered a significant amount from the tortfeasor but for the settlement. On the other hand, if the tortfeasor has no significant assets, a court generally will not find substantial prejudice.⁴⁰

This simple test ignores an important fact—when the insured releases the tortfeasor without his or her insurer's consent, the underinsurance carrier is thrust into an adversarial relationship with its own insured. Because the release has destroyed any subrogation right that the insurer may have had and because there is a likelihood of disagreement between insurer and insured regarding the value of the lost subrogation right, it is likely that the insured will have to sue his or her own underinsurance carrier to obtain payment on the underinsurance policy. Two elements of prejudice to the insurer not presently recognized under the substantial prejudice doctrine⁴¹ may arise in this situation. First, the insurer is at a disadvantage in any suit brought by its own insured to determine whether the lost subrogation right was of significant value. Juries rarely look with favor on the "deep-pocket" carrier in an action brought by the already-victimized insured.⁴² Juries may perceive the insurance carrier as a fat fish chasing after "mere flotsam and jetsam floating on the sea of economic irresponsibility" when the insurance carrier claims that the release of a particular underinsured motorist caused it to suffer substantial prejudice.⁴³ Thus, an insurance carrier is unlikely to be able to convince a jury that it has lost a valuable subrogation right. Juries often think of a few thousand dollars as an insignificant loss to the insurer, failing to realize the aggregate financial burden that many of these "insignificant losses" may impose. Second, even if a carrier is successful in a suit brought by its own insured, such suits are bad for business. An insurer with a reputation for forcing its insureds into court to obtain payment is unlikely to attract many new customers.

The settlement and subrogation procedure the general assembly adopted eliminates many of the conflicts and uncertainties that have characterized uninsured and underinsured motorist coverage. Despite the 1985 amendment, how-

38. See 12A G. COUCH, *CYCLOPEDIA OF INSURANCE LAW* § 45:645, at 186; (2d rev. ed. 1981); see, e.g., *Nayerahamadi*, 593 F. Supp. at 218; *Frey v. Independence Fire & Casualty Co.*, 698 P.2d 17, 21 (Okla. 1985).

39. See *Rampy v. State Farm Mut. Auto. Ins. Co.*, 278 So. 2d 428, 433-34 (Miss. 1973) (holding that an insurer was not substantially prejudiced when the subrogation right applied to an indigent motorist).

40. See, e.g., *Rampy v. State Farm Mut. Auto. Ins. Co.*, 278 So. 2d 428, 433-34 (Miss. 1973).

41. See *supra* notes 38-39 and accompanying text.

42. This phenomenon has been referred to by practitioners as the "target defendant stigma." Interview with Robert Gardner, Regional Claims Attorney for Nationwide Insurance Co. (Sept. 20, 1985); see also, *State Farm Mut. Auto. Ins. Co. v. Galloway*, 354 N.W.2d 527, 531 (Minn. Ct. App. 1984) (insured's settlement with joint tortfeasors for less than their policy limits did not bar insured's claim for uninsured benefits).

43. *Rampy v. State Farm Mut. Auto. Ins. Co.*, 278 So. 2d 428, 433 (Miss. 1973) (quoting *Lovering v. Erie Indem. Co.*, 412 Pa. 551, 554, 195 A.2d 365, 367 (1963)).

ever, it is still difficult to predict the effect of a release executed without the underinsurance carrier's consent. The substantial prejudice doctrine often yields a result consistent with the statute's purpose—to provide coverage for the injured insured.⁴⁴ In many instances, however, the insured recovers at the expense of the underinsurance carrier because he or she has impaired the right to subrogation of the claim against the party primarily liable—the underinsured tortfeasor.⁴⁵ Because fault for this situation is properly attributable to the wrongfully executed release, it is arguable that the insured should bear some of the burden. When faced with the decision, however, a jury almost invariably will decide for the victimized insured if the only alternative is to deny recovery totally. Because the wrongful release situation is not addressed in the amendment to the underinsured motorist statute, the North Carolina courts still shoulder the responsibility for its resolution. A properly executed release is vital to the smooth functioning of the new statutory settlement procedure, and the courts should reevaluate the substantial prejudice doctrine. To be effective, a judicial rule for this situation should weigh the competing policies of compensating the injured insured and protecting the insurer from the financial burden of the wrongfully executed release. The substantial prejudice doctrine ignores both the potential for damage to the insurer's reputation that would arise from suing its own insured and the financial burden of the judicially excused wrongful release. Therefore, it may be necessary for courts to allocate at least part of the financial burden to the insured who has wrongfully released the tortfeasor.

II. STACKING COVERAGE LIMITS TO COMPENSATE THE INJURED INSURED

Stacking is the aggregation of insurance coverage limits when more than one coverage applies;⁴⁶ it allows an insured to combine the coverage amounts of all available policies "to create a larger pool from which the injured party may draw in order to compensate him for his actual loss when a single policy is not sufficient to make him whole."⁴⁷ Stacking may never be used to permit recovery beyond the amount of the injured party's actual loss.⁴⁸ Although most insurance policies contain an "other insurance" clause with which an insurer "attempts to make its policy excess to all other available policies,"⁴⁹ North Carolina does not allow such a clause to prevent recovery by an injured insured

44. See *Moore v. Hartford Fire Ins. Co.*, 270 N.C. 532, 543, 155 S.E.2d 128, 136 (1967) ("[O]ur statute is designed to protect the insured as to his actual loss . . .").

45. Although the fault for the loss of the subrogation right is attributable to the insured, it is the "target defendant" insurer who usually pays the price. See *supra* note 42 and accompanying text.

46. 12A G. COUCH, *supra* note 38, § 45:628, at 77.

47. *Id.*

48. *Id.* at 73.

49. See *id.* at 70. Many jurisdictions have declared these other insurance clauses to be invalid in the uninsured or underinsured motorist context. See *Allstate Ins. Co. v. Dairyland Ins. Co.*, 271 So. 2d 457, 458 (Fla. 1972) (provision struck down on public policy grounds); *Wood v. State Farm Mut. Auto. Ins. Co.*, 234 Ga. App. 782, 785, 218 S.E.2d 65, 67 (1975) (declaring other insurance clause void as conflicting with the policy behind the uninsured motorist statute).

whose damages exceed the limits of other applicable policies.⁵⁰

Several states have enacted "anti-stacking" statutes.⁵¹ Such statutes are for the most part a reaction to the abuses of stacking allowed by some courts.⁵² Even in states that allow stacking an injured party may not recover more than the actual loss.⁵³ Generally, however, there is a trend toward a more permissive use of stacking.⁵⁴

Two primary reasons exist for allowing an injured insured to stack coverages when it is necessary to compensate the insured fully. First, stacking is harmonious with the general purpose of North Carolina General Statutes section 20-279.21(b). In *Moore v. Hartford Insurance Co.*⁵⁵ the North Carolina Supreme Court enunciated the policy behind the statute:

Its purpose was to provide, within fixed limits, some financial recompense to innocent persons who receive bodily injury or property damage, and to the dependents of those who lose their lives through the wrongful conduct of an uninsured motorist who cannot be made to respond in damages. A compulsory motor vehicle insurance act is a remedial statute and will be liberally construed so that the beneficial purpose intended by its enactment by the General Assembly may be accomplished.⁵⁶

Second, the insured has paid premiums for the additional policies with an expectation that he or she will receive the benefit of the bargain—compensation for losses suffered as a result of an injury caused by an underinsured motorist.⁵⁷

50. In *Turner v. Nationwide Mut. Ins. Co.*, 11 N.C. App. 699, 182 S.E.2d 6 (1971), the court of appeals held that:

the defendant cannot under the uninsured motorist provisions of its policy nor under its "other insurance" clauses, deny coverage to plaintiff on the ground that the insured (plaintiff) had other similar insurance available to her and paid to her, plaintiff's judgment being in excess of the uninsured motorist coverage available to her as such would be contrary to the intent and provisions of [N.C. GEN. STAT. §] 20-279.21.

Turner, 11 N.C. App. at 702-03, 182 S.E.2d at 8 (quoting the trial court's conclusions of law and judgment).

51. See, e.g., LA. REV. CODE § 22: 1406(D)(1)(c) (1981) (prohibiting stacking except for a person "injured while occupying an automobile not owned by said injured party."). In any event, stacking is limited to one additional policy.

52. *Holmes v. Reliance Ins. Co.*, 359 So. 2d 1102 (La. Ct. App.), cert. denied, 362 So. 2d 1120 (La. 1978) (allowing stacking of 160 policies).

53. 12A G. COUCH, *supra* note 38, § 45:628, at 77.

54. *Id.*

55. 270 N.C. 532, 155 S.E.2d 128 (1967).

56. *Id.* at 535, 155 S.E.2d at 130-31. The court in *Moore* also pointed out that it was "not intended by the General Assembly that an insured shall receive more from such coverage than his actual loss, although he is the beneficiary under multiple policies issued pursuant to the statute." *Id.* at 543, 155 S.E.2d at 136.

57. The New Hampshire Supreme Court recognized the insured's right to expect the benefits of stacking in *Descoteaux v. Liberty Mut. Ins. Co.*, 125 N.H. 38, 480 A.2d 14 (1984). The court noted that "[w]hen an insured purchases additional coverage he reasonably expects to be protected against uninsured motorists up to the amount for which he paid. Since the legislature created an option for additional coverage, it intended that those choosing to buy increased protection should receive its benefits." *Id.* at 45, 480 A.2d at 19 (quoting *Visneault v. Travelers Ins. Co.*, 118 N.H. 75, 80, 382 A.2d 910, 914 (1978)). The court noted further that the fact "additional coverage is provided by more than one policy, rather than through increased liability limits should not undermine that legislative decision." *Descoteaux*, 125 N.H. at 45, 480 A.2d at 19 (quoting *Courtemouche v. Lumbermen's Mut. Casualty Co.*, 118 N.H. 168, 172, 385 A.2d 105, 107 (1978)).

Stacking enables the insured to receive this benefit.

The 1985 amendment to North Carolina General Statutes section 20-279.21(b)(4) specifically addresses the question of stacking.⁵⁸ The amended statute permits stacking when two or more policies apply. It is unclear, however, whether stacking is permitted when more than one vehicle is insured under a single policy.⁵⁹ Thus, if an insured has two vehicles insured under different policy instruments, the policy limits may be combined or stacked. If an insured has two vehicles insured in the same policy instrument, however, only one coverage limit may be available. These anomalous results would occur even though the policy premiums would be the same in both cases.

The general assembly did not specifically address a situation in which a policyholder has two separate policies on two different vehicles issued by the same insurance carrier. Whether a policyholder would be able to stack the liability limits of the two policies to the extent of damages is unresolved. In *Descoteaux v. Liberty Mutual Insurance Co.*⁶⁰ the New Hampshire Supreme Court answered this question in the affirmative stating "[w]e hold that the insured is entitled to stack the medical payments coverage of the two separate policies in return for the premiums paid, regardless of whether the premiums are paid to the same or different carriers."⁶¹ That an insured pays a premium based on the amount of exposure to which the insurance carrier obligates itself supports the result in *Descoteaux*. An insured paying two separate premiums does so as consideration for the insurer's increased exposure and in expectation of increased coverage.⁶²

The Connecticut Supreme Court in *Dixon v. Empire Mutual Insurance Co.*⁶³ used the same rationale to permit aggregation of coverage limits when a second vehicle was added to a five-month-old policy. Because of the separate listing and payment of a separate premium on the second vehicle, the court permitted stacking of the policy limits on both vehicles.⁶⁴ This argument logically extends to all instances in which insurance companies charge separate premiums for separate vehicles.⁶⁵

Two characteristics of the multivehicle policy, however, arguably support denying a policyholder the right to stack the coverages for each vehicle. First,

58. N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985).

59. See *id.* The distinction made by the amendment can best be illustrated as follows. If the insured has two cars and purchases a separate policy for each car, the insured can stack the underinsured motorist coverage on each vehicle. If, on the other hand, the insured has two cars and purchases insurance for each car, but the insurance contracts are contained in one insurance agreement, the insured may not be able to stack the underinsured coverage that he or she has paid for each vehicle.

