Paying the Piper:
The Availability of Punitive Damages in Cases of Insurer Bad Faith

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Preface

Punitive damages have had cultural and legal significance since before the American Revolution.[2] Nearly 700 years ago, they were immortalized in the children's tale *The Pied Piper of Hamelin.[3]* In the tale, a village besieged by a rat infestation enlists the help of a self-proclaimed rat catcher known as the Pied Piper. After the villagers promise to pay the Piper if he rids the village of the infestation, he enspells the rats with his magical flute and drowns them in a nearby river. When the Piper returns to the village to collect, the villagers refuse to pay him. Enraged, the Piper exacts his revenge by enspelling the village children until the villagers agree to pay him not only what they promised, but also an additional sum as punishment.

In the wake of Hurricane Sandy, the significance of punitive damages has once more been catapulted into the national spotlight as disputes between policyholders and their insurance carriers begin to be litigated. In New York and New Jersey, legislation to facilitate policyholders' ability to litigate claims against their insurance carriers has been proposed.[4] In line with a number of other states, these legislative proposals focus upon two facets of bad faith law that have historically policed insurers' treatment of their insureds: the award of attorney's fees and punitive damages. Legislative proposals permitting the award of attorney's fees to a prevailing policyholder counterbalance an insurer's incentive to deny claims or delay payment,

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[2] *See, e.g., Wilkes v. Wood*, Lofft 1, 18, 98 Eng. Rep. 489, 498 (1763); *Huckle v. Money*, 2 Wils. 205, 95 Eng.Rep. 768 (C.P.1763).
[3] The tale's origins trace back to a stained-glass window in the Church of Hamelin, circa 1300. For the modern tale, s*ee* ROBERT BROWNING, THE PIED PIPER OF HAMELIN (Frederick Warne and Co., Ltd., 1888).
[4] *See*, *e.g.*, New Jersey Senate Bill No. 2460, the so-called "Consumer Protection Act of 2012" (January 8, 2013).

while punitive damages serve to punish and deter unfair claims handling practices that substantially prejudice an insured's rights. This article provides a general overview of the constitutional rubric governing the latter, as well as an up-to-date snapshot of the state of punitive damage awards in bad faith cases nationwide.

Warming Up: A Look at the States

The standards for an award of punitive damages in the bad faith context vary widely from state to state in terms of procedural prerequisites, enabling statutes, and common law, but they are legally permitted in nearly every state. Absent a contrary statute, third-party bad faith claims generally require the assignment of an insured's rights. The majority of states that permit punitive damages for an insurer's bad faith conduct require conduct by the insurer that reflects a reckless or malicious disregard of an insured's rights, proven by clear and convincing evidence. A significant minority of states permit punitive damages if actionable misconduct is proven by a preponderance of the evidence, though one state requires proof beyond a reasonable doubt.

A current state by state survey of the availability of punitive damages for insurer bad faith and the applicable standards of proof is summarized below:

STATE	**PUNITIVE DAMAGES***	**BURDEN**
Alabama	Yes	Clear and convincing
Alaska	Yes	Clear and convincing
Arizona	Yes	Clear and convincing
Arkansas	Yes	Clear and convincing
California	Yes	Clear and convincing
Colorado	Yes	Beyond a reasonable doubt
Connecticut	Yes	Preponderance of evidence
Delaware	Yes	Clear and convincing

* Punitive damages for insurer bad faith. In a few states, punitive damages are not available *per se*, but state statutory provisions for bad faith claims permit penalties, such as actual damages multipliers. We consider such states to be "yes" states.

