6/03 - JONATHAN NEIL V. JONES [AC]

S107855

IN THE SUPREME COURT OF CALIFORNIA

JONATHAN NEIL & ASSOCIATES, INC.,

Plaintiff and Appellant,

vs.

FRED JONES,

Defendant and Respondent.

AFTER A DECISION BY THE COURT OF APPEAL,
FIFTH APPELLATE DISTRICT
(CASE NOS. F029400, F030300)

APPLICATION FOR LEAVE TO FILE AMICUS CURIAE BRIEF; AMICUS CURIAE BRIEF OF STATE COMPENSATION INSURANCE FUND IN SUPPORT OF CAL EAGLE INSURANCE COMPANY

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Pursuant to rule 29.1(f) of the California Rules of Court, State Compensation Insurance Fund (SCIF) requests permission to file the attached amicus curiae brief supporting cross-defendant and appellant Cal Eagle Insurance Company (Cal Eagle).

SCIF was established by the Legislature in 1914 as a non-profit, public workers' compensation insurance enterprise. It is currently the largest workers' compensation insurer in California. Though a state agency, SCIF is self-supporting (no funds are received from the General Fund), and it is subject to the same laws and regulations that govern other insurers in the state. SCIF operates by charter like a mutual insurance company, rebating excess

premiums to its policyholders based on experience and actuarial expectations.

SCIF's amicus curiae brief addresses an important issue raised by this case: whether an insurer that breaches its implied covenant of good faith and fair dealing by charging an excessive premium can be held liable in *tort*, even though the insurer did not fail to honor its basic commitment to provide insurance protection. SCIF has litigated this issue to decision in a number of cases, several of which have resulted in published Court of Appeal decisions holding that SCIF is subject to liability in *tort* for conduct that did not deny the insured the basic protection afforded by its policy but merely affected the insured's premium. (See *post*, pp. 23-27.)

SCIF's counsel has reviewed the briefs filed by the parties and believes that SCIF's amicus curiae brief provides a unique perspective and argument that will substantially assist the court. Unlike the parties, who ask this court either to *follow* (see Opening Brief of Defendants Fred Jones, et al., pp. 23-24 & fn. 8) or to *distinguish* (see Answer Brief on the Merits, pp. 44-45 & fn. 21) the above-mentioned Court of Appeal decisions, SCIF asks this court to *disapprove* those decisions. SCIF's brief traces the history of this court's jurisprudence in the area of tortious breach of the implied covenant and demonstrates that the above-mentioned Court of Appeal decisions cannot be squared with that jurisprudence. SCIF's amicus curiae brief will thus aid the court in understanding the full scope of the issue presented.

For these reasons, SCIF requests that the court grant leave for SCIF to file its amicus curiae brief.

INTRODUCTION

This amicus curiae brief addresses the following issue: when an insurer breaches its implied covenant of good faith and fair dealing by charging an excessive premium, can the insurer be liable not only in contract but also in *tort*?

The Court of Appeal captured the issue nicely: "[W]e do not question in any way the applicability of the covenant [of good faith and fair dealing] to each and every aspect of a party's conduct in discharging its duties under a contract; the issue before us is whether a *tort* cause of action arises from breach of the covenant in particular circumstances." (*Jonathan Neil & Associates, Inc. v. Jones* (May 14, 2002, F029400 & F030300) slip. opn., p. 28, fn. 3, review granted Aug. 14, 2002, S107855 (hereafter "slip opn.").) The "particular circumstances" here involve "an insurer's abuse of its rights to audit the financial records of its insured and to collect an additional premium under an approved rate structure . . . ." (*Id*. at p. 23.)

The Court of Appeal held that, while these circumstances "may constitute a breach of the covenant of good faith and fair dealing[,] [s]uch a breach . . . is fully remediable in a contract action with damages measured according to traditional contract principles." (Slip opn. p. 23.) The court distinguished the conduct at issue here from the conduct of an insurer *qua* insurer: "When an insurer is called upon to act as an insurer – that is, to defend, settle, or pay a claim" (*id*. at p. 22), the insurer's failure to discharge its duties in good faith gives rise to tort liability. But "the general administration of an insurance policy 'is not sufficiently similar' to the duties

involved in investigating, defending, and settling claims to justify imposition of tort liability on an insurer who acts in bad faith." (*Id.* at p. 21.)

In support of the Court of Appeal's judgment, we examine this court's opinions establishing the law of tortious breach of the implied covenant of good faith and fair dealing in the insurance context. We demonstrate that this court's opinions support tort liability for breach of the implied covenant *only* when the insurer unreasonably refuses to settle a third party claim within policy limits or unreasonably withholds payment of the insured's claim; in other words, when the insurer unreasonably refuses to honor its basic commitment to provide insurance protection. Nothing in this court's opinions supports *tort* liability for breach of the implied covenant when an insurer charges an excessive premium.