60. 125 N.H. 38, 480 A.2d 14 (1984).

61. *Id.* at 43, 480 A.2d at 18.

62. See *supra* note 57 and accompanying text.

63. 189 Conn. 449, 456 A.2d 335 (1983).

64. *Id.* at 453, 456 A.2d at 336-37.

65. See *Veal v. Aetna Casualty & Sur. Co.*, 39 Conn. Supp. 90, 469 A.2d 1234 (1983) (rule permitting stacking of liability limits should be the same whether coverage on different policies is contained in the same policy or on separate policies); *accord* *Auto-Owners Mut. Ins. Co. v. Lewis*, 10 Ohio St. 3d 156, 462 N.E.2d 396 (1984).

many multivehicle policies list one premium amount even though that amount usually represents the sum of the premiums for each vehicle. The argument against stacking in this situation is that it appears to afford the benefit of two separate policies for the price of one. When only one premium amount is paid it is often assumed that the parties to the policy contemplated only one coverage limit.⁶⁶ Second, there is often a discount on multivehicle policies. The discount supports the argument that the parties did not contemplate the same coverage that would be afforded under separate, full-price policies.

In reality, the distinctions between multivehicle policies and separate policies are superficial. The existence of a single premium has little significance when a policy lists two or more vehicles and provides for a premium equal to the combined total of premiums charged for similar vehicles on separate policies. From the insured's perspective, because premiums are based on the amount of potential exposure,⁶⁷ it would be unjust to allow the insurer to charge for two full premiums and then afford coverage for only one simply because both vehicles are listed on the same policy. Similarly, the discounting of premiums for vehicles subsequently added to a multivehicle policy does not reflect either the insurer's expectation of decreased exposure or the insured's expectation of diminished coverage.⁶⁸ Rather, the discount reflects a savings in administrative costs—usually only a matter of a few dollars—that the insurer passes on to the insured.⁶⁹

The amended version of North Carolina General Statutes section 279.21(b)(4) allows stacking when "more than one policy may apply . . ."⁷⁰ Therefore, the statutory language appears to deny a policyholder the right to stack coverage limits on a multivehicle policy. Restricting stacking based on the single versus multivehicle policy distinction is too arbitrary. Neither logic nor equity supports a denial of stacking on multivehicle policies, while permitting stacking of policies that list only one vehicle. Furthermore, the public policy underlying the statute—to compensate the innocent victim of an accident caused by an uninsured or underinsured motorist—is not served by such an arbitrary restriction.

III. THE INSURER'S DUTY TO DEFEND

The standard motor vehicle insurance policy contains a clause obligating

66. See *Allstate Ins. Co. v. Piatt*, 417 So. 2d 705 (Fla. Dist. Ct. App. 1982) (stacking not permitted when insured had paid one premium for policy covering two vehicles).

67. The amount of potential exposure is the total amount for which the insurer could be liable should all covered accidents occur.

68. See *Lopez v. Foundation Reserve Ins. Co.*, 98 N.M. 166, 646 P.2d 1230 (1982) (stacking held appropriate when insurance contract covered two automobiles with separate uninsured motorist coverage and premium on second vehicle was reduced by one dollar).

69. Interview, *supra* note 42; see also *Lopez v. Foundation Reserve Ins. Co.*, 98 N.M. 166, 172, 646 P.2d 1230, 1235 (1982) (suggesting that a small discount on the premium for a second vehicle in a multivehicle liability policy reflects the decreased likelihood that both cars will be at risk at the same time).

70. N.C. GEN. STAT. § 279.21(b)(4) (Supp. 1985).

the insurer to defend in any action against the insured.⁷¹ The duty to defend is the distinguishing characteristic between "indemnity" and "liability" insurance policies. As Professor Couch has explained, "[liability insurance policies] protect the insured against liability although he has not actually paid the injured person, and are thus distinguishable from an 'indemnity' policy which binds the insurer to pay only after a final judgment against the insured has been paid."⁷²

The 1985 amendment to North Carolina General Statutes section 20-279.21 raises some questions regarding the nature of the duty to defend. This section states:

[P]rovided that application is made to and approved by a presiding superior court judge, . . . any insurer providing primary liability insurance on the underinsured highway vehicle may upon payment of all of its applicable limits of liability be released from further liability or obligation to participate in the defense of such proceeding. However, prior to approving any such application, the court shall be persuaded that the owner . . . of the underinsured highway vehicle . . . [has been given] his right to select counsel of his own choice to appear in such action on his separate behalf.⁷³

This provision allows a tortfeasor's insurance carrier to pay its liability limits and thus relieve itself of its duty to defend.

Arguably, an insurer has always had the right to withdraw from a suit against its insured once it has paid the liability limits of the policy. Under the standard insuring agreement, the insurer provides that the "duty to settle or defend ends when [the] limit of liability has been exhausted."⁷⁴ In conjunction with a policy provision that reserves to the insurer the right "to settle or defend as we consider appropriate," the power to "pay in and get out" has always belonged to the insurer.⁷⁵

Insurers often use the provision allowing for settlement or defense to avoid a suit. Take, for example, a primary insurer (the tortfeasor's insurer) who becomes liable for damages negligently caused by its insured who has the minimum 25,000 dollar policy limit. The injured party estimates damages to be about 25,000 dollars. The primary insurer can pay its policy limit to the injured party and avoid a suit as long as it obtains a release for its insured. Alternatively, if the insurance company believes the claim for damages is specious or exaggerated, it can defend its insured in court with the hope of paying out less in final judgment than the 25,000 dollar settlement proposed by the injured party. By litigating the issue of damages, however, the insurer assumes the risk of paying not only the full damages of 25,000 dollars but also of paying litigation expenses.

71. Most insurance policies contain the following type of clause: "In addition to our limit of liability, we will pay all defense costs we incur. Our duty to settle or defend ends when our limit of liability for this coverage has been exhausted." State Farm Ins. Co., Automobile Insurance Policy Form No. 98338.2 (including copyrighted material of N.C. Rate Bureau, 1980).

72. See 12 G. COUCH, *supra* note 38, § 45:17, at 247 (2d rev. ed. 1984).

73. N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985).

74. See *supra* note 71.

75. See *supra* note 71.

On these facts, the amended version of North Carolina General Statute section 20-279.21(b)(4) would allow the primary insurer to pay the 25,000 dollar policy limit and be released from all further obligations.⁷⁶ This result acts as an inducement for the primary insurer to settle rather than litigate. Therefore, the 1985 amendment may reduce litigation and facilitate the prompt payment of claims.

The cost of this decrease in litigation and increase in efficient claims processing, however, will be paid by the insured. The liability contract, for which the insured bargained, imposes a duty on the insurance carrier to defend the insured and pay the costs of defense.⁷⁷ Under the 1985 amendment, an insurer faced with the situation described above would opt for payment of the policy limits. In fact, the insurer might pay the policy limits even if it believed it could successfully defend or if it believed the claim to be exaggerated.⁷⁸ Because a protracted defense of the insurer's insured could be quite expensive, it is likely that many insurers will choose to pay the policy limits, forcing the insured to hire separate counsel.⁷⁹

The statutory provision allowing an insurer to pay its policy limits and escape responsibility for defending the insured enables one of the parties to the insurance contract to repudiate part of its bargain. Part of the benefit of any automobile liability insurance policy is that the insurer's obligations arise at the moment a covered injury is sustained.⁸⁰ The insurer's liability should extend to the costs of a suit against the insured when so provided in the insurance contract.

IV. CONCLUSION

The 1985 amendment of North Carolina General Statutes section 20-270.21(b)(4) offers long overdue legislative guidance for settlement of underinsured motorist claims. The procedure for subrogation undoubtedly is the most valuable contribution of the amendment. By clarifying the rights and obligations of both insurers and insureds, the amendment assures that victims of underinsured tortfeasors no longer will have to wait for compensation because of sparring between insurance companies.

The provision that restricts stacking by excluding coverage on multivehicle

76. N.C. GEN. STAT. § 20-279.21(b)(4) (Supp. 1985). See *supra* text accompanying note 73 for the relevant language of the statute.

77. See *Jamestown Mut. Ins. Co. v. Nationwide Mut. Ins. Co.*, 277 N.C. 216, 176 S.E.2d 751 (1970) (insurance company held liable for costs of defense when insurer wrongfully refused to defend its insured against claims arising out of a covered automobile accident).

78. An interesting situation arises when the underinsurance carrier believes that its insured is exaggerating his or her damages. If the injured insured brings suit for payment on the underinsurance policy, the underinsurance carrier may be forced to defend the tortfeasor to prove that the injured insured is exaggerating his or her damages. See N.C. GEN. STAT. § 279.21(b)(4) (Supp. 1985).

79. See *id.* Under the amended statute the court must determine that the tortfeasor has been given the right "to select counsel of his own choice" before allowing the tortfeasor's liability carrier the right to drop out of the suit.

80. 12 G. COUCH, *supra* note 38, § 45:24, at 255.

policies, however, contradicts the general purpose of the underinsured motorist statute—to provide compensation for the innocent victim of an underinsured tortfeasor.⁸¹ Furthermore, the amendment's restriction on stacking denies policyholders coverage for which they have paid and have a right to expect. Similarly, the amendment may deprive the policyholder of another benefit of liability coverage—the insurer's duty to defend.

With this amendment to the Underinsured Motorist Statute, the North Carolina General Assembly has sought to provide an equitable and efficient resolution of the conflicts surrounding the rights of parties caught in the underinsurance morass. The carefully planned and even-handed procedure for subrogation and settlement included in the amendment is a significant step toward that end. Nevertheless, the arbitrary restriction on stacking and the erosion of the insurer's duty to defend have no rightful place in a "remedial statute [designed to be] liberally construed so that the beneficial purpose intended by its enactment . . . may be accomplished."⁸² The North Carolina General Assembly should reconsider its decision to include these changes in the uninsured motorist statute.

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81. See *Moore v. Hartford Fire Ins. Co.*, 270 N.C. 532, 535, 155 S.E.2d 128, 130 (1967) (stating the general purposes of the uninsured motorist statute).

82. *Id.* at 535, 155 S.E.2d at 131.

Bad Faith Refusal to Pay First-Party Insurance Claims: A Growing Recognition of Extra-Contract Damages

The tort of bad faith,¹ now recognized by a growing number of jurisdictions,² has extended the liability of insurance companies in first-party insurance actions.³ Acknowledging that a special relationship exists between an insurer and insured, most courts have reevaluated traditional common-law principles when dealing with an insurance company that has breached its duty to act in good faith toward its insured.⁴ Furthermore, the vast resources of the insurance industry⁵ and the public interest inherent in insurance⁶ have prompted courts to provide expansive tort remedies to aggrieved policyholders in first-party bad faith actions.