District of Columbia	No	N/A
Florida	Yes	Clear and convincing
Georgia	Yes	Clear and convincing
Hawaii	Yes	Clear and convincing
Idaho	Yes	Clear and convincing
Illinois	Yes	Preponderance of evidence
Indiana	Yes	Clear and convincing
Iowa	Yes	Clear and convincing
Kansas	No	N/A
Kentucky	Yes	Clear and convincing
Louisiana	Yes	Preponderance of evidence
Maine	No	N/A
Maryland	No	N/A
Massachusetts	Yes	Preponderance of evidence
Michigan	No	N/A
Minnesota	No	N/A
Mississippi	Yes	Clear and convincing
Missouri	Yes	Clear and convincing
Montana	Yes	Clear and convincing
Nebraska	No	N/A
Nevada	Yes	Clear and convincing
New Hampshire	No	N/A
New Jersey	Yes	Clear and convincing
New Mexico	Yes	Preponderance of evidence
New York	Yes	Clear and convincing
North Carolina	Yes	Clear and convincing
North Dakota	Yes	Clear and convincing
Ohio	Yes	Clear and convincing
Oklahoma	Yes	Clear and convincing
Oregon	Yes	Clear and convincing
Pennsylvania	Yes	Clear and convincing
Rhode Island	Yes	Clear and convincing

South Carolina	Yes	Clear and convincing
South Dakota	Yes	Clear and convincing
Tennessee	Yes	Clear and convincing
Texas	Yes	Clear and convincing
Utah	Yes	Clear and convincing
Vermont	Yes	Preponderance of evidence
Virginia	No	Preponderance of evidence
Washington	No	N/A
West Virginia	Yes	Preponderance of evidence
Wisconsin	Yes	Clear and convincing
Wyoming	Yes	General jury instruction

Some states require that an underlying coverage suit be decided in favor of an insured prior to filing a bad faith suit, while others impose limits on the amount of punitive damages that may be awarded, independent of constitutional limitations.[5] Still others mandate that a portion of any punitive damages awarded be paid to the state, in line with the philosophical rationale that punitive damages are meant to punish conduct beyond that suffered by an insured party.[6]

<u>Running Between the (Constitutional) Guideposts</u>

Incidentally, the first U.S. Supreme Court case to consider the constitutionality of punitive damages award was a case involving an insurer's bad faith refusal to settle a claim. In *Aetna Life Insurance v. Lavoie*,[7] the Supreme Court was asked to decide whether a state supreme court judge involved in the decision below holding Aetna liable for punitive damages should have been recused from the proceeding.[8] Although the Court never addressed the merits of Aetna's claims that the Due Process Clause of the 14th Amendment prohibited excessive

[5] Twenty-six states have general statutory limitations on punitive damages awards, which include dollar value caps, multiplier limits on the ratio of compensatory to punitive damages, or limits specific to particular tort claims.
[6] Alaska, Georgia, Illinois, Indiana, Iowa, Missouri, Oregon, and Utah have statutory provisions requiring portions of all types of punitive damages awards be paid to the state. The respective portions range from the completely discretionary to formal percentages of 75%.
[7] *Aetna Life Ins. Co. v. Lavoie*, 475 U.S. 813 (1986).
[8] *Id.*

punitive damages, the Court concluded its opinion by noting that the issue had constitutional significance: "These arguments raise important issues which, in an appropriate setting, must be resolved; however, our disposition of the recusal-for-bias issue makes it unnecessary to reach them."[9]

The seminal U.S. Supreme Court case discussing substantive Due Process Clause limits on punitive damages is *Pacific Mutual Life v. Haslip*.[10] In *Haslip*, the Court evaluated the constitutionality of an award for punitive damages that was four times greater than the award for compensatory damages.[11] The Court upheld the award but noted that "unlimited jury discretion - or unlimited judicial discretion for that matter - in the fixing of punitive damages may invite extreme results that jar one's constitutional sensibilities."[12] In what would become the defining feature of future constitutional jurisprudence, the Court added: "We need not, and indeed we cannot, draw a mathematical bright line between the constitutionally acceptable and the constitutionally unacceptable that would fit every case."[13]

The *Haslip* court's holding was refined in the disgorgement context in *TXO*.[14] In *TXO*, the Court upheld a punitive damages award that was 526 times greater than the award for compensatory damages, based upon evidence that TXO had engaged in similar fraudulent schemes nationwide.[15] The Court held that the award was constitutionally permissible given that it addressed "the magnitude of potential harm that the defendant's conduct would have caused its intended victim if the wrongful plan had succeeded, as well as the possible harm to other victims that might have resulted if similar future behavior were not deterred."[16] The Court was also