We also ask this court to disapprove certain Court of Appeal decisions that support or approve tort liability for breach of the implied covenant even where the insurer did not fail to honor its basic commitment to provide insurance protection. In particular, we ask this court to disapprove a line of workers' compensation insurance cases that support or approve tort liability for breach of the implied covenant in assessing premiums.

LEGAL DISCUSSION

I.

THIS COURT HAS LIMITED *TORT* LIABILITY FOR BREACH OF THE IMPLIED COVENANT IN THE INSURANCE CONTEXT TO CASES WHERE THE INSURER UNREASONABLY REFUSES TO HONOR ITS BASIC COMMITMENT TO PROVIDE INSURANCE PROTECTION.

A. Liability for breach of the implied covenant is almost always limited to contract remedies. An exception exists in the insurance context.

"The distinction between tort and contract is well grounded in common law, and divergent objectives underlie the remedies created in the two areas. Whereas contract actions are created to enforce the intentions of the parties to the agreement, tort law is primarily designed to vindicate 'social policy.'" (*Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 654, 683 (*Foley*).) "'"[T]ort actions are created to protect the interest in freedom from various kinds of harm. The duties of conduct which give rise to them are imposed by law, and are based primarily on social policy . . . ."'" (*Applied Equipment Corp. v. Litton Saudi Arabia Ltd.* (1994) 7 Cal.4th 503, 514-515.)

"Because the covenant [of good faith and fair dealing] is a contract term, . . . compensation for its breach has almost always been limited to contract rather than tort remedies." (*Foley*, *supra*, 47 Cal.3d at p. 684; see *Aas v. Superior Court* (2000) 24 Cal.4th 627, 643, quoting *Erlich v. Menezes* (1999) 21 Cal.4th 543, 552 (*Erlich*), quoting *Freeman & Mills, Inc. v. Belcher Oil Co.* (1995) 11 Cal.4th 85, 107 (conc. & dis. opn. of Mosk, J.) ["'"[c]ourts will generally enforce the breach of a contractual promise through contract law, except when the actions that constitute the breach violate a social policy that merits the imposition of tort remedies"'"].)

"An exception to this general rule has developed in the context of insurance contracts where, for a variety of policy reasons, courts have held that breach of the implied covenant will provide the basis for an action in tort." (*Foley*, *supra*, 47 Cal.3d at p. 684.) In the following sections, we trace the evolution of this exception.

B. This court first recognized tort liability for breach of the implied covenant in the insurance context in cases where a liability insurer unreasonably refuses to settle within policy limits. The stated rationale was to deter the insurer from abusing its control over defense and settlement of the third party claim.

The present case involves liability insurance. [1/] (Slip opn. pp. 2, 30.) Tort liability for breach of the implied covenant of good faith and fair dealing in the insurance context finds its origin in two liability insurance cases: *Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654 (*Comunale*) and *Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425 (*Crisci*). In these cases, this court held: "When there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim. Its unwarranted refusal to do so constitutes a breach of the implied covenant of good faith and fair dealing." (*Comunale*, *supra*, 50 Cal.2d at p. 659; accord, *Crisci*, *supra*, 66 Cal.2d at p. 429.)

In *Crisci*, this court held that the "action for wrongful refusal to settle" sounds in tort. (*Crisci*, *supra*, 66 Cal.2d at p. 433.) This court also said that the "tort duty is ordinarily based on the insurer's assumption of the defense and of settlement negotiations . . . ." (*Id*. at p. 432, fn. 3.) "It is generally held

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1/ "A third party liability policy . . . provides coverage for liability of the insured to a 'third party' . . . . In the typical third party liability policy, the carrier assumes a contractual duty to pay judgments the insured becomes legally obligated to pay as damages because of bodily injury or property damage caused by the insured." (*Montrose Chemical Corp. v. Admiral Ins. Co.* (1995) 10 Cal.4th 645, 663.)

that since the insurer has reserved control over the litigation and settlement it is liable for the entire amount of a judgment against the insured, including any portion in excess of the policy limits, if in the exercise of such control it is guilty of bad faith in refusing a settlement." (*Comunale*, *supra*, 50 Cal.2d at p. 660, citing *Brown v. Guarantee Ins. Co.* (1957) 155 Cal.App.2d 679, 682 (*Brown*), and *Ivy v. Pacific Automobile Ins. Co.* (1958) 156 Cal.App.2d 652, 659 (*Ivy*).)

In *Ivy*, the Court of Appeal explained: "This duty to act in good faith, while not expressly set forth in the policy, is necessarily implied as a correlative duty growing out of certain rights and privileges which the insurance contract gives to the insurer. By the terms of the insurance policy the control of the defense of the action is turned over to the insurer, and the insured is precluded from interfering in any settlement procedure. But when liability in excess of the policy limits is involved the insured's interests became directly involved. It is then that the duty to act in good faith becomes important." (*Ivy*, *supra*, 156 Cal.App.2d at pp. 659-660.)