The insured's purchase of insurance establishes a contract in which the insurer promises to pay a designated or ascertainable sum when certain contingencies occur.⁷ The insured seeks peace of mind that the insurer will provide bargained-for relief to prevent further hardship should a serious personal or financial setback occur. When a breach of contract occurs, the long standing rule of *Hadley v. Baxendale*⁸ limits consequential damages to those damages either

1. The tort of bad faith developed in response to abusive settlement practices by insurers in third-party insurance actions. See W. SHERNOFF, M. GAGE, & H. LEVIN, *INSURANCE BAD FAITH LITIGATION* § 5.02, at 5-4 (1985) [hereinafter cited as W. SHERNOFF]. For example, a liability insurer defending an insured against liability for injuring a third person might refuse to settle, thereby exposing the insured to the risk of a judgment in excess of the policy limits. *Id.* § 3.01, at 3-4 to 3-5. To deter such conduct, courts developed the rule that when an insurer refuses to settle and the refusal is in bad faith, the insurer will be liable for the excess judgment. *Id.* at 3-5. Characterizing the action as a tort allows the insured to recover a broader range of damages generally not available in actions based on breach of contract. *Id.* § 2.02[2] at 2-5.

2. See, e.g., *Washington v. Group Hospitalization, Inc.*, 585 F. Supp. 517 (D.D.C. 1984); *Rodgers v. Pennsylvania Life Ins. Co.*, 539 F. Supp. 879 (S.D. Iowa 1982); *Phillips v. Aetna Life Ins. Co.*, 473 F. Supp. 984 (D. Vt. 1979); *Chavers v. National Sec. Fire & Cas. Co.*, 405 So. 2d 1 (Ala. 1981); *Noble v. National Am. Life Ins. Co.*, 128 Ariz. 188, 624 P.2d 866 (1981); *Aetna Cas. & Sur. Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463 (1984); *Grand Sheet Metal Prod. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 375 A.2d 428 (1977); *Ledingham v. Blue Cross Plan*, 29 Ill. App. 3d 339, 330 N.E.2d 540 (1975), *rev'd on other grounds*, 64 Ill. 2d 338, 356 N.E.2d 75 (1976); *United States Fidelity & Guar. Co. v. Peterson*, 91 Nev. 617, 540 P.2d 1070 (1975); *Dailey v. Integon Gen. Ins. Corp.*, 75 N.C. App. 387, 331 S.E.2d 148, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985); *Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co.*, 279 N.W.2d 638 (N.D. 1979); *Christian v. American Home Assur. Co.*, 577 P.2d 899 (Okla. 1978); *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313 (R.I. 1980); *Nichols v. State Farm Mut. Auto. Ins. Co.*, 279 S.C. 336, 306 S.E.2d 616 (1983); *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 271 N.W.2d 368 (1978).

3. First-party insurance policies indemnify an insured for a personal loss covered under the insurance contract. The special relationship between insurer and insured creates an implied covenant of good faith and fair dealing in the insurance contract. W. SHERNOFF, *supra* note 1, § 5.02, at 5-4. The breach of the duty constitutes a tort, separate and distinct from the contract, allowing an insured to recover tort damages for an insurer's bad faith refusal to pay. See *infra* notes 37-48 and accompanying text; cf. *Daily v. Integon Gen. Ins. Co.*, 75 N.C. App. 387, 395-96, 331 S.E.2d 148, 154 (punitive damages are recoverable even though the tort constitutes or accompanies a breach of contract), *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985).

4. See *infra* notes 7-22 and accompanying text.

5. See *infra* notes 53-54 and accompanying text.

6. See *infra* notes 55-60 and accompanying text.

7. J. MCCARTHY, *PUNITIVE DAMAGES IN BAD FAITH CASES* § 1.1, at 2-3 (1983).

8. 9 Ex. Ch. 341, 156 Eng. Rep. 145 (1854). Most states including North Carolina have

arising naturally from the breach or reasonably within the contemplation of the parties at the time the contract was made.⁹ The breach of an insurance contract frequently results in the insured suffering consequential damages such as emotional distress, economic loss, inconvenience, and legal expenses. However, an insured often cannot recover these damages for two important reasons. First, courts strictly construe the *Hadley* concept of foreseeability to limit damages to those specifically related to the rights and duties set forth in the contract.¹⁰ Second, even when specific consequences are foreseeable, the insurance contract is typically viewed as an agreement to pay money and, therefore, recovery of damages is limited to the amount due under the contract plus interest.¹¹ Moreover, the insured cannot recover punitive damages because such damages are generally not awarded in breach of contract actions, regardless of how willful, malicious, or fraudulent the breach.¹²

Given the limitations of traditional contract remedies, an insurance company could refuse to pay a legitimate claim without risking any more than if it had paid the claim immediately.¹³ In fact, when commercial interest rates are above legal interest rates, it may actually be profitable for an insurance company to withhold payment on a claim.¹⁴ As a result, an insured can be forced to incur substantial legal expenses in order to recover benefits under the policy.¹⁵ Faced with this alternative, an insured may settle for an amount far below what he or she would be entitled to under the policy.¹⁶

To deter unethical conduct by insurance companies, a growing number of jurisdictions now allow extra-contract damages¹⁷ in cases in which an insurer has acted in bad faith. Based on tort law principles,¹⁸ an insurer's bad faith

adopted the *Hadley* limitation on damages. See, e.g., *Price v. Goodman*, 226 N.C. 223, 228-29, 37 S.E.2d 592, 596 (1946).

9. *Hadley*, 9 Ex. Ch. at 354, 156 Eng. Rep. at 151.

10. See W. SHERNOFF, *supra* note 1, § 7.02[2], at 7-6 to -7 & n.11.

11. See *Insurance Co. v. Piaggio*, 83 U.S. 378, 386 (1872); see also *Pennsylvania Threshermen & Farmers Mut. Cas. Ins. Co. v. Robertson*, 157 F. Supp. 405, 411 (M.D.N.C. 1957) (insurer's liability to insured limited to value of policy plus interest), *rev'd on other grounds*, 259 F.2d 389 (4th Cir. 1958), *cert. denied*, 359 U.S. 950 (1959).

12. See *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 400, 89 Cal. Rptr. 78, 92 (1970); *St. Paul at Chase Corp. v. Manufacturers Life Ins. Co.*, 262 Md. 192, 236-39, 278 A.2d 12, 33-35, *cert. denied*, 404 U.S. 857 (1971); *King v. Insurance Co. of N. Am.*, 273 N.C. 396, 398, 159 S.E.2d 891, 893 (1968).

13. Note, *Increasing Liability for Refusal To Pay First Party Claims: Bad Faith and Punitive Damages*, 13 WAKE FOREST L. REV. 685, 685-86 (1977).

14. *Id.* at 686. In recent years, the legal interest rates have been far below the commercial rates. As a result, the interest earned by the insurance company while litigation is pending will usually be substantial compared to the amount it will pay under the lower legal interest rate. W. SHERNOFF, *supra* note 1, § 7.01, at 7-3.

15. W. SHERNOFF, *supra* note 1, § 7.01, at 7-3.

16. W. SHERNOFF, *supra* note 1, § 7.01, at 7-3.

17. "Extra-contract" damages refer to damages, whether compensatory or punitive, that are recoverable in excess of the benefits provided under an insurance contract or the policy proceeds recovered because of a loss. G. Kornblum, *Defense of a First-Party Extra Contract Claims Action Against a Life, Health and Accident Insurer*, 29 AM. JUR. TRIALS 481, 489 (1982). For a discussion of extra-contract damages in North Carolina, see Comment, "Extra-Contractual" Remedies for Breach of Contract in North Carolina, 55 N.C.L. REV. 1125 (1977).

18. Unlike contract law, which focuses primarily on the consensual agreement of the parties, tort law imposes duties of conduct influenced by social policy. W. SHERNOFF, *supra* note 1,

refusal¹⁹ to settle with its insured may constitute a tort allowing the insured to recover damages for emotional distress, as well as economic losses associated with the tortious conduct.²⁰ In addition, when the insurer's conduct is accompanied by some type of aggravated conduct, the insured also can be awarded punitive damages.²¹ In a series of cases decided by the North Carolina courts, it has become clear that an insurance company can be held liable in North Carolina for punitive damages for a tortious, bad faith refusal to settle with its insured.²² This Note examines the evolution of the tort of bad faith and addresses the implications extra-contract damages may have on North Carolina insurance law, as well as noninsurance commercial law.

A cause of action for fraud was the first legal theory used by courts to provide an insured with a tort measure of recovery for an insurer's failure to pay on a policy. By combining a contract claim with a tort action for fraud, the insured could recover the benefits of the policy plus punitive damages.²³ The plaintiff, however, was frequently faced with the obstacle of proving the insurer's fraudulent intent at the time the contract was made.²⁴ Given that the plaintiff's grievances usually concerned bad faith settlement practices that took place after the claim for payment arose, the insured often had difficulty establishing a fraudulent act relating to the formation of the insurance contract.²⁵ To overcome this barrier, the California Court of Appeals in *Wetherbee v. United Insurance Co. of America*²⁶ allowed the plaintiff to recover for fraud by permitting the insurer's post-contract conduct to support an inference of precontract fraudulent intent.²⁷ Although this approach eased a plaintiff's burden of proof for fraudulent

§ 7.02[1], at 7-5 to -6. Because of this distinction there is a marked difference between the measure of damages recoverable under each theory. In breach of contract actions, courts attempt to place the aggrieved party in the position he or she would have been in had the contract not been breached. *Id.* at 7-6. In tort actions, the plaintiff is compensated for all damages proximately caused by the defendant's conduct, regardless of whether the damages could have been anticipated by the defendant. *Id.*

19. What constitutes bad faith conduct varies among jurisdictions. Situations that evince a bad faith refusal to pay a claim include: (1) an insurance company's rejection of a claim even though it clearly has a legal obligation to pay, (2) an insurer's failure to properly investigate a claim and refusal to pay a claim without a reasonable basis for doing so, and (3) deliberate and abusive conduct by an insurer in an attempt to force the insured to settle for an amount far below what is reasonable. See W. SHERNOFF, *supra* note 1, § 5.11[1] to -12[1], at 5-12 to -15.

20. Such damages are generally recoverable in a tort action. See *supra* note 18.

21. See *infra* notes 70-73 and accompanying text & text accompanying note 79.

22. See *infra* notes 85-95 and accompanying text.

23. See Comment, *The Availability of Excess Damages for Wrongful Refusal to Honor First Party Insurance Claims—An Emerging Trend*, 45 FORDHAM L. REV. 164, 171 (1976).

24. Note, *supra* note 13, at 692.

25. W. SHERNOFF, *supra* note 1, § 1.06, at 1-16.

26. 265 Cal. App. 2d 921, 71 Cal. Rptr. 764 (1968). Plaintiff in *Wetherbee* became worried that her disability policy could be terminated at the will of the insurer. *Id.* at 925, 71 Cal. Rptr. at 766. As a result, plaintiff returned the policy and requested reimbursement of her premium. Defendant assured plaintiff that the policy would not be terminated if she became disabled. Because of these assurances, plaintiff elected to continue making payments on her policy. After plaintiff became disabled, however, the insurer refused to make payments under the policy. *Id.* at 926-27, 71 Cal. Rptr. at 767.