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[9] *Id.* at 828-829.
[10] *Pacific Mutual Life Ins. Co. v. Haslip*, 499 U.S. 1 (1991).
[11] 499 U.S. 1 n.2.
[12] *Id.* at 18.
[13] *Id.*
[14] *TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443 (1993).
[15] *Id. at* 450-451.
[16] *Id. at* 460.

careful to point out that although the punitive damages award was 526 times greater than the actual compensatory damages award, "that shock dissipates when one considers the *potential* loss to respondents […] had petitioner succeeded in its illicit scheme,"[17] which the Court noted would have been at least $1 million.[18]

The most significant contribution by the U.S. Supreme Court to the modern punitive damages landscape is *BMW v. Gore*.[19] In *Gore*, the dispute arose from the revelation that BMW had repainted approximately 1,000 cosmetically damaged vehicles and sold them as "new." The Supreme Court held that an award of $2 million in punitive damages resulting from a claim for $4000 in compensatory damages was unconstitutionally excessive.[20]

In arriving at this conclusion, the Court erected three constitutional "guideposts" that lower courts should use to evaluate punitive damages awards: the degree of reprehensibility of a litigant's conduct; the ratio of compensatory damages to punitive damages, and the related civil and criminal penalties for similar misconduct.[21] Altogether, the Court reasoned, these guideposts would provide reviewing courts with a punitive damages rubric to ensure that "there is a reasonable relationship between the punitive damages award and the harm likely to result from the defendant's conduct as well as the harm that actually has occurred."[22]

Applied to the facts in *Gore*, the Court held that the conduct was not particularly reprehensible in that: the loss was purely economic in nature; there was no effect on the vehicle's safety or performance; there was no indifference to the health and safety of others; the economic injury was not committed on a vulnerable party; the safe harbor provision of a state

[17] *Id. at* 462.
[18] *Id.* In such a case, the ratio of punitive damages to compensatory damages could have been as low as 10:1. *See State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 430 n.1 (2003).
[19] *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996).
[20] *Id.*
[21] *Id.* at 574-575.
[22] *Id.* at 581, quoting *TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443, 460 (1993) and *Haslip*, 499 U.S., at 21.

non-disclosure statute was potentially applicable to BMW's conduct; and the company had never been informed that its conduct was potentially unlawful.[23]

The Court further determined that the ratio of punitive to compensatory damages, 500:1, was not warranted in light of prior decisions indicating that the analysis is dependent upon "the difference between [the punitive damages] figure and the harm to the victim that would have ensued if the tortious plan had succeeded."[24] Still, the Court reaffirmed its insistence that no mathematical formula or bright line exists: "Indeed, low awards of compensatory damages may properly support a higher ratio than high compensatory awards, if, for example, a particularly egregious act has resulted in only a small amount of economic damages. A higher ratio may also be justified in cases in which the injury is hard to detect or the monetary value of noneconomic harm might have been difficult to determine."[25]

Finally, with respect to the civil or criminal penalties associated with such conduct, the Court found that the highest applicable civil penalty would have been $10,000 and that the related state statutes did not provide BMW with fair notice that a violation of this kind could potentially subject it to a multimillion dollar penalty.[26]

Abandoning Ship? *Exxon v. Baker*

Courts determining the constitutionality of a punitive damages award after *Gore* continue to employ the three constitutional guideposts of reprehensibility, ratio, and related penalties in their analysis. Although the Supreme Court has elaborated upon the *Gore* factors in cases such as *State Farm v. Campbell*[27] and *Phillip Morris v. Williams,*[28] these three constitutional guideposts remain current law.

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[23] *Id.* at 575-581.
[24] *Id.* at 581, quoting *TXO*, 509 U.S. at 454.
[25] *Id*. at 582.
[26] *Id*. at 584.
[27] *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003).
[28] *Phillip Morris USA v. Williams*, 549 U.S. 346 (2007).

