

Bad-Faith Remedies and Insurer Responses

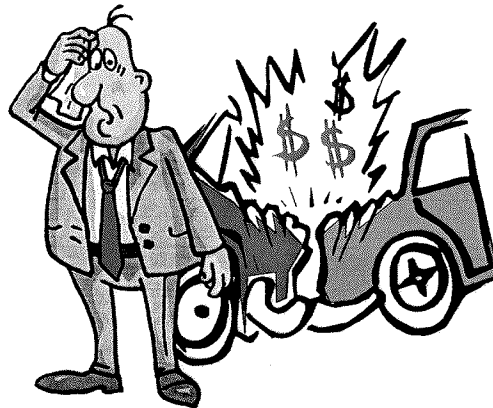
By Robert Puelz, Ph.D., Ch.F.C., CLU

A theme one hears from insurance market claimants is the anxious prospect of having to work with insurers after an accident. Usually the anxiety stems from a couple of factors. First, that the insurer will recalibrate one's riskiness after a loss and subsequently increase the premium at the next renewal, and second, that the insurer and its claim representatives who are ultimately responsible for the claim will be difficult during the claims-handling process, subjecting the claimant to a negotiated claims settlement — or worse, a substantial resistance to paying the claim. Usually the problem is enhanced for an individual, since insurers hold a large information advantage when negotiating with the personal claimholder, a gap likely narrowed when facing a corporate claimholder.

The notion that claimholders may need some help, even though all parties are supposed to act with utmost good faith, is embodied by the reciprocal concept of "bad faith," whereby insurers may be subject to penalties if they do not work fairly and appropriately with their insurance stakeholders — a legal reaction that better aligns incentives among the parties to an insurance contract. Such a legal stricture doesn't necessarily have to be widely known by noninsurance-company parties to a contract. All that matters is that insurance personnel know of its existence for it to be a threat credible to alter the behavior of insurers in "good" ways so that claims

are fairly paid while protecting the interests of insurers that shouldn't have to pay for claims that fall outside of their insurance agreements.

Although the law varies across the states, not until I joined with Ellen Pryor and Mark Browne in an article published in the *Journal of Legal Studies* was there empirical work that evalu-



A theme one hears from insurance market claimants is the anxious prospect of having to work with insurers after an accident.

ated the association between bad-faith laws and actual claim payouts. We were interested in whether the presence of bad-faith laws correlated with higher economic and noneconomic claim payouts, and we found evidence that, indeed, variations in bad-faith law were associated with variations in claim settlement amounts consistent with those predicted by theory in our relatively large

sample of 1992 data from the automobile insurance market. Although the results of this study are associated with a particular insurance market, they do support a more general theory and invite further research into this topic.

The Incentive Argument

If, as is reasonable to posit, insurers are fully aware of the legal ramifications of their actions in light of the obligation for fair dealing, then it is also reasonable to assume that insurers take steps to communicate, educate and train adjusters with whom they contract to handle claims properly. Claims decision-makers are well aware of the regulatory/legal environment in which they operate; generally, behavior follows such knowledge, and we expect that adjusters would behave differently in states for which there exists an extracontractual cause of action for bad-faith denials or bad-faith foot-dragging during the settlement process. In the time frame of our study, there existed a group of states that did not permit such an extracontractual

(Remedies, continued inside)

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(**Remedies**, cont'd from cover)

cause of action in addition to those that did, providing a theoretical distinction that adjusters would respond differently to claims of otherwise similar characteristics, depending on the state in which they were adjusting the claim.

The nature of the claim provides an additional distinction when considering an incentive-based view of the world. Adjusters view economic damage claims

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as more certain and potentially less fraudulent with less effort required to legitimize a claim. Making a real-time decision about issuing benefits immediately versus the potential costs of contesting the validity of a claim versus nearer-term adjusting costs of investigating the claim more fully is complicated when claims have a noneconomic component. Evaluating issues such as mental anguish and pain and suffering foists the adjuster into a decision mode that is potentially more litigious if the regulatory regime in which he or she is operating penalizes behavior construed as unfair to the claimant. Noneconomic damages are more difficult to value, and the variability of opinion about true value

can lead to arguments about whether the adjuster and its insurer were acting reasonably. To complicate matters, some would argue that economic damages are potentially more problematic in light of bad faith. The clarity of an economic-damages claim makes an underpaid claim more obvious and more difficult

to defend. In any event, the theoretical argument is that adjusters, acting within the “shadow of the law,” will handle claims differently depending on the nature of the claim and the potential insurer

(**Remedies**, continued opposite)

FROM NEAR AND FAR



Florida — According to Florida’s Office of Insurance Regulation, damages arising from Hurricane Dennis are estimated to be about \$1 to 3 billion. In Florida alone there were more than 45,000 claims. Dennis slammed ashore in the Florida Panhandle on July 10.



Texas — Texas Governor Rick Perry appointed 36-year-old Michael Geeslin as the state’s new insurance commissioner. Geeslin has spent the last two years as deputy commissioner under José Montemeyor. Prior to working in the insurance department, Geeslin was an advisor to Perry on insurance and regulatory matters.