27. Note, *supra* note 13, at 692. The court stated that defendant's fraudulent intent not to abide by its previous representations could be inferred from its discontinuance of benefits. *Wetherbee*, 265 Cal. App. 2d at 932, 71 Cal. Rptr. at 769-70.

intent, an insured typically experienced difficulty proving fraud based on the insurer's post-claim conduct.²⁸

The tort of intentional infliction of emotional distress provided an alternative means by which first-party insureds could recover damages outside the policy limits.²⁹ The elements of the tort include extreme and outrageous conduct by the defendant with the intent to cause, or reckless disregard of causing, severe emotional distress, and severe emotional distress resulting from the defendant's wrongful conduct.³⁰ *Fletcher v. Western National Life Insurance Co.*³¹ was the first case to uphold an insured's claim for intentional infliction of emotional distress against a first-party insurer.³² Since *Fletcher*, several courts have awarded damages based on this theory of recovery.³³ These courts have found two factors determinative of outrageous conduct by insurance companies: (1) the use of extreme "bullying tactics" and other "high pressure" methods to force the insured into settling;³⁴ and (2) the insurer's possession of knowledge that the insured is particularly susceptible to emotional distress by reason of some physical or mental condition.³⁵ Although intentional infliction of emotional distress allows tort recovery by some insureds for unfair claims practices, this remedy is far from ideal. The requirement that the defendant's conduct be outrageous, and perhaps more importantly, that the plaintiff suffer severe emotional distress, diminishes the utility of the tort as a remedy in first-party insurance actions.³⁶

28. W. SHERNOFF, *supra* note 1, § 1.06, at 1-17.

29. See, e.g., *Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1, 3-5 (7th Cir. 1972) (applying Illinois law); *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal. App. 3d 376, 396-98, 89 Cal. Rptr. 78, 90-91 (1970); *World Ins. Co. v. Wright*, 308 So. 2d 612 (Fla. Dist. Ct. App.), *cert. denied*, 322 So. 2d 913 (Fla. 1975).

30. See RESTATEMENT (SECOND) OF TORTS § 46 (1965). To recover, the plaintiff must show that the defendant's conduct was "so outrageous in character, and so extreme in degree, as to go beyond all possible bounds of decency, and to be regarded as atrocious, and utterly intolerable in a civilized community." *Id.* § 46 comment d.

31. 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970).

32. In *Fletcher* the insurer refused to pay the insured approximately \$50,000 under a disability insurance policy. The insurer alleged that the disability resulted from an illness, for which two years of benefits were to be provided under the policy, rather than by an accident, for which thirty years of benefits were to be provided under the policy. *Id.* at 388, 89 Cal. Rptr. at 84. The insurer subsequently acted in bad faith by refusing to make payments under the policy and directing false and threatening communications to the insured to force an unreasonable settlement. *Id.* at 389-92, 89 Cal. Rptr. at 85-87. Presented with these facts, the court had little trouble finding extreme and outrageous conduct on the part of the insurer and imposed liability for the tort of intentional infliction of emotional distress. *Id.* at 401, 89 Cal. Rptr. at 93.

33. See cases cited *supra* note 29. The North Carolina Court of Appeals in *Daily v. Integon Gen. Ins. Corp.*, 75 N.C. App. 387, 331 S.E.2d 148, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985), suggested that a claim for intentional infliction of emotional distress could be recognized for an insurer's bad faith refusal to settle a claim. *Id.* at 400-01, 331 S.E.2d at 157-58. The court found, however, that plaintiff failed to show that he had suffered any compensable emotional distress and therefore dismissed plaintiff's claim for compensatory damages. *Id.* at 401, 331 S.E.2d at 158.

34. *Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1, 4 (7th Cir. 1972) (applying Illinois law). For a further discussion of bad faith conduct, see *supra* note 19.

35. *Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1, 4 (7th Cir. 1972) (applying Illinois law); see Comment, *supra* note 23, at 175.

36. W. SHERNOFF, *supra* note 1, § 1.06, at 1-20. Frequently, an insured's mental anguish does not flow directly from the defendant's conduct, but from the personal and financial losses caused by the insurer's refusal to pay. Comment, *supra* note 23, at 177. The tort of intentional infliction of emotional distress, however, does not compensate for the invasion of economic interests. *Id.* Recognizing these difficulties associated with the tort, the court in *Fletcher* held that the insured could also

Given the limitations of actions for fraud and intentional infliction of emotional distress, most courts have relied on the tort of bad faith to impose tort liability for improper claims practices by insurers.³⁷ An insurer's bad faith refusal to pay a valid first-party insurance claim was first recognized in *Gruenberg v. Aetna Insurance Co.*³⁸ In *Gruenberg* the California Supreme Court stated that the implied duty of good faith and fair dealing applies to all insurance contracts and that an insurer has an obligation not to deprive the insured of the policy's benefits.³⁹ Thus, an insurance company's bad faith and unreasonable withholding of payments to an insured subjects the insurer to liability in tort.⁴⁰

recover under the theory of tortious interference with a protected property interest. *Fletcher*, 10 Cal. App. 3d at 401-02, 89 Cal. Rptr. at 93-94. This allowed the insured to recover emotional damages without showing outrageous conduct by the insurer, and without suffering severe emotional distress. See W. SHERNOFF, *supra* note 1, § 1.06, at 1-21. In addition, the insured could be compensated for other types of damage, such as economic loss caused by the defendant's conduct and possibly punitive damages. *Fletcher*, 10 Cal. App. 3d at 401-02, 89 Cal. Rptr. at 93-94. Recovery for tortious interference with a protected property interest has not gained widespread acceptance because most courts have relied on the tort of bad faith to impose tort liability for unfair insurance claims practices. W. SHERNOFF, *supra* note 1, § 1.06, at 1-21.

37. The pioneering case in bad faith litigation was *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958), an action by the insured against his insurer for refusing to settle within the policy limits. *Id.* at 657, 328 P.2d at 200. The insurer's refusal to settle with the third party led to a judgment against the insured for an amount in excess of his policy limits. *Id.* The California Supreme Court imposed an implied duty of good faith and fair dealing on insurance contracts and stated that this duty of good faith "requires an insurer to settle in an appropriate case although the express terms of the policy do not impose such a duty." *Id.* at 659, 328 P.2d at 201. Furthermore, the insurer must give the interests of the insured equal consideration when evaluating a settlement offer. *Id.* The court held that the defendant's breach of this duty, in addition to giving rise to an action for breach of the insurance contract, gave rise to a tort action for bad faith. *Id.* Therefore, the insurer could be found liable for an amount in excess of the policy limit. *Id.* at 660-61, 328 P.2d at 202. For a further discussion of third party claims, see *supra* note 1.

38. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973). Plaintiff in *Gruenberg* was the owner of a nightclub, insured under three separate policies, that was damaged by fire. *Id.* at 570, 510 P.2d at 1034, 108 Cal. Rptr. at 482. Criminal charges were brought against the insured for the crimes of arson and defrauding an insurer, but were subsequently dismissed for lack of probable cause. *Id.* at 570-71, 510 P.2d at 1034-35, 108 Cal. Rptr. at 482-83. In the interim, the insurers' counsel requested that Gruenberg appear for an examination under oath concerning the fire loss. *Id.* at 570, 510 P.2d at 1034, 108 Cal. Rptr. at 482. Provisions of the California Insurance Code gave the insurer the right to request such an examination. *Id.* Gruenberg's counsel responded that he had instructed his client to make no statements concerning the fire while the felony charges were still pending. *Id.* at 570-71, 510 P.2d at 1034-35, 108 Cal. Rptr. at 482-83. Insurer's counsel replied that Gruenberg's failure to appear would be treated as a breach of contract and that coverage for the loss would be denied. *Id.* at 571, 510 P.2d at 1035, 108 Cal. Rptr. at 483. After the criminal charges were dismissed, Gruenberg's attorney advised the insurers that his client was prepared to submit to an examination. The insurers, however, reaffirmed that liability was to be denied because of plaintiff's earlier failure to appear. *Id.*

Gruenberg brought a cause of action in tort against defendants for breach of the implied covenant of good faith and fair dealing. *Id.* at 573, 510 P.2d at 1036, 108 Cal. Rptr. at 484. The court held that plaintiff had alleged sufficient facts to state a cause of action in tort. *Id.* at 581, 510 P.2d at 1042, 108 Cal. Rptr. at 490.

39. *Id.* at 573, 510 P.2d at 1036, 108 Cal. Rptr. at 484. This duty was first recognized in third-party insurance actions. See *supra* note 37.

40. *Gruenberg*, 9 Cal. 3d at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486. Since *Gruenberg*, a number of courts have imposed tort liability on insurers for breaching the implied duty of good faith in first-party actions. See, e.g., *Escambia Treating Co. v. Aetna Cas. & Sur. Co.*, 421 F. Supp. 1367 (N.D. Fla. 1976); *Grand Sheet Metal Prod. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 375 A.2d 428 (1977); *United States Fidelity & Guar. Co. v. Peterson*, 91 Nev. 617, 540 P.2d 1070 (1975); *Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co.*, 279 N.W.2d 638 (N.D. 1979); *Christian v. American Home Assur. Co.*, 577 P.2d 899 (Okla. 1978).

Although some disparity exists as to the rationale behind allowing extra-contract damages,⁴¹ most courts agree on the factors needed to establish bad faith. In *Anderson v. Continental Insurance Co.*⁴² the Wisconsin Supreme Court identified the elements of a claim for first-party bad faith against an insurer as (1) an absence of a reasonable basis for denying benefits to the insured under the policy; and (2) knowledge or reckless disregard of the lack of a reasonable basis for denying the claim.⁴³ The reasonableness of the denial of a claim is judged by the reasonable person standard common to tort law.⁴⁴ The *Anderson* standard also requires an intentional wrongdoing on the part of the insurer⁴⁵ for the insured to recover compensatory damages in a bad faith action. This requirement of intentional or reckless conduct by the insurer approaches the standard applied by most courts in awarding punitive damages.⁴⁶ Although some courts have adopted this higher degree of culpability in bad faith actions,⁴⁷ others have not distinguished between negligent and intentional behavior.⁴⁸

Despite this trend in insurance bad faith litigation, many jurisdictions have refused to recognize the bad faith tort in first-party insurance actions.⁴⁹ These courts assert that through statutory penalties such as fines, imprisonment, and the imposition of attorney's fees, the legislature has provided adequate protection to the public against unfair claims practices by first-party insurers.⁵⁰ More-

41. Note, *An Insurer's Bad Faith Refusal to Pay a Valid First Party Claim: A Tort Whose Time Has Come in Iowa*, 32 *DRAKE L. REV.* 987, 989-90 (1983).

42. 85 Wis. 2d 675, 271 N.W.2d 368 (1978).

43. *Id.* at 691, 271 N.W.2d at 376. In *Aetna Life Ins. Co. v. Lavoie*, 470 So. 2d 1060 (Ala. 1984), the Alabama Supreme Court established the following elements of a first-party bad faith action:

(a) an insurance contract between the parties and a breach thereof by the defendant; (b) an intentional refusal to pay the insured's claim; (c) the absence of any reasonably legitimate or arguable reason for that refusal (the absence of a debatable reason); (d) the insurer's actual knowledge of the absence of any legitimate or arguable reason; (e) if the intentional failure to determine the existence of a lawful basis is relied upon, the plaintiff must prove the insurer's intentional failure to determine whether there is a legitimate or arguable reason to refuse to pay the claim.

Id. at 1071 (quoting *National Sec. Fire & Cas. Co. v. Bowen*, 417 So. 2d 179, 183 (Ala. 1982)).

44. See Note, *supra* note 41, at 991-92.

45. See W. SHERNOFF, *supra* note 1, § 5.03[3], at 5-10.1.

46. W. SHERNOFF, *supra* note 1, § 5.03[3], at 5-10.

47. See, e.g., *Chavers v. National Sec. Fire & Cas. Co.*, 405 So. 2d 1, 6 (Ala. 1981) (actionable tort recognized for an insurer's intentional refusal to pay a direct claim); *Aetna Cas. and Surety Co. v. Broadway Arms Co.*, 281 Ark. 128, 131, 664 S.W.2d 463, 465 (1984) ("claim based on the tort of bad faith must include affirmative misconduct by the insurance company, without a good faith defense, and . . . the misconduct must be dishonest, malicious, or oppressive in an attempt to avoid its liability under an insurance policy"); *Gruenberg*, 9 Cal. 3d at 375, 510 P.2d at 1038, 108 Cal. Rptr. at 486 (insurer has the "duty not to threaten to withhold or actually withhold payments, maliciously and without probable cause, for the purpose of injuring its insured").