In *Brown*, the Court of Appeal explained: "'It is the right of the insurer to exercise its own judgment upon the question of whether the claim should be settled or contested. But because it has taken over this duty, and because the contract prohibits the insured from settling, or negotiating for a settlement, or interfering in any manner except upon the request of the insurer . . . , its exercise of this right should be accompanied by considerations of good faith.'" (*Brown*, *supra*, 155 Cal.App.2d at p. 685.)

This court's decisions since *Comunale* and *Crisci* have reiterated that tort liability for breach of the implied covenant in a liability insurance contract is imposed "'for failure to meet the *duty to accept reasonable settlements*, a duty included within the implied covenant of good faith and fair dealing.'" (*Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 573, emphasis added

(*Gruenberg*); see *Silberg v. California Life Ins. Co.* (1974) 11 Cal.3d 452, 460 ["the duty of an insurer to *accept a reasonable settlement* so as to absolve its insured of liability to a third person is implied in the covenant of good faith and fair dealing which exists in every insurance contract. . . . Violation of the duty of the insurer sounds in tort" (emphasis added)] (*Silberg*); *Johansen v. California State Auto. Assn. Inter-Ins. Bureau* (1975) 15 Cal.3d 9, 18 ["a breach of the insurer's obligation to *accept a reasonable offer of settlement*, a duty included within the implied covenant of good faith and fair dealing, 'sounds in both contract and tort'" (emphasis added)]; *Murphy v. Allstate Ins. Co.* (1976) 17 Cal.3d 937, 941 ["The *duty to settle* is implied in law to protect the insured from exposure to liability in excess of coverage as a result of the insurer's gamble — on which only the insured might lose" (emphasis added)], 941-942 ["When the carrier does breach its *duty to settle*, the insured has been allowed to recover excess award over policy limits [citation], economic loss [citation], physical impairment [citation], emotional distress [citations], and punitive damage [citation]" (emphasis added)]; *PPG Industries, Inc. v. Transamerica Ins. Co.* (1999) 20 Cal.4th 310, 312 ["If the insurer breaches the implied covenant *by unreasonably refusing to settle the third party suit*, the insured may sue the insurer in tort" (emphasis added)].)

Most recently, in *Cates Construction, Inc. v. Talbot Partners* (1999) 21 Cal.4th 28 (*Cates*), this court, citing *Crisci*, *supra*, 66 Cal.2d at page 432, footnote 3, reiterated "that the tort duty of a liability insurer ordinarily is based on its assumption of the insured's defense and of settlement negotiations of third party claims." (*Cates*, *supra*, 21 Cal.4th at p. 44; see *id*. at p. 56 ["a principal basis for recognizing tort liability in the context of liability insurance [is] the insurer's assumption of the insured's defense and of settlement negotiations of third party claims"].)

C. This court later extended tort liability for breach of the implied covenant in the insurance context to cases where a first party insurer unreasonably withholds payment of the insured's claim. The rationale for tort liability was restated in various ways.

After establishing tort liability for breach of the implied covenant of good faith and fair dealing when a liability insurer unreasonably refuses to settle within policy limits, this court extended tort liability to first party insurance contracts. [2/] In *Gruenberg*, *supra*, 9 Cal.3d 566, this court explained:

> In [*Comunale* and *Crisci*], we considered the duty of the insurer to act in good faith and fairly in handling the claims of third persons against the insured, described as a "duty to accept reasonable settlements"; in the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy. These are merely two different aspects of the same duty. . . . Where in [discharging its contractual responsibilities, the insurer] fails to deal fairly and in good faith with its insured by *refusing, without proper cause, to compensate its insured for a loss covered by the policy*, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.

(*Id*. at pp. 573-574, emphasis deleted and added; see *id*. at p. 575 ["The duty to so act is immanent in the contract whether the company is attending to the claims of third persons against the insured or the claims of the insured itself.

2/ "[A] first party insurance policy provides coverage for loss or damage sustained directly by the insured (e.g., life, disability, health, fire, theft and casualty insurance). . . . In the usual first party policy, the insurer promises to pay money to the insured upon the happening of an event, the risk of which has been insured against." (*Montrose Chemical Corp. v. Admiral Ins. Co.*, *supra*, 10 Cal.4th at p. 663.)

Accordingly, when the insurer *unreasonably and in bad faith withholds payment of the claim of its insured*, it is subject to liability in tort" (emphasis added)].)

This court's decisions since *Gruenberg* have reiterated that tort liability for breach of the implied covenant in a first party insurance contract is imposed for the insurer's failure to meet its duty not to unreasonably withhold payment of the insured's claim. (See *Silberg*, *supra*, 11 Cal.3d at pp. 461 [the principles of tort liability established in *Comunale* and *Crisci* "have been extended to cases in which the insurer unreasonably and in bad faith *withholds payment of the claim* of the insured" (emphasis added)], 462 [referring to the insurer's "failure to afford relief to its insured against the very eventuality insured against by the policy"]; *Neal v. Farmers Ins. Exchange* (1978) 21 Cal.3d 910, 920 ["when an insurer 'fails to deal fairly and in good faith with its insured by refusing, without proper cause, to *compensate its insured for a loss covered by the policy*, such conduct may give rise to a cause of action in tort'" (emphasis added)]; *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 818 ["'[W]hen the insurer unreasonably and in bad faith *withholds payment of the claim* of its insured, it is subject to liability in tort'" (emphasis added)] (*Egan*).)