London — With the excitement of the 2012 Olympic Games selection on July 6 shattered by the terrorist bombings in London on July 7, some within the insurance industry have turned their attention to discussing the amount of terrorism coverage that the Games will require. According to a report in A.M. Best, David Bruce, divisional head of specialty for Hiscox’s Syndicate 33 at Lloyd’s, expects total insurance coverage for the Games to be between \$2 billion and \$2.5 billion.



Toronto — Insurers could be on the hook for about \$200 million in insurance claims following the crash of an Air France jetliner at Toronto’s Pearson Airport. All 309 people on board survived when the Airbus 340 skidded off the runway on August 2.



North Dakota — According to the North Dakota Insurance Commissioner, a hailstorm that struck the state last month caused more than \$100 million in damage to insured property. More than 20,000 claims have been filed so far.

(Remedies, cont'd from opposite)

liability for wrongdoing. In particular, insurers, via their adjusters, will pay more money to settle claims in states in which they would otherwise confront an extracontractual cause of action. Whether such a reaction is more pronounced for noneconomic damages than economic damages is an empirical question.

Practice Meets Theory

How, then, could the theory be tested? Generally, one of the challenges in insurance research is that the data needed to test hypotheses usually are proprietary and unavailable to the general public. Fortunately, through the Insurance Research Council (IRC) <http://www.ircweb.org/>, we were able to obtain claim data that was gathered from more than 60 insurers for automobile claims that were closed during 1992. The data came from a portion of the IRC survey that is conducted every six to eight years or so. Thus, we had the good fortune of working with actual insurance claims, even though the precise insurer associated with each claim was unknown to us.

Although the global dataset is refined in a number of ways, it is noteworthy that we focused on first-party claims — in particular, uninsured motorist and underinsured motorist claims because variability in the law across states exists, as contrasted with third-party liability claims, where the “duty to settle” requirement is widely applied. In our final sample of more than 2,200 claims, 38 states were represented. Of these, 24 states fell into our category of recognizing an extracontractual cause of action; 14 states fell into our category of rejecting an extracontractual claim for first-party


bad faith during the time period of this study.

While controlling for a variety of demographic, legal and economic factors that are associated with the value of an insurance claim, we explored the association between the presence of a bad-faith “threat” and claim value. Among our data, we found statistical support for the proposition that when we include a proxy that describes variation in bad-faith law, the proxy is significant in explaining variations in claim amounts. We found that the settled noneconomic portion of an insurance claim is 5.6 percent

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higher in states that permit a bad-faith remedy, while the economic portion of the insurance claim is 13.7 percent higher, *ceteris paribus*. The relationship between bad faith and the total claim amount was a positive 0.3 percent. The different percentage amounts are partially attributable to different variables employed in the process of performing the statistical analysis across the different claim types. Although the interpretation of the actual percentage changes needs to be undertaken carefully, a general conclusion is clear: states with a bad-faith remedy exhibited higher claim amounts, reflecting support for our hypotheses about incentives and adjusting behavior.

Last, we found a somewhat surprising result: if an individual claimant was not represented by an attorney, then in bad-faith-remedy states there was an association that revealed even higher claim settlement amounts. Although most automobile claims with legal representation likely arise because of a legal “sign ‘em up and see what sticks” mentality rather than a more formalized decision process, insurers may settle for higher amounts with claimants in bad-faith states when they more obviously have an information advantage over their claim counterpart that could later be used against them. More-satisfied claimants are less likely to retain legal services.

The requirement that insurers act in good faith, strengthened with a bad-faith remedy, has had an impact on the execution of adjusting claims by insurers. The web of complexity among claim amounts, bad-faith law and the role of attorneys makes this field ripe for further research. 

Reference

Mark J. Browne, Ellen S. Pryor and Bob Puelz, 2004, “The Effect of Bad-Faith Laws on First-Party Insurance Claims Decisions,” *Journal of Legal Studies* Vol. 33 no. 2, pp. 355-390.

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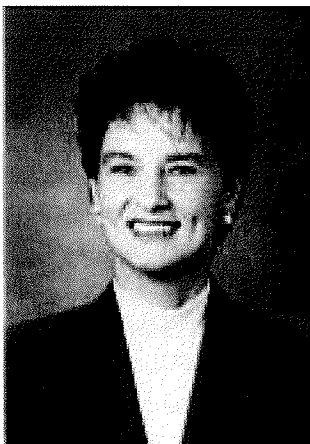
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On September 22, 2005, Joan Lee will celebrate 25 years as a member of the Robert Hughes Associates family. Joan joined Bob Hughes as his personal assistant back in 1980 and has been an exceptional loyal employee and friend to everyone at RHA. Joan grew up in Cookstown, Ontario, Canada, and moved to the



Joan Lee

Dallas area in 1977, where she began her career in the insurance industry with Liberty Mutual Insurance Company. She joined RHA one year after its 1979 formation, and other than company chairman Bob Hughes, Joan is the firm's longest-serving employee. 

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