48. Note, *supra* note 41, at 991-92.

49. See, e.g., *Spencer v. Aetna Life & Cas. Ins. Co.*, 227 Kan. 914, 611 P.2d 149 (1980); *Lawton v. Great S.W. Fire Ins. Co.*, 118 N.H. 607, 392 A.2d 576 (1978); *Farris v. U.S. Fidelity & Guar. Co.*, 284 Or. 453, 587 P.2d 1015 (1978); *D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Ins. Co.*, 494 Pa. 501, 431 A.2d 966 (1981); *Beck v. Farmers Ins. Exchange*, 701 P.2d 795 (Utah 1985).

50. See *Spencer v. Aetna Life & Cas. Ins. Co.*, 227 Kan. 914, 926, 611 P.2d 149, 158 (1980) ("[W]e hold the [legislative] remedies are adequate to force compliance with the terms of insurance contracts."); see also *Debolt v. Mutual of Omaha*, 56 Ill. App. 3d 111, 116, 371 N.E.2d 373, 377 (1978) ("Where the legislature has provided a remedy on a subject matter we are not only loath but in addition harbor serious doubts as to the desirability and wisdom of implementing or expanding

over, many of these courts have found the policy arguments underlying a first-party bad faith tort to be unpersuasive.⁵¹

Courts that allow extra-contract damages emphasize that the special relationship between the insurer and insured justifies imposing a broader legal responsibility on insurance companies.⁵² Most of these courts focus on the disparity of financial resources between insurer and insured and the inequality of bargaining power that necessarily follows.⁵³ By exposing insurance companies to tort liability, the courts attempt to equalize the relationship between the parties and ensure that the insured receives the expected benefit of the bargain.⁵⁴

A second factor cited by most courts to support extra-contract damages is the public interest⁵⁵ inherent in the insurance industry. Because the insurance industry is affected with a public interest⁵⁶ and is frequently regarded as quasi-

the legislative remedy by judicial decree."); *Lawton v. Great S.W. Fire Ins. Co.*, 118 N.H. 607, 614, 392 A.2d 576, 581 (1978) ("[T]he legislature has established mechanisms designed to deal with insurer malfeasance in this area, which, in our opinion, vitiates the need for recognition of a new cause of action in tort."); *D'Ambrosio v. Pennsylvania Nat'l Mut. Cas. Ins. Co.*, 494 Pa. 501, 507, 431 A.2d 966, 970 (1981) ("[T]here is no evidence to suggest . . . [that] the Unfair Insurance Practices Act . . . must be supplemented by a judicially created cause of action."). *But cf.* *Phillips v. Aetna Life Ins. Co.*, 473 F. Supp. 984, 990 & n.4 (D. Vt. 1979) (stating that a Vermont statute's requirement of prompt payment of insurance claims added support to a recognition of a cause of action in tort); *Christian v. American Home Assur. Co.*, 577 P.2d 899, 904-05 (Okla. 1978) (relying on an Oklahoma statute and holding that a bad faith rejection of an insurance claim gives rise to an action in tort). For a further discussion of legislative remedies see *infra* note 60.

51. For a discussion of the policy arguments supporting a first party bad faith tort, see *infra* notes 53-68 and accompanying text.

52. See *W. SHERNOFF, supra* note 1, § 1.01, at 1-3 to -4.

53. See *Rodgers v. Pennsylvania Life Ins. Co.*, 539 F. Supp. 879, 883 (S.D. Iowa 1982) (An insured may be "particularly vulnerable to oppressive tactics on the part of an economically powerful entity.") (quoting *Amsden v. Ginnell Mut. Reinsurance Co.*, 203 N.W.2d 252, 255 (Iowa 1972)); *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 820, 620 P.2d 141, 146, 169 Cal. Rptr. 691, 696 (1979) (relationship between the insurer and insured is inherently unbalanced), *cert. denied*, 445 U.S. 912 (1980); *Grand Sheet Metal Prod. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 51, 375 A.2d 428, 430 (1977) ("[T]he unequal bargaining power of the parties, the special nature of the insurance business, and the disastrous economic effects that a bad-faith refusal to pay may cause the insured are paramount considerations."); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 116, 229 S.E.2d 297, 303 (1976) ("[B]ecause of the great disparity of financial resources which generally exists between insurer and insured . . . we recognize the wisdom of a rule which would deter refusals on the part of insurers to pay valid claims when the refusals are both unjustified and in bad faith.").

54. *W. SHERNOFF, supra* note 1, § 1.03, at 1-9. Because insurance policies are frequently held to be adhesion contracts, it is not surprising that courts have allowed tort remedies to assure full compliance with the terms of the agreement. See *Rodgers v. Pennsylvania Life Ins. Co.*, 539 F. Supp. 879, 883 (S.D. Iowa 1982) ("Insurance policies are simply contracts of adhesion under which the insured's 'chances of successfully negotiating with the company for any substantial change in the proposed contract are just about zero.'") (quoting *C&J Fertilizer, Inc. v. Allied Mut. Ins. Co.*, 227 N.W.2d 169, 174 (Iowa 1975)); *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 820, 620 P.2d 141, 146, 169 Cal. Rptr. 691, 696 (1979) (adhesion nature of insurance contracts puts the insurer in a superior bargaining position), *cert. denied*, 445 U.S. 912 (1980); see also *Brown v. South Carolina Ins. Co.*, 284 S.C. 47, 54, 324 S.E.2d 641, 645 (S.C. Ct. App. 1984) ("[I]nsurance contracts are not ordinary negotiated commercial contracts [because] [t]hey are marketed and purchased as a standardized product"), *cert. granted in part and denied in part*, 285 S.C. 456, 329 S.E.2d 768 (1985).

55. Public interest is "[s]omething in which the public, the community at large, has some pecuniary interest, or some interest by which their legal rights or liabilities are affected." BLACK'S LAW DICTIONARY 1106 (5th ed. 1979).

56. See *Grand Sheet Metal Prod. Co. v. Protection Mut. Ins. Co.*, 34 Conn. Supp. 46, 51, 375 A.2d 428, 430 (1972); *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 116, 229 S.E.2d 297, 303 (1976); *Nichols v. State Farm Mut. Auto Ins. Co.*, 279 S.C. 336, 340, 306 S.E.2d 616, 619 (1983). *But cf.* *Farris v. United States Fidelity and Guar. Co.*, 284 Or. 453, 467, 587 P.2d 1015, 1023 (1978)

public in nature,⁵⁷ insurers' conduct has been subject to strict scrutiny by the judiciary.⁵⁸ A comparison is often made between insurance companies and common carriers or public utilities.⁵⁹ As a result, insurance companies are not treated like ordinary commercial businesses, but are deemed to have additional obligations as quasi-public entities.⁶⁰

(noting that because the legislature recognized the public interest in the enforcement of insurance contracts and provided penalties for wrongful conduct, it is inappropriate to use further civil penalties).

57. See, e.g., *Christian v. American Home Assur. Co.*, 577 P.2d 899, 904 (Okla. 1978) ("We have recognized the quasi-public nature of insurance companies and the need to subject the companies to state control for the protection and benefit of the public."). One commentary notes:

The insurers' obligations are . . . rooted in their status as purveyors of a vital service labeled quasi-public in nature. Suppliers of services affected with a public interest must take the public's interest seriously, where necessary placing it before their interest in maximizing gains and limiting disbursements. . . . [A]s a supplier of a public service rather than a manufactured product, the obligations of insurers go beyond meeting reasonable expectations of coverage. The obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibilities of a fiduciary. Insurers hold themselves out as fiduciaries, and with the public's trust must go private responsibility consonant with that trust.

Goodman & Seaton, *Forward: Ripe for Decision, Internal Workings and Current Concerns of the California Supreme Court*, 62 CALIF. L. REV. 309, 346-47 (1974).

58. See Goodman & Seaton, *supra* note 57, at 346-47; see, e.g., *Washington v. Group Hospitalization, Inc.*, 585 F. Supp. 517, 521 (D.D.C. 1984) ("[A]n insurer has additional obligations to its insured which subject it to more stringent standards of conduct than those normally imposed on parties to a contract.").

59. The North Carolina Supreme Court in *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 229 S.E.2d 297 (1976), made reference to the similarities between insurance companies, common carriers, and public utilities. *Id.* at 116, 229 S.E.2d at 303. By making this comparison, the court expressed its willingness to hold insurers liable for punitive damages in breach of contract actions. Punitive damages have long been awarded against public utilities and common carriers for a breach of duty to serve the public. Note, *supra* note 13, at 706.

60. Additional obligations have been imposed on insurance companies through governmental regulation of insurance settlement practices. States have enacted Unfair Trade Practices Acts to regulate trade practices in the insurance business. See, e.g., ARK. STAT. ANN. § 66-3005 (1980 & Supp. 1983); CAL. INS. CODE § 790.03 (West 1972 & Supp. 1986); MO. REV. STAT. § 375.936 (Vernon 1968 & Supp. 1986); TEX. INS. CODE ANN. § 21.21-2 (Vernon 1981); VA. CODE ANN. § 38.1-52.9 (1981).

North Carolina law provides a list of unfair and deceptive acts or practices in connection with the settlement of insurance claims:

- b. Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies; . . .
- d. Refusing to pay claims without conducting a reasonable investigation based upon all available information; . . .
- f. Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;
- g. Compelling [the] insured to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insured;
- h. Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled;

N.C. GEN. STAT. § 58-54.4(11) (1982). The general assembly recently amended this statute to apply to third party as well as first party insurance claims. See S. 873, § 18, N.C. Gen. Assembly, 1985 Session (to be codified at N.C. GEN. STAT. § 58-54.4(11)).

Under N.C. GEN. STAT. §§ 58-54.5 to -54.7 (1982), the Commissioner of Insurance has the power "to investigate, bring charges, and issue cease and desist orders" to remedy unfair trade practices in the insurance industry. *Commissioner of Ins. v. Integon Life Ins. Co.*, 28 N.C. App. 7, 11, 220 S.E.2d 409, 413 (1975). In addition, North Carolina courts have held that N.C. GEN. STAT. § 75-1.1 (1985), a statute proscribing unfair or deceptive acts affecting commerce, provides a private

Courts also have focused on the deterrence inherent in a tort theory of recovery.⁶¹ Absent a threat of tort liability, including a threat of punitive damages, an insurer "could intentionally and unreasonably refuse payment of a legitimate claim with veritable impunity."⁶² Typically, the insured does not have adequate resources to engage in protracted litigation to obtain relief under the insurance policy. Indeed, the high pressure tactics used by insurers, coupled with the insured's own personal and financial plight, make the insured particularly vulnerable to an unfair settlement offer.⁶³ An insured purchases insurance for both financial security and peace of mind,⁶⁴ and allowing a tort action for an insurer's bad faith refusal to settle ensures that the policyholder will recover the full benefits of the insurance contract.