In *Egan*, *supra*, 24 Cal.3d 809, this court articulated the rationale for imposing tort liability on an insurer that breaches its duty not to unreasonably withhold payment of the insured's claim: "The insured in a contract like the one before us does not seek to obtain a commercial advantage by purchasing the policy — rather, he seeks protection against calamity." (*Egan, supra,* 24 Cal.3d at p. 819.) This court elaborated:

> "The insurer's 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." [Citation.] Furthermore, the relationship of insurer and insured is inherently unbalanced: the adhesive nature of insurance contracts places the insurer in a superior bargaining position. The availability of punitive damages is thus compatible with recognition of insurers' underlying public obligations and reflects an attempt to restore balance in the contractual relationship.

(*Id*. at p. 820.)

This rationale presumably applied, as well, to tort liability for breach of the liability insurer's duty not to unreasonably refuse to settle within policy limits.

Since *Egan*, this court has restated in various ways the rationale for tort liability for breach of the implied covenant of good faith and fair dealing in the insurance context.

In *Foley*, *supra*, besides reiterating the rationale stated in *Egan* (see *Foley*, 47 Cal.3d at pp. 684-685), this court said: "[A]n insured faces [an economic dilemma] when an insurer in bad faith refuses to pay a claim or to accept a settlement offer within policy limits. When an insurer takes such actions, the insured cannot turn to the marketplace to find another insurance company willing to pay for the loss already incurred." (*Id*. at p. 692.) This court also said: "In the insurance relationship, the insurer's and insured's interest are financially at odds. If the insurer pays a claim, it diminishes its fiscal resources. The insured, of course, has paid for protection and expects to have its losses recompensed. When a claim is paid, money shifts from insurer to insured, or, if appropriate, to a third party claimant." (*Id*. at p. 693.) The "inherent . . . tension between the interests . . . of insurers and insureds,"

the "conflicting interests at stake in the insurance context," create the "need to place disincentives" on the insurer's conduct. (*Ibid*.)

In *Hunter v. Up-Right, Inc.* (1993) 6 Cal.4th 1174, 1180-1181 (*Hunter*), this court reiterated the rationale stated in *Foley*.

In *Cates*, *supra*, 21 Cal.4th 28, this court said: "[T]ort remedies for breach of the implied covenant are permitted in the insurance policy setting for policy reasons pertaining to the distinctive nature of such contracts and the relationship between the contracting parties." (*Id*. at p. 50; see *id*. at p. 44.) "[T]ort recovery is considered appropriate in the insurance policy setting because such contracts are characterized by elements of adhesion and unequal bargaining power, public interest and fiduciary responsibility." (*Id*. at p. 52; see *id*. at pp. 44, 60.) "In general, insurance policies are not purchased for profit or advantage; rather, they are obtained for peace of mind and security in the event of an accident or other catastrophe." (*Id*. at p. 44.) "[I]nsureds . . . seek protection against calamity. . . . [T]he typical insurance policy protects an insured against accidental and generally unforeseeable losses caused by a calamitous or catastrophic event such as disability, death, fire, or flood . . . ." (*Id*. at p. 53.) "[T]he vast majority of insureds . . . must accept insurance on a 'take-it-or-leave-it' basis . . . ." (*Id*. at p. 52.) "[W]hen an insurer in bad faith refuses to pay a claim or accept a settlement offer within policy limits, its insured cannot turn to the marketplace to find another insurance company willing to pay for losses already incurred." (*Id*. at p. 54; see *id*. at p. 44.) The fact that the insured "typically can look only to the insurer for recovery in the event of a covered loss" presents a "unique 'economic dilemma.'" (*Id*. at p. 54; see *id*. at p. 44.) "Additionally, a principal basis for recognizing tort liability in the context of liability insurance [is] the insurer's assumption of the insured's defense and of settlement negotiations of third party claims . . . ." (*Id*. at p. 56; see *id*. at p. 44.)

Finally, in *Kransco v. American Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4th 390 (*Kransco*), this court explained that "[t]he availability of tort remedies in the limited context of an insurer's breach of the covenant advances the social policy of safeguarding an insured in an inferior bargaining position who contracts for calamity protection, not commercial advantage." (*Id*. at p. 400, emphasis deleted.)

D. The rationale for recognizing tort liability for breach of the implied covenant in the insurance context applies only when the insurer unreasonably refuses to honor its basic commitment to provide insurance protection.