In *Campbell*, the Supreme Court alluded to a constitutional outer limit for punitive damages when it invalidated a $145 million punitive damage award in an automobile liability case seeking $1 million in compensatory damages.[29] Remanding the case to the Utah court, the Court stated: "in practice, few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process."[30] The Court further elaborated that in cases where "compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee."[31] On remand, the punitive damages award was reduced to a ratio of nine times the compensatory damages, and the Supreme Court denied subsequent certiorari review.[32]

In *Williams*, the Supreme Court refused to permit a punitive damages award of approximately $80 million that was based, in part, on a theory of liability that punished Phillip Morris for harm to nonparty victims of its allegedly deceitful cigarette advertising campaigns.[33] The *Williams* court did not decide whether or not the 100:1 ratio of punitive to compensatory damages was unconstitutionally excessive, but did hold that punitive damages may not be employed to punish a party for harm to non-parties.[34] The Court clarified that harm to non-parties may be *considered* in the reprehensibility analysis, but cannot be employed to effectively adjudicate a party's liability for harm to unnamed non-parties.[35] As the attorneys in *Williams* discovered, this distinction may prove difficult to properly explain to a jury.[36] And in the bad faith context, it is assuredly an ominous concern for insurers.

[29] *Campbell*, 538 U.S. 408.
[30] *Id*. at 425.
[31] *Id.*
[32] *Campbell v. State Farm Mut. Auto. Ins. Co.*, 98 P.3d 409 (Utah 2004), *cert. denied*, 125 S. Ct. 114 (U.S. 2004).
[33] *Williams*, 549 U.S., at 346.
[34] *Id.* at 347.
[35] *Id.* at 353-354.
[36] On remand, the lower *Williams* court grappled with the legality of a proposed jury instruction regarding the harm to nonparties. *Williams v. Philip Morris Inc.*, 344 Or. 45, 55 (2008).

Both *Campbell* and *Williams* make clear that the Due Process Clause affords litigants significant procedural and substantive safeguards with respect to punitive damages awards, especially in cases where "risks of arbitrariness, uncertainty, and lack of notice" are raised by an insurer.[37] Still, some litigants have attempted to elevate these general safeguards into the kind of bright line rejected by the Court in *Haslip*.[38] These attempts have increased significantly in the wake of *Exxon v. Baker*.[39]

In *Baker*, the Supreme Court examined the constitutionality of a multi-billion dollar punitive damages award against Exxon under federal admiralty law, concluding that a damages ratio of 1:1 was constitutionally appropriate there.[40] The Court recalled its prior admonition in *Gore*, which was particularly appropriate in light of the more than $500 million in compensatory damages awarded: the greater the award of compensatory damages, the less likely it is that a similarly significant punitive damages award will be constitutionally permissible.[41]

The *Baker* Court explicitly limited its holding to federal maritime cases, relying upon a number of national social studies surveying punitive damages awards.[42] On average, these studies found that compensatory damages awards commonly exceed punitive damages awards.[43] The Court reasoned that a damages ratio of 1:1 would thus comport with "jurors' sense of reasonable penalties" in cases like *Baker* where there were "no earmarks of exceptional blameworthiness" or other *Gore* factors which commonly warranted higher ratios of punitive damages awards.[44]

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[37] *Id.* at 354.
[38] *Haslip*, 499 U.S. 1.
[39] *Exxon Shipping Co. v. Baker*, 554 U.S. 471 (2008).
[40] *Id.*
[41] *Id.* at 514-515.
[42] *Id.* at 497-503. The Court relied upon data compiled almost exclusively prior to 2002, though more up-to-date data is currently available. *See* THOMAS H. COHEN, BUREAU OF JUSTICE STATISTICS, PUNITIVE DAMAGES AWARDS IN STATE COURTS, 2005, (2011).
[43] *Id.*
[44] *Id.* at 512-513.