A final rationale supporting the tort of bad faith is the concept that a fiduciary relationship⁶⁵ exists between an insurer and insured. Courts have reasoned that because a fiduciary duty has long been recognized in third-party situations,⁶⁶ an extension of the duty to first-party situations is appropriate.⁶⁷ Because of the distinction between first-party and third-party insurance actions, however, a number of courts have expressly refused to adopt this rationale.⁶⁸

cause of action for unfair trade practices in the insurance industry. *Ellis v. Smith Broadhurst, Inc.*, 48 N.C. App. 180, 183, 268 S.E.2d 271, 273 (1980). Moreover, the North Carolina Supreme Court in *Pearce v. American Defender Life Ins. Co.*, 316 N.C. 461, 373 S.E.2d 174 (1986) held that "a violation of N.C.G.S. § 58-54.4 as a matter of law constitutes an unfair or deceptive trade practice in violation of N.C.G.S. § 75-1.1." *Id.* at 470, 373 S.E.2d at 179. The amendment to N.C. GEN. STAT. § 58-54.4(11), however, casts doubt as to whether a violation of § 58-54.4(11) constitutes a per se violation of § 75-1.1. See S. 873, § 18, N.C. Gen. Assembly, 1985 Session (to be codified at N.C. GEN. STAT. § 58-54.4(11)) ("no violation of this subsection shall of itself create any cause of action in favor of any person other than the Commissioner") (emphasis added).

In addition, a number of states have enacted statutes that provide for recovery of attorney's fees in suits against insurers to recover benefits under an insurance policy. See, e.g., KAN. STAT. ANN. § 40-256 (1981); MONT. CODE ANN. § 33-1-616 (1985); S.C. CODE ANN. § 38-9-320 (Law. Co-op. 1985); TEX. INS. CODE ANN. § 1.14-1(7) (Vernon 1981). The North Carolina statute provides that in a suit against an insurance company for an unwarranted refusal to pay a claim, when the recovery of damages is \$5,000 or less, the court in its discretion, may allow a reasonable fee to the attorney representing the party obtaining a judgment for damages. N.C. GEN. STAT. § 6-21.1 (1981).

61. See, e.g., *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 116, 229 S.E.2d 297, 303 (1976) ("[W]e recognize the wisdom of a rule which would deter refusals on the part of insurers to pay valid claims when the refusals are both unjustified and in bad faith."); *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 697, 271 N.W.2d 368, 379 (1978) ("Punitive damages are awarded to punish wrongful conduct and to serve as a deterrent.").

62. *Standard Life Ins. Co. v. Veal*, 354 So. 2d 239, 248 (Miss. 1977).

63. See *Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1, 5 (7th Cir. 1972); *Rodgers v. Pennsylvania Life Ins. Co.*, 539 F. Supp. 879, 883 (S.D. Iowa 1982).

64. One of the primary reasons a consumer purchases insurance is the peace of mind and security that it provides in the event of a loss. *McCorkle v. Great Atlantic Ins. Co.*, 637 P.2d 583, 588 (Okla. 1981); see *Eckenrode v. Life of Am. Ins. Co.*, 470 F.2d 1, 5 (7th Cir. 1972); *Feathers v. State Farm Fire & Cas. Co.*, 667 S.W.2d 693, 696 (Ky. Ct. App. 1983).

65. A fiduciary relationship is "[o]ne founded on trust or confidence reposed by one person in the integrity and fidelity of another." BLACK'S LAW DICTIONARY 564 (5th ed. 1979).

66. See *supra* note 1 and *infra* note 68.

67. See *Goodman & Seaton*, *supra* note 57, at 346-47; see also *Brown v. South Carolina Ins. Co.*, 284 S.C. 47, 54-55, 324 S.E.2d 641, 646, (S.C. Ct. App. 1984) (relation of the insurer to its insured is more than simply a debtor-creditor relationship), *cert. granted in part and denied in part*, 285 S.C. 456, 329 S.E. 2d 768 (1985).

68. See, e.g., *Spencer v. Aetna Life & Cas. Ins. Co.*, 227 Kan. 914, 922, 611 P.2d 149, 155 (1980) (The relationship in first-party situations is adversarial in nature.); *Duncan v. Andrew*

There is consensus among a growing number of jurisdictions that a tort action for bad faith serves as an effective deterrent against unfair claims practices. More importantly, the threat of insurers' liability for punitive damages has prompted widespread reform in the insurance industry.⁶⁹ The development of first-party bad faith actions in North Carolina has focused primarily on punitive damage awards for deleterious insurance settlement practices.

Generally, North Carolina decisions have allowed punitive damages both to punish a wrongdoer and to serve as a deterrent for future behavior.⁷⁰ Although punitive damages are never recovered as a matter of right,⁷¹ if a plaintiff pleads and proves facts that show some element of aggravation, an award of punitive damages may be justified.⁷² Such aggravated conduct has been defined to include "fraud, malice, gross negligence, insult, . . . [acting] willfully or under circumstances of rudeness or oppression, or in a manner which evinces a reckless and wanton disregard of the plaintiff's rights."⁷³ North Carolina courts generally do not allow punitive damages in breach of contract actions unless the contract is a promise to marry.⁷⁴ Nonetheless, the courts have recognized that awarding punitive damages may be appropriate in breach of contract actions with "substantial tort overtones" arising from fraudulent or deceitful conduct.⁷⁵

County Mut. Ins. Co., 665 S.W.2d 13, 19-20 (Mo. Ct. App. 1983); *Lawton v. Great S.W. Fire Ins. Co.*, 118 N.H. 602, 614, 392 A.2d 576, 581 (1978).

Under third-party liability coverage, when the insured is sued by a third party, the insured's insurance company defends the suit and "the insured cannot settle the matter without the permission of the insurer." *Craft v. Economy Fire & Cas. Co.*, 572 F.2d 565, 569 (7th Cir. 1978). It is the insurer's control of the litigation, in addition to the risk of an excess judgment, that gives rise to the fiduciary nature of the insurer's duty. *Id.*; see *supra* note 1.

69. See Levine, *Demonstrating and Preserving the Deterrent Effect of Punitive Damages In Insurance Bad Faith Actions*, 13 U.S.F. L. REV. 613, 621-27 (1979).

70. See *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 113, 229 S.E.2d 297, 302 (1976); *Cotton v. Fisheries Prod. Co.*, 181 N.C. 151, 152-53, 106 S.E. 487, 488 (1921); *Motsinger v. Sink*, 168 N.C. 548, 551, 84 S.E. 847, 848 (1915). Punitive damages are known as "vindictive damages" or "smart money" and are vengeful in nature. Ervin, *Postscript: Punitive Damages in North Carolina*, 59 N.C.L. REV. 1255, 1255 (1981).

71. See *Oestreicher v. American Nat'l Stores, Inc.*, 290 N.C. 118, 134, 225 S.E.2d 797, 807-08 (1976). Punitive damages are never awarded as compensation. They are awarded above and beyond actual damages as a punishment for the defendant's intentional wrong. *Overnite Transp. Co. v. International Bd. of Teamsters*, 257 N.C. 18, 30, 125 S.E.2d 277, 286 (1962).

72. See *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 112, 229 S.E.2d 297, 301 (1976); *Baker v. Winslow*, 184 N.C. 1, 5, 113 S.E. 570, 572 (1922).

73. *Dailey v. Integon Gen. Ins. Corp.*, 75 N.C. App. 387, 394, 331 S.E.2d 148, 154 (citing *Baker v. Winslow*, 184 N.C. 1, 5, 113 S.E. 570, 572 (1922)), *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985). Whether the plaintiff has alleged facts sufficient to allow the award of punitive damages is a question of law. *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 111, 229 S.E.2d 297, 300 (1976). Once the pleading requirements are met, it is in the jury's discretion to determine whether punitive damages should be awarded, and if so, the amount to be awarded. Ervin, *supra* note 70, at 1257.

74. *Newton v. Standard Fire Ins. Co.*, 291 N.C. 105, 111, 229 S.E.2d 297, 301 (1976); *King v. Insurance Co.*, 273 N.C. 396, 398, 159 S.E.2d 891, 893 (1968); *Dailey v. Integon Ins. Corp.*, 75 N.C. App. 387, 394, 331 S.E.2d 148, 153, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985). The rule in most jurisdictions is that punitive damages are not allowed even though the breach is willful, malicious, or oppressive. See J. MCCARTHY, *supra* note 7, § 1.42, at 92-93.

75. *Oestreicher v. American Nat'l Stores, Inc.*, 290 N.C. 118, 136, 225 S.E.2d 797, 809 (1976). In *Oestreicher* a lessor brought a breach of contract action against his lessee and demanded punitive damages based on the continuing fraud involved in the breach. The lease provided that the lessee was to pay a minimum rental fee plus five percent of the net sales above a stated amount. *Id.* at 132, 225 S.E.2d at 806. The lessor claimed that the lessee had fraudulently failed to abide by the lease

In *Newton v. Standard Fire Insurance Co.*⁷⁶ plaintiff brought an action seeking punitive damages for the insurer's alleged "heedless, wanton, and oppressive conduct" in failing to pay the insured's claim.⁷⁷ The North Carolina Supreme Court stated that "where there is an identifiable tort even though the tort also constitutes, or accompanies, a breach of contract, the tort itself may give rise to a claim for punitive damages."⁷⁸ In addition, the court stated that the tortious conduct must be accompanied by some element of aggravation before punitive damages will be awarded.⁷⁹ The court concluded that plaintiff's allegations about the insurer's refusal to pay were insufficient to plead any recognizable tort, and that the complaint did not establish any intentional wrongdoing by the insurer other than the breach itself.⁸⁰ In dicta, however, the court alluded to the type of behavior that might have allowed plaintiff to recover for the insurer's bad faith refusal to pay.⁸¹ The court also discussed the policy considerations that would support extra-contract damages in bad faith insurance actions,⁸² but emphasized that caution should be taken before exposing insurers to liabilities beyond those specified in the insurance contract.⁸³

Notwithstanding this caveat, subsequent cases have referred to the *Newton*

because the lessee intentionally understated gross sales revenue and thereby substantially reduced the amount to which the lessor was entitled under the contract. *Id.* at 133, 225 S.E.2d at 806. The court allowed the lessor's claim for punitive damages because the fraudulent misrepresentation accompanying the breach amounted to a separate tort. *Id.* at 135-36, 225 S.E.2d at 808.

76. 291 N.C. 105, 229 S.E.2d 297 (1976).

77. *Id.* at 107, 229 S.E.2d at 298-99. Plaintiff in *Newton* lost merchandise and suffered damage due to a theft and burglary. Plaintiff demanded indemnity from the insurer to cover the loss, but the insurance company refused to pay. *Id.* at 109, 229 S.E.2d at 300. Plaintiff brought an action against the insurance company seeking \$5,000 in actual damages and \$50,000 in punitive damages. *Id.* at 110, 229 S.E.2d at 300. The trial court dismissed plaintiff's claim for punitive damages. *Id.* at 111, 229 S.E.2d at 304.

78. *Id.* at 111, 229 S.E.2d at 301.

79. *Id.* at 112, 229 S.E.2d at 301.

80. *Id.* at 114, 229 S.E.2d at 302. Before dismissing plaintiff's punitive damages claim, the court examined several California cases relied on by plaintiff which supported imposing a special implied-in-law duty on an insurer not to act in a manner that would deprive the insured of the policy's benefits. *Id.* at 115, 229 S.E.2d at 303. The court noted that a common element in all of the California cases was a bad faith refusal by the insurance company to pay a legitimate claim. *Id.* Conversely, plaintiff in *Newton* made no claims of bad faith, nor did he allege facts that could support a finding of bad faith. *Id.*

81. *Id.* at 115-16, 229 S.E.2d at 303. The court in *Newton* stated that if plaintiff had claimed that after a reasonable investigation the insurer determined the claim was valid and nevertheless denied the claim, or that the insurer refused to investigate at all and the refusal to pay was in bad faith with an intent to cause harm to plaintiff, a cause of action for punitive damages may have been allowed. *Id.*

82. *Id.* at 116, 229 S.E.2d at 303. The court emphasized two important policy considerations: the disparity of financial resources between the insurer and insured and the public interest aspect of the insurance industry. *Id.* The court's comparison of insurance companies and public utilities indicated that in certain situations punitive damages might be appropriate in first-party insurance actions. *Id.* For a further discussion of policy considerations see *supra* notes 53-68 and accompanying text.