Although this court has stated in various ways its rationale for recognizing tort liability for breach of the implied covenant in the insurance context, one thing is clear: the rationale applies *only* when the insurer unreasonably refuses to settle a third party claim within policy limits or unreasonably withholds payment of the insured's claim; that is, when the insurer unreasonably refuses to honor its basic commitment to provide insurance protection.

Vital public service.

Fundamental to the rationale for imposing tort liability for breach of the implied covenant in the insurance context is the recognition that insurers are "'purveyors of a vital service labeled quasi-public in nature.'" (*Egan*, *supra*, 24 Cal.3d at p. 820; *Foley*, *supra*, 47 Cal.3d at p. 685; *Hunter*, *supra*, 6 Cal.4th at p. 1181.) Insurance allows one party "to shift to another a contingent risk that the first party . . . cannot itself bear" (*Cates*, *supra*, 21 Cal.4th at p. 65 (conc. & dis. opn. of Mosk, J.)), i.e., "the risk of an unpredictable and potentially severe loss" (*ibid*.). The insurer "accepts the

risk under the . . . business principle . . . that the premiums collected for the coverage of numerous such risks will, together with the investment income generated by holding this money as capital, allow for a profit." (*Ibid*.)

By creating "'confidence that in the event of calamity, there is protection'" (*Cates, supra*, 21 Cal.4th at p. 66 (conc. & dis. opn. of Mosk, J.)), that is, by "provid[ing] financial security and peace of mind" (*Freeman & Mills, Inc. v. Belcher Oil Co., supra*, 11 Cal.4th at p. 109 (conc. & dis. opn. of Mosk, J.)), [3/] insurance "'promot[es] the conduct of business and personal affairs,'" permitting "greater freedom of activity by more participants than would be possible if each had to bear all the risks of its own enterprise" (*Cates, supra*, 21 Cal.4th at pp. 66, 65 (conc. & dis. opn. of Mosk, J.)). [4/]

3/ See *Kransco*, *supra*, 23 Cal.4th at page 400 ("an insured . . . contracts for calamity protection"); *Cates*, *supra*, 21 Cal.4th at page 44 ("In general, insurance policies . . . are obtained for peace of mind and security in the event of an accident or other catastrophe"); *id*. at page 53 ("insureds . . . seek protection against calamity. [Citations.] . . . [T]he typical insurance policy protects an insured against accidental and generally unforeseeable losses caused by a calamitous or catastrophic event such as disability, death, fire, or flood"); *Hunter*, *supra*, 6 Cal.4th at page 1181 ("'The insured . . . seeks protection against calamity'"); *Foley*, *supra*, 47 Cal.3d at page 684 (same); *Egan*, *supra*, 24 Cal.3d at page 819 (same); *Crisci*, *supra*, 66 Cal.2d at page 434 (the insured seeks to "protect . . . against the risks of accidental losses, including the mental distress which might follow from the losses"); see also slip opn. p. 22 (referring to the insured "suffer[ing] the 'calamity' of property or income loss or of a third-party trying to collect a large judgment against it").

4/ See, e.g., *Carpenter v. Pacific Mut. Life Ins. Co.* (1937) 10 Cal.2d 307, 329 ("Insurance is a public asset, a basis of credit, and a vital factor in business activity"); *Sullivan v. Union Oil Co. of Cal.* (1940) 16 Cal.2d 229, 236 ("'Life insurance occupies [an] important place in our national and economic life'"); *MacGruer v. Fidelity & Casualty Co.* (1928) 89 Cal.App. 227, 233 ("Insurance . . . is essential to economic progress and is encouraged under the law").

One can hardly imagine the adverse impact on business and personal

(continued...)

Because insurance protection is "an essential service or product" (*Hunter, supra*, 6 Cal.4th at p. 1188 (dis. opn. of Mosk, J.)) that affords vitally important benefits to society at large, there is a strong social policy in favor of enforcing the contractual promise to provide insurance protection. "The reasonable expectation of both the public and the insured is that the insurer will duly perform *its basic commitment: to provide insurance*." (*Barrera v. State Farm Mut. Automobile Ins. Co.* (1969) 71 Cal.2d 659, 669, emphasis added (*Barrera*).)

Unbalanced relationship.

Also fundamental to the rationale for imposing tort liability for breach of the implied covenant in the insurance context is the recognition that the relationship between insurer and insured is out of balance, leaving the insured with no choice but to "depend on the good faith and performance of the insurer" (*Vu v. Prudential Property & Casualty Ins. Co.* (2001) 26 Cal.4th 1142, 1151 (*Vu*)).