To Pay or Not to Pay

Many litigants have attempted to elevate *Baker*'s holding of a 1:1 ratio of compensatory to punitive damages to a constitutional outer limit, but there is no clear indication that courts addressing such entreaties do so on a consistent basis. Some courts have adopted arguments that a 1:1 ratio is the only constitutionally permissible ratio in cases involving significant compensatory damages awards, relying upon *Gore* and *Baker*. Other courts have consistently signaled to the contrary, abiding by *Haslip*'s seminal holding that the Supreme Court should provide mere suggestions of "reasonableness and adequate guidance" to the state courts, and permit them to exercise their independent judgments.[45] This divide is perhaps unsurprising given the vast variety of state standards and prerequisites for the award of punitive damages, but courts indulging arguments for *Baker*'s expansion ignore the Supreme Court's repeated insistence that it is illogical - - indeed, unjust - - to presume that there can ever be a categorical rule that applies to a potentially infinite variety of tort injuries.

Recent punitive damages awards in the bad faith context seem to comport with this notion. An informal survey of recent awards sustained on appeal suggests that bad faith cases may *commonly* bear the "earmarks of exceptional blameworthiness" that the *Baker* court telegraphed warrant higher ratios of punitive damages.[46] What is more compelling is that many

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[45] *Id.* at 18.

[46] *See*, *e.g*., *Hollock v. Erie Ins. Exch*., 842 A.2d 409 (Pa. Super. Ct. 2004) (sustaining a ratio of 10:1 despite a compensatory award of over $250,000); *Greenberg v. Paul Revere Life Ins. Co.*, 91 F. App'x 539 (9th Cir. 2004) (sustaining a 4:1 ratio despite a compensatory award of over $550,000); *Weinstein v. Prudential Prop. & Cas. Ins. Co.*, 149 Idaho 299 (2010) (sustaining a ratio of 9:1 despite a compensatory award of $210,000); *Deters v. USF Ins. Co.*, 797 N.W.2d 621 (Iowa Ct. App. 2011) (sustaining a ratio of 14:1); *Strawn v. Farmers Ins. Co. of Oregon*, 350 Or. 336 (2011) *adhered to on reconsideration,* 350 Or. 521 (2011) and *cert. denied,* 132 S. Ct. 1142 (U.S. 2012) (sustaining an ratio of 8:1, though not on the merits); *Allstate Ins. Co. v. Dodson*, 2011 Ark. 19 (2011), *reh'g denied* (Mar. 3, 2011) (sustaining a ratio of 2.5:1 despite a compensatory award of $6 million); *Rhodes v. AIG Domestic Claims, Inc.*, 461 Mass. 486, 506 (2012) (sustaining a ratio of 2:1 despite a compensatory award of $11 million); *Cf. Walker v. Farmers Ins. Exch.*, 63 Cal. Rptr. 3d 507 (Cal. Ct. App. 2007) (reducing an award to a 1:1 ratio where $1.5 million in compensatory damages were awarded); *Amerigraphics, Inc., v. Mercury Cas. Co.*, 182 Cal. App. 4th 1538 (2d Dist. 2010) (reducing an award to $500,000 where $130,000 in compensatory damages were awarded); *Nardelli v. Metro. Group Prop. & Cas. Ins. Co.*, 230 Ariz. 592 (Ariz. Ct. App. 2012), *review denied* (Jan. 8, 2013) (reducing an award to a 1:1 ratio given minimal reprehensibility).

of these awards also feature significant compensatory damage awards.[47] To the extent that these results are not simply the product of different courts applying the law to different facts, they may perhaps be explained by reference to *TXO* and *Gore*. As insurer bad faith practices often continue unabated until they are revealed in the context of specific litigation, they can be likened to both the fraudulent business practices condemned by the *TXO* court and the "hard to detect" misconduct that the *Gore* court noted would warrant substantially higher ratios of punitive damages awards.[48]

From the insured's perspective, such results provide reassurance that policy premiums do in fact provide meaningful protection and that an insurer's bad faith conduct will not go unpunished. From the insurer's perspective, these results provide fair warning of the awards that may be sustained on appeal should their conduct rise to the requisite level of blameworthiness. Together, they confirm that punitive damages are not the product of a bygone era, and insurers who recklessly or intentionally prejudice their policyholders' rights may one day be made to pay the Pied Piper.

[47] *Id*.
[48] *Gore*, 517 U.S. at 582; *TXO*, 509 U.S. at 462.