83. The *Newton* court stated in dicta:

We are slow to impose upon an insurer liabilities beyond those called for in the insurance contract. To create exposure to such risks except for the most extreme circumstances would, we are certain, be detrimental to the consuming public whose insurance premiums would surely be increased to cover them.

Newton, 291 N.C. at 116, 229 S.E.2d at 303.

dicta when addressing claims alleging first-party bad faith by an insurer.⁸⁴ It was not until 1982 in *Dailey v. Integon General Insurance Corp.*⁸⁵ (*Dailey I*), however, that a North Carolina court held an insured had sufficiently alleged a tortious act accompanied by aggravated conduct so as to state a claim for special and punitive damages for an insurer's bad faith refusal to settle.⁸⁶ Unlike *Newton*, plaintiff in *Dailey I* specifically pled facts and allegations that supported "recognizable, aggravated tortious behavior" by the insurance company.⁸⁷

After remand,⁸⁸ the court of appeals in *Dailey v. Integon General Insurance Corp.*⁸⁹ (*Dailey II*) considered whether the trial court erred in entering a judgment *non obstante veredicto* against the insured on the issue of punitive damages.⁹⁰ The court held that the trial court erred because plaintiff had produced evidence at trial that was clearly sufficient to support the jury's finding of a

84. See *Shields v. Nationwide Mut. Fire Ins. Co.*, 50 N.C. App. 355, 273 S.E.2d 756 (1981). In *Shields*, defendant insurance company refused payment on plaintiff's claim for fire damage. *Id.* at 356, 273 S.E.2d at 756. Plaintiff brought an action seeking punitive damages, alleging that defendant carelessly asserted that plaintiff was involved in causing the fire and that plaintiff misrepresented certain facts to defendant concerning the loss. *Id.* at 356, 273 S.E.2d at 756-57. Plaintiff also alleged that defendant failed to act expeditiously and in good faith and attempted to deprive plaintiff of the benefits of his policy. *Id.* at 356-57, 273 S.E.2d at 757.

The court of appeals, quoting *Newton*, held that the materials submitted to the trial court were insufficient to support a claim for punitive damages. *Id.* at 363, 273 S.E.2d at 760. The court stated that defendant's denial of the claim, based on its belief after an investigation that plaintiff was involved in starting the fire, did not indicate bad faith. *Id.* Although the claim was denied 19 months after the fire, defendant's investigation continued until that time, and defendant based its denial on the information gathered in the investigation. *Id.*; cf. *Murray v. Allstate Ins. Co.*, 51 N.C. App. 10, 18, 275 S.E.2d 195, 200 (1981) (plaintiffs did not allege that defendant's failure to repair property was wanton, willful, or grossly negligent so as to establish a claim for punitive damages).

85. 57 N.C. App. 346, 291 S.E.2d 331 (1982).

86. *Id.*, at 350, 291 S.E.2d at 333. For a discussion of the facts in *Dailey*, see *infra* note 90.

87. *Dailey*, 57 N.C. App. at 350, 291 S.E.2d at 333.

88. In the trial court *Dailey* received a judgment for compensatory damages in the amount of \$157,000 and punitive damages in the amount of \$120,000, together with costs and prejudgment interest. The trial court, however, entered a judgment *non obstante veredicto* for the defendant on the issue of punitive damages. *Dailey v. Integon Gen. Ins. Corp.*, 75 N.C. App. 387, 390, 331 S.E.2d 148, 151, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985).

89. 75 N.C. App. 387, 331 S.E.2d 148, *disc. rev. denied*, 314 N.C. 664, 336 S.E.2d 399 (1985).

90. *Id.* at 394, 331 S.E.2d at 153. On July 25, 1980, plaintiff's house was rendered uninhabitable by fire. *Id.* at 391, 331 S.E.2d at 151-52. An investigation by the Fire Marshall determined that the fire had been deliberately set, but plaintiff was cleared as a suspect. *Id.* at 391, 331 S.E.2d at 152. In early August, Integon sent plaintiff a letter that erroneously included a waiver of rights form. *Id.* Over the next several weeks, plaintiff sent defendant three different proof of loss forms. Integon rejected the first two. Plaintiff mailed a third form to defendant, but it was neither returned nor acted on for weeks. *Id.*

At the advice of one of Integon's adjusters, plaintiff obtained and submitted five cost estimates for repairing the house, and plaintiff's wife prepared a detailed list of personal items damaged in the fire. *Id.* Plaintiff's estimator's, a professional construction engineer and four licensed contractors, believed that the house was rendered useless, and the cost of repairs would exceed the policy limits of \$105,000. *Id.*

The estimate Integon received was prepared by a carpenter, not licensed as a general contractor, who testified that the house could be repaired for \$48,286.83. *Id.* at 392, 331 S.E.2d at 152. Consequently, on January 26, 1981, Integon offered to settle plaintiff's entire claim for \$69,607.85. *Id.*

Some weeks after the fire, Integon engaged Mr. Charnock of INS Investigations to investigate and determine whether plaintiff was involved in starting the fire. *Id.* Charnock spent three days investigating the claim. He questioned 16 neighbors and the Fire Marshall. *Id.* Allegedly, Charnock offered two people \$10,000 if they would help establish that plaintiff had his house burned down. *Id.* at 392-93, 331 S.E.2d at 152-53. At trial, Charnock denied these allegations and stated he

tortious breach of contract accompanied by aggravated conduct.⁹¹ The court emphasized that under some circumstances the law of North Carolina allows the "recovery of punitive damages on claims for tortious, bad faith refusal to settle under an insurance policy, even though . . . the refusal to settle is also a breach of contract."⁹² Furthermore, the court rejected defendant's contention that a "separate identifiable tort unrelated to the contract" was required.⁹³ Rather, punitive damages are recoverable when there is an "identifiable" tort, even though the tort also constitutes or accompanies a breach of contract.⁹⁴ In *Dailey II* the identifiable tort alleged by plaintiff—the insurer's bad faith refusal to settle—not only accompanied the breach of contract, but also included aggravated conduct.⁹⁵

Although decisions prior to *Dailey II* held that an insured had stated a valid claim for special and punitive damages for an insurer's bad faith refusal to pay, *Dailey II* was the first case to reinstate a punitive damages award against an insurance company. The question arises to what extent the tort of bad faith will influence insurance law in North Carolina. In addition, the question arises whether extra-contract damages will be extended beyond the insurance context and into the area of noninsurance commercial contracts.

Historically, North Carolina courts have taken a cautious approach to exposing insurers to liabilities beyond those imposed by the insurance contract.⁹⁶ Because the courts recognize the financial impact of excess liability judgments, there is concern that the cost of punitive damage awards against insurance companies will be passed to consumers through higher insurance premiums.⁹⁷ The

had told one person that there was a \$10,000 reward for apprehending the arsonists. *Id.* at 393, 331 S.E.2d at 153.

Plaintiff's complaint set forth three claims against Integon. The first claim was for breach of the insurance contract. *Id.* at 387, 331 S.E.2d at 150. The second claim was for Integon's bad faith failure to pay its obligations and plaintiff's resulting embarrassment, mental distress, and legal expenses. *Id.* The third claim, also based on the insurer's bad faith refusal to settle, was for \$200,000 in punitive damages. *Id.*

91. *Id.* at 398, 331 S.E.2d at 156. The court emphasized that the insurer's inadequate investigation of the claim, the inordinate delay of the unreasonable settlement, and the bad faith conduct of Charnock clearly established that Integon had engaged in aggravated conduct toward the plaintiff. *Id.* at 397, 331 S.E.2d at 155.

92. *Id.* at 395, 331 S.E.2d at 154; see *Payne v. State Farm Bureau Mut. Ins. Co.*, 67 N.C. App. 692, 313 S.E.2d 912 (1984); *Dailey I*, 57 N.C. App. 346, 291 S.E.2d 331 (1982).

93. *Dailey II*, 75 N.C. App. at 395-96, 331 S.E.2d at 154.

94. *Id.* at 396, 331 S.E.2d at 154. The court's language in *Dailey II* reiterates North Carolina's acceptance of tortious breach of contract. The court dispenses with the requirement that the plaintiff prove a separate identifiable tort outside the contract. Rather, the insurer's tortious conduct accompanying the breach of contract allows for the recovery of extra-contract damages. *Id.*

Arguably, the court's emphasis on tortious conduct "accompanying" or "constituting" a breach of contract somewhat blurs the distinction between tort and contract law. Although public policy may demand tort damages in certain breach of contract actions, the parties' freedom to allocate risks and expectations in a contract necessarily will be upset unless sound judicial reasoning controls expansive tort remedies. To what extent public policy will require the expansion of tortious breach of contract remains unclear. See *infra* notes 109-21 and accompanying text.

95. *Dailey II*, 75 N.C. App. at 396, 331 S.E.2d at 154.

96. See *supra* note 83 and accompanying text; see also *Olive v. Great Am. Ins. Co.*, 76 N.C. App. 180, 190, 333 S.E.2d 41, 46 (court will approach the issue of tortious breach of contract with caution), *disc. rev. denied*, 314 N.C. 668, 336 S.E.2d 400 (1985).

97. See *Newton*, 291 N.C. at 116, 229 S.E.2d at 303. Insurance premiums also might increase

inequality of bargaining power⁹⁸ between the insurer and the insured, and the quasi-public nature⁹⁹ of the insurance industry, however, have convinced North Carolina courts to extend tort liability to insurers who have refused to deal fairly with their insureds.

Arguably, application of a strict liability standard against insurers would promote compliance with contractual duties and deter unfair claims practices.¹⁰⁰ North Carolina and other jurisdictions, however, have refused to impose a strict liability standard on insurance companies. Thus, an honest mistake or reasonable disagreement between the insurer and the insured will not constitute bad faith per se.¹⁰¹ Moreover, even if an insurer does engage in wrongful conduct, an insured will not recover punitive damages unless the insurer's conduct is accompanied by some element of aggravation.¹⁰²

Although a variety of activities could constitute bad faith conduct by an insurance company, two factors are often critical in the determination of bad faith: (1) the sufficiency of the insurer's investigation of a claim, and (2) the subsequent evaluation of the validity of the claim.¹⁰³ *Dailey II* placed much emphasis on the fact the insurance company's investigation of the insured's claim was both delinquent and improper, and the resulting settlement offer was grossly inadequate.¹⁰⁴

because insurers, faced with the threat of a punitive damages award for disputing a claim with their insureds, may elect to settle frivolous and meritless insurance claims.

98. See *supra* notes 53-54 & 82 and accompanying text.

99. See *supra* notes 55-60 & 82 and accompanying text.

100. Comment, *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CAL. W.L. REV. 358, 376-77 (1978). This student commentator argues that fiduciary duties should be imposed on insurance companies, with a rule of strict liability against an insurer who harms the insured by failing to pay a claim. *Id.* Under this standard the insured would be relieved of the burden of proving bad faith conduct by the insurance company. *Id.* at 377.