"[T]he vast majority of insureds . . . must accept insurance on a 'take-it-or-leave-it' basis" (*Cates, supra*, 21 Cal.4th at p. 52), with the terms of the insurance contract creating a relationship that is "skewed in favor of insurers

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4/ (...continued)
affairs if insurance suddenly disappeared. As this court has recognized, even the insolvency of a single insurer is cause for grave concern: "Obviously, if an insurance company gets into financial difficulties, something must be done to remedy the situation. Either the company must be liquidated, and its assets distributed to its creditors, thus immeasurably injuring many of its policyholders who are thus deprived of insurance protection, or the business must, if possible, be rehabilitated. The public has a *grave and important interest in preserving the business* if that is possible." (*Carpenter v. Pacific Mut. Life Ins. Co.*, *supra*, 10 Cal.2d at p. 329, emphasis added; see *Commercial Nat. Bank v. Superior Court* (1993) 14 Cal.App.4th 393, 398 [same]; see also Dickerson, *Workers' Comp Crisis Worsens*, L.A. Times (May 25, 2003) p. A1 [discussing economic turmoil resulting from insolvency of nearly two dozen workers' compensation insurers].)

and against insureds" (*Kransco, supra,* 23 Cal.4th at p. 413 (conc. opn. of Mosk, J.)). "[T]he insurer has virtually sole control of the proceedings, including the decision to settle third-party claims [citation] and the decisions to investigate and pay claims by its own insured [citation]." (Slip opn. p. 22.) The insured does not "wield sufficient bargaining power to demand contractual provisions for interest, attorney's fees and liquidated damages," i.e., "to negotiate terms that encourage timely performance . . . and that provide for attorneys' fees and interest when breaches occur." [5/] (*Cates, supra,* 21 Cal.4th at p. 57.)

"A fundamental disparity exists between the insured, which performs its basic duty of paying the policy premium at the outset, and the insurer, which, depending on a number of factors, may or may not have to perform its basic duties of defense and indemnification under the policy. (See *Foley, supra,* 47 Cal.3d at p. 693 [noting that the 'insurer's and insured's interest are financially at odds'].) [6/] An insured is thus not on equal footing with its insurer — the relationship between insured and insurer is inherently unequal, the inequality resting on contractual asymmetry." (*Kransco, supra,* 23 Cal.4th at pp. 404-405.)

If the insurer refuses to honor its promise to provide insurance

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5/ See *Vu, supra,* 26 Cal.4th at page 1151 (insurers and insureds have a relationship that is "often characterized by unequal bargaining power"); *Kransco, supra,* 23 Cal.4th at page 400 (referring to the insured's "inferior bargaining position"); *Erlich, supra,* 21 Cal.4th at pages 552-553 (referring to the "'"special relationship" between insurer and insured, characterized by elements of . . . adhesion'"); *Cates, supra,* 21 Cal.4th at pages 44, 50, 53 ("adhesion and unequal bargaining power . . . are inherent in insurance policies"); *Hunter, supra,* 6 Cal.4th at pages 1180-1181 ("'the relationship of insurer and insured is inherently unbalanced: the adhesive nature of insurance contracts places the insurer in a superior bargaining position'"); *Foley, supra,* 47 Cal.3d at page 685 (same); *Egan, supra,* 24 Cal.3d at page 820 (same).

6/ And see *ante*, page 13, where we quote the entire passage from *Foley*.

protection, the insured has nowhere to turn. "[A]n insured faces a unique 'economic dilemma' when its insurer breaches the implied covenant of good faith and fair dealing. [Citation.] Unlike other parties in contract who typically may seek recourse in the marketplace in the event of a breach, an insured will not be able to find another insurance company willing to pay for a loss already incurred." (*Cates, supra*, 21 Cal.4th at p. 44; see *id*. at pp. 54, 56 [referring to the "economic dilemma that an insured faces after a catastrophic loss or accident"]; *Hunter, supra*, 6 Cal.4th at p. 1181; *Foley, supra*, 47 Cal.3d at p. 692.)

Instead, the insured must endure "the precise harm (i.e., lack of funds in times of crisis) the contract was designed to prevent" (*Love v. Fire Ins. Exchange* (1990) 221 Cal.App.3d 1136, 1148; see *Agricultural Ins. Co. v. Superior Court* (1999) 70 Cal.App.4th 385, 397 ["An insurer's breach can . . . frustrate the core purpose of insurance (protecting the insured from calamity) and leave the insured exposed to a disaster it has paid to avoid"]). For example, "an insured has nowhere to turn to replace monthly disability payments. Money damages paid pursuant to a judgment years after the insurer has initially reneged on payment do not remedy the harm suffered by the insured, namely the immediate inability to support oneself and its attendant horrors." (*Wallis v. Superior Court* (1984) 160 Cal.App.3d 1109, 1118.)

"The benefit contracted for by the insured is the availability of money *promptly* upon the happening of the event insured against, and when an insurer refuses unreasonably to make a payment of the benefits due under the terms of the policy, it deprives the insured of the essential benefit of the agreement. This follows, for the insured bargained for prompt payment, not a right of action against the insurer." (*Austero v. National Cas. Co.* (1978) 84 Cal.App.3d 1, 29-30, emphasis added, disapproved on other grounds in *Egan, supra*, 24 Cal.3d at p. 824, fn. 7.)

***Fiduciary-like obligation*.**

The remaining aspect of the rationale for tort liability for breach of the implied covenant in the insurance context is the fact that the duty imposed by the implied covenant is akin to a fiduciary duty.

In *Egan*, *supra*, 24 Cal.3d 809, this court addressed "the extent of the duties imposed by the implied covenant in liability insurance policies." (*Id*. at p. 818.) "[T]he insurer, when determining whether to settle a claim, must give at least as much consideration to the welfare of its insured as it gives to its own interests." (*Ibid*.) This court also explained: "The implied covenant imposes obligations not only as to claims by a third party but also as to those by the insured. [Citations.] In both contexts the obligations of the insurer 'are merely two different aspects of the same duty.' . . . For the insurer to fulfill its obligation not to impair the right of the insured to receive the benefits of the agreement, it again must give at least as much consideration to the latter's interests as it does to its own." (*Id*. at pp. 818-819; see *Vu*, *supra*, 26 Cal.4th at p. 1150.)

"'[T]hese "special" duties are akin to, and often resemble, duties which are also owed by fiduciaries . . . .'" [7/] (*Vu*, *supra*, 26 Cal.4th at p. 1151.) The

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7/ See *Erlich*, *supra*, 21 Cal.4th at page 553 (referring to the "'"special relationship" between insurer and insured, characterized by elements of . . . fiduciary responsibility'"); *Cates*, *supra*, 21 Cal.4th at pages 44 ("an insurance policy is characterized by elements of . . . fiduciary responsibility"), 52, 56, 60; *Egan*, *supra*, 24 Cal.3d at page 820 ("'Insurers hold themselves out as fiduciaries, and with the public's trust must go private responsibility consonant with that trust'").

"The insurer-insured relationship, however, is not a true 'fiduciary relationship' . . . ." (*Vu*, *supra*, 26 Cal.4th at p. 1150.) "[A] true fiduciary must first consider and always act in the best interests of its trust and not allow self-interest to overpower its duty to act in the trust's best interests. [Citation.] An insurer, however, may give its own interests consideration equal to that it gives the interests of its insured . . . ." (*Love v. Fire Ins. Exchange*, *supra*, 221

(continued...)

remedies for breach of fiduciary duty are in tort. (*Exxess Electronixx v. Heger Realty Corp.* (1998) 64 Cal.App.4th 698, 708; *Stanley v. Richmond* (1995) 35 Cal.App.4th 1070, 1086, 1097; *Jahn v. Brickey* (1985) 168 Cal.App.3d 399, 406; *Vale v. Union Bank* (1979) 88 Cal.App.3d 330, 339-340.)

In sum, this court has allowed tort remedies — in particular, punitive damages [8/] — for breach of the implied covenant in the insurance context because: (1) there is a strong social policy in favor of enforcing an insurer's contractual promise to provide insurance protection; (2) the relationship between insurer and insured is so unbalanced that it leaves the insured with no choice but to depend on the good faith and performance of the insurer; and (3) the duty that the implied covenant imposes on the insurer (to give at least as much consideration to the insured's interests as it does to its own) is akin to a fiduciary duty. These reasons justify recognizing tort remedies where an insurer fails to honor its *basic promise to provide insurance protection*.

In comments as true today as they were nearly 40 years ago, this court reflected on the importance of compelling the insurer's fidelity to *its basic promise to insure*:

> [T]he individual consumer in the highly organized and integrated society of today must necessarily rely upon

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7/ (...continued)
Cal.App.3d at pp. 1148-1149.)

8/ Punitive damages are the key tort remedy, since the measure of contract damages in the insurance context is quite broad to begin with. When an insurer unreasonably refuses to settle within policy limits, the measure of contract damages includes "liab[ility] for the entire judgment against the insured even if it exceeds the policy limits." (*Comunale*, *supra*, 50 Cal.2d at p. 661.) Also, when an insurer unreasonably refuses to settle within policy limits or unreasonably withholds payment of the insured's claim, the measure of contract damages includes emotional distress. (*Crisci*, *supra*, 66 Cal.2d at p. 434; see 1 Witkin, Summary of Cal. Law (9th ed. 1987) Contracts, § 832, p. 750.)

> institutions devoted to the public service to perform the basic functions which they undertake. At the same time the consumer does not occupy a sufficiently strong economic position to bargain with such institutions as to specific clauses of their contracts of performance, and, in any event, piecemeal negotiation would sacrifice the advantage of uniformity. Hence the courts in the field of insurance contracts have tended to require that the insurer render the *basic insurance protection* which it has held out to the insured.

(*Gray v. Zurich Insurance Co.* (1966) 65 Cal.2d 263, 280, emphasis added (*Gray*).)

E. In this case, the insurer did not unreasonably refuse to honor its basic commitment to provide insurance protection. Therefore, the rationale for tort liability for breach of the implied covenant does not apply.