101. See, e.g., *State Farm Gen. Ins. Co. v. Clifton*, 86 N.M. 757, 759, 527 P.2d 798, 800 (1974) (citing *Milledgeville Water Co. v. Fowler*, 129 Ga. 111, 58 S.E. 643 (1907)) ("Mere delay or failure of the insurer in making the repairs or disputing the extent of the insurer's obligation under its contract does not give rise to a tort action."); *Christian v. American Home Assur. Co.*, 577 P.2d 899, 905 (Okla. 1978) ("We recognize that there can be disagreement between insurer and insured on a variety of matters Resort to a judicial forum is not per se bad faith or unfair dealing on the part of the insurer regardless of the outcome of the suit.").

102. See *supra* notes 71-73 & 79 and accompanying text.

103. See *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 817, 620 P.2d 141, 144, 169 Cal. Rptr. 691, 694 (1979), cert. denied, 445 U.S. 912 (1980); *Anderson v. Continental Ins. Co.*, 85 Wis. 2d 675, 692, 271 N.W.2d 368, 377 (1978) (In applying the test to prove the tort of bad faith, it is appropriate "to determine whether a claim was properly investigated and whether the results of the investigation were subjected to a reasonable evaluation and review.").

North Carolina law defines an unfair business practice in connection with first-party and third-party claims as the insurer's failure to adopt and implement reasonable standards for the prompt investigation of claims that arise under an insurance policy. See *supra* note 60.

104. *Dailey II*, 75 N.C. App. at 396-97, 331 S.E.2d at 155.

Commenting on the evidence, the court in *Dailey II* quoted the trial judge's appraisal of defendant's conduct:

I would say to you in all candor that when this jury went out that I went and called my insurance agent to check that my fire insurance wasn't with your client. There is no question in my mind based on the evidence I heard that your client did not act in good faith in settling this claim. I wouldn't any more let those two people in Goldsboro work on my house, much less go inside my house than anything. I can understand why the jury would feel the same way. The plaintiff on the one hand offered uncontested evidence from five licensed contractors who build the majority of the homes apparently in the New Bern area

If an investigation is purposeful and done in good faith, bad faith will not be found even though a significant period of time elapses before the insurer acts on the claim.¹⁰⁵ Moreover, as emphasized by one commentator, an insurer's failure to properly investigate a claim generally will not subject it to liability unless the failure causes harm to the insured.¹⁰⁶ Thus, if the insurer, aware of all the facts, still would have denied the claim, then the insurer's failure to investigate will not allow the insured to recover excess damages.¹⁰⁷ Similarly, if the insurance company has no legal duty to pay a claim, it is not important that the company or its agents improperly investigated the claim.¹⁰⁸

Notwithstanding the limitations of tortious breach of contract in the insurance context, a recovery of extra-contract damages in certain noninsurance cases would seem likely. Most courts, however, have been reluctant to extend the bad faith tort beyond insurance contracts.¹⁰⁹ These courts reason that parties should have the right to bargain for their own benefit and should be given the freedom to contract as they please.¹¹⁰ Moreover, when a breach of contract

as to the cost of repair and the only evidence really that you had was two people from Goldsboro, a father and son team who were going to work at six percent profit and use their profit—just give up their profit—to buy all the extra materials they would need; and you know, I love American businessmen but I just never have met two quite as kind as those people. It was just a little far fetched, you know, that legitimate licensed contractors could be so far afield from these two people. I think your client in representing that those two gentlemen from Goldsboro were competent in good faith to repair this home breached a duty that they had to their policy holder; and, then they would come along with an appraiser who testifies as to the personal property that every pair of shoes I have which is over a year old has no cash value whatsoever and when that is coupled with an investigator who comes down and tours the neighborhood and goes and talks to others and conducts himself as the jury found he did then I think the evidence clearly supports the punitive damage verdict if that verdict, if that issue, were properly to be submitted to the jury.

Id. at 397, 331 S.E.2d at 155-56.

105. See *Shields v. Nationwide Mut. Fire Ins. Co.*, 50 N.C. App. 355, 363, 273 S.E.2d 756, 760 (1981); cf. *Olive v. Great Am. Ins. Co.*, 76 N.C. App. 180, 190, 333 S.E.2d 41, 46 (when defendant promptly denied plaintiff's insurance claim based on a reasonable interpretation of the policy, and defendant's agents, in good faith, provided plaintiff with inaccurate information, plaintiff failed to meet the minimum proof necessary to show tortious breach of contract), *disc. rev. denied*, 314 N.C. 668, 336 S.E.2d 400 (1985); *Beasley v. National Sav. Life Ins. Co.*, 75 N.C. App. 104, 108, 330 S.E.2d 207, 209 (1985) (allegations that defendant insurer made false statements and misrepresentations of fact to the insured, without precise facts to support the allegations, did not constitute an element of aggravation to justify punitive damages for breach of contract), *disc. rev. denied*, 316 N.C. 372, 373, 341 S.E.2d 338, 339 (1986) (per curiam) (The North Carolina Supreme Court granted review in 314 N.C. 537, 335 S.E.2d 13 (1985), but after careful consideration concluded that discretionary review was improvidently allowed.).

106. Ashley, *The Problem of Causation in the Law of Bad Faith*, 1 BAD FAITH L. REP. 93, 96 (1985).

107. *Id.*

108. *Id.*

109. The distinguishing characteristics between insurance and non-insurance contracts, coupled with the lack of any clear criteria in identifying the bad faith tort, makes the extension of the tort into commercial contract cases difficult. *Louderback, Standards for Limiting the Tort of Bad Faith Breach of Contract*, 16 U.S.F. L. REV. 187, 188 (1982).

110. In *Bliss v. Southern Pac. Co.*, 212 Or. 634, 321 P.2d 324 (1958), the Oregon Supreme Court expressed the rule as follows:

When two or more persons competent for that purpose, upon a sufficient consideration, voluntarily agree to do or not to do a particular thing which may be lawfully done or omitted, they should be held to the consequences of their bargain. It is elementary that public policy requires that such contracts be held sacred and shall be enforced by the courts of justice unless some other overpowering rule of public policy intervenes which

occurs, most courts have found traditional contract remedies to be adequate to compensate the aggrieved party. In certain instances, however, contracts involving a substantial public interest may lead to judicial intervention to compensate for breaches which offend public policy.¹¹¹

Relationships in some ordinary commercial contracts possess characteristics similar to that of insurer and insured and deserve analagous treatment.¹¹² Several factors critical in insurance bad faith litigation should be present before extra-contract damages are allowed for tortious breach of a noninsurance contract.¹¹³ First, the tort of bad faith should only be applied when one of the parties to the contract is able to dictate the terms because of a superior bargaining position.¹¹⁴ Second, the motivation for entering into the contract should not be for profit, but rather should be to obtain a necessary "service or product," or to gain "financial security or peace of mind."¹¹⁵ Third, the relationship between the parties should be "such that the weaker party places its trust and confidence in the larger entity."¹¹⁶ Fourth, the conduct of the breaching party must evince an intent to interfere with or frustrate the weaker party's ability to enjoy the benefits of the contract.¹¹⁷ Last, traditional contract remedies should be inadequate to compensate the injured party.¹¹⁸

Several commercial settings could satisfy the above requirements and support the imposition of tort liability for bad faith breach of contract. For example, the tort of bad faith could be applied in the leasing and purchasing of residential real property,¹¹⁹ or in employment discharge cases that violate public

renders such agreement illegal or unenforceable. This rule imposes upon the court a duty to give contracts of that character effect, especially when they have been acted upon by the parties. Without such a rule the commerce of the world would soon lapse into a chaotic state.

Id. at 646, 321 P.2d at 330.

111. *See id.* at 646, 321 P.2d at 330.

112. *See Seaman's Direct Buying Service, Inc. v. Standard Oil Co.*, 36 Cal. 3d 752, 768-69, 686 P.2d 1158, 1166-67, 206 Cal. Rptr. 354, 362-63 (1984); *Cleary v. American Airlines*, 111 Cal. App. 3d 443, 453, 168 Cal. Rptr. 722, 729 (1980) (plaintiff who brought an action for wrongful discharge from employment stated a cause of action for the tort of bad faith breach of contract); *Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1119, 207 Cal. Rptr. 123, 129 (1984) (plaintiff's employment contract with defendant shares the necessary similarities with an insurance contract).

113. *See Louderback, supra* note 109, at 220-23, 227 (discussing four factors); *see also Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) (citing five factors).

114. *Louderback, supra* note 109, at 227; *see also Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) ("the contract must be such that the parties are in inherently unequal bargaining positions").

115. *Louderback, supra* note 109, at 227; *see also Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) ("the motivation for entering the contract must be a non-profit motivation, i.e. to secure peace of mind, security, future protection").

116. *Louderback, supra* note 109, at 227; *see also Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) ("one party is especially vulnerable because of the type of harm it may suffer and of necessity places trust in the other part to perform").

117. *Louderback, supra* note 109, at 227; *see also Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) (stronger party is aware of weaker party's vulnerability).

118. *See Wallis v. Superior Court*, 160 Cal. App. 3d 1109, 1118, 207 Cal. Rptr. 123, 129 (1984) ("ordinary contract damages are not adequate because (a) they do not require the party in the superior position to account for its actions, and (b) they do not make the inferior party 'whole'").

119. North Carolina courts have recognized the public policy interest in providing purchasers of residential dwellings with an implied warranty of habitability. *See Hartley v. Ballou*, 286 N.C. 51, 209 S.E.2d 776 (1974), in which the court stated the rule as follows:

policy.¹²⁰ By applying the suggested criteria effectively, the courts can protect the public interest in regulating the conduct of parties in certain types of contracts, while preserving the parties' fundamental right of freedom to contract.¹²¹

The recent development of tortious breach of contract in North Carolina is indicative of the growing trend in extending tort liability to contract breaches that offend public policy. Recognizing the public interest in preventing deleterious conduct by first-party insurers, North Carolina courts have cautiously extended extra-contract liability to bad faith settlement practices that evince signs of aggravated conduct. Although the courts have exercised a reasonable degree of restraint, it is incumbent on the judiciary to carefully regulate expansive damage recoveries in breach of contract actions. A fundamental precept of contract law is that parties to an agreement should have the freedom to allocate benefits and risks as they choose. A bargained-for contract provides parties with a sense of certainty and security that is essential in day-to-day transactions. Thus, the blurring of tort law and contract law must be limited by sound judicial reasoning. Unless recovery for tortious breach of contract is limited to contractual relationships that involve an overriding public policy, the important conceptual differences between tort and contract law will disappear.

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[I]n every contract for the sale of a recently completed dwelling, and in every contract for the sale of a dwelling then under construction, the vendor, if he be in the business of building such dwelling, shall be held to impliedly warrant to the initial vendee that . . . the dwelling, together with all its fixtures, . . . is sufficiently free from major structural defects and is constructed in a workmanlike manner

Id. at 62, 209 S.E.2d at 783. The Residential Rental Agreements Act provides that a landlord shall make repairs and keep the premises of the residential lessee in a habitable condition. N.C. GEN. STAT. § 42-42 (1984).

120. In *Sides v. Duke Hospital*, 74 N.C. App. 331, 328 S.E.2d 818 (1985), the North Carolina Court of Appeals recognized that employment discharges that violate public policy could give rise to a tort action for wrongful discharge, notwithstanding the well established terminable-at-will rule. *Id.* at 342-43, 328 S.E.2d at 826-27. For a discussion of *Sides*, see Note, *Sides v. Duke Hospital: A Public Policy Exception to the Employment-At-Will Rule*, 64 N.C.L. REV. 840 (1986).

121. See Louderback, *supra* note 109, at 227.