This case does *not* involve "the basic insurance protection which [the insurer] has held out to the insured" (*Gray*, *supra*, 65 Cal.2d at p. 280). It involves only the price of that protection. This is not to say that price is unimportant. Generally speaking, however, there is no comparison between the harm to individual insureds and to society that results when insurers unreasonably refuse to honor their basic commitment to provide insurance protection, and the harm that results when insurers attempt to charge an excessive premium. The former is far more serious from society's standpoint than the latter.

Moreover, with regard to the price of insurance, the insured is not dependent on the good faith and performance of the insurer. "In this case the insured can do nothing and make the insurer prove its entitlement to additional premiums in litigation initiated by the insurer [citation] or, in the alternative, the insured can present its records in comprehensible form to the insurer and

the Insurance Commissioner for resolution of the dispute. . . . While the insured is under the financial pressure shared by any potential litigant with an inchoate claim on the horizon, the insured has not suffered the 'calamity' of property or income loss or of a third-party trying to collect a large judgment against it." (Slip opn. p. 22.)

Finally, with regard to the price of insurance, the insurer has no fiduciary-like duty. The price "implicates the marketplace aspect of [the insured's] relationship with [the insurer], not the fiduciary-type relationship which pertains only to the receipt of benefits under the insurance policy." (*New Plumbing Contractors, Inc. v. Nationwide Mutual Ins. Co.* (1992) 7 Cal.App.4th 1088, 1097.)

The rationale for tort liability for breach of the implied covenant in the insurance context simply does not apply in this case.

II.

THIS COURT SHOULD DISAPPROVE THE COURT OF APPEAL DECISIONS THAT ALLOWED TORT LIABILITY FOR BREACH OF THE IMPLIED COVENANT EVEN THOUGH THE INSURER DID NOT FAIL TO HONOR ITS BASIC COMMITMENT TO PROVIDE INSURANCE PROTECTION.

A. Cases involving assessment of premiums or dividends.

This section of our amicus brief concerns the following Court of Appeal decisions, all of which support or expressly allow *tort* liability for breach of the implied covenant of good faith and fair dealing in assessing workers' compensation insurance premiums or dividends:

Mission Ins. Group, Inc. v. Merco Construction Engineers, Inc. (1983) 147 Cal.App.3d 1059, 1065-1066 (holding that "the doctrine of the implied covenant of good faith and fair dealing subjects an insurer to liability to its insured for arbitrarily or unreasonably increasing loss reserves covering insurance claims when the increase adversely affects the amount of a dividend that the insured will receive" [p. 1066], and suggesting that liability is in tort [p. 1065]), 1066-1068 (holding that a triable issue of fact existed as to whether the insurer's "attachment of a condition to the payment of [a dividend] that [the insurer] has always conceded to be due constituted a breach of [the insurer's] implied covenant of good faith and fair dealing" [p. 1068], and suggesting that liability is in tort [p. 1067]) (*Mission*);

Security Officers Service, Inc. v. State Compensation Ins. Fund (1993) 17 Cal.App.4th 887, 889-890 (holding that "under an insurance regime in which the insured's annual claims experience inexorably influences its premiums, the insurer may be liable [for breach of the implied covenant of good faith and fair dealing] if it processes claims and sets reserves without good faith regard for their impact on the insured's premiums and potential dividends" [p. 890]), 899 (holding that liability is in tort because the implied covenant claim arises "[i]n the insurance context") (*Security Officers Service*);

Tricor California, Inc. v. State Compensation Ins. Fund (1994) 30 Cal.App.4th 230, 237 (*Security Officers Service*, *supra*, "held that, if proved, essentially identical conduct as alleged here breached tort and contractual implied covenants of good faith and fair dealing") (*Tricor*);

Lance Camper Manufacturing Corp. v. Republic Indemnity Co. (1996) 44 Cal.App.4th 194, 203 ("The appeal before us is factually indistinguishable from the *Security Officers* and *Tricor* cases. Those holdings control here") (*Lance Camper I*);

Notrica v. State Comp. Ins. Fund (1999) 70 Cal.App.4th 911, 921-925

(rejecting the argument that "an impact on future premiums is not a sufficient basis in and of itself to support [a] tort damage award for breach of the implied covenant of good faith and fair dealing" [p. 921], and agreeing with *Security Officers Service*, *supra*, on this issue [p. 925]) (*Notrica*); [9/] and

Lance Camper Manufacturing Corp. v. Republic Indemnity Co. (2001) 90 Cal.App.4th 1151, 1160 ("this court and others have repeatedly held . . . that a workers' compensation insurer may be liable in tort for offending conduct that diminishes the employer's dividend or increases future premiums," citing *Notrica*, *supra*, and *Security Officers Service*, *supra*) (*Lance Camper II*).

All the above-cited cases involve only "premiums (and dividends) rather than liability exposure" (*Security Officers Service*, *supra*, 17 Cal.App.4th at p. 896). Yet all these cases support or expressly allow *tort* liability for breach of the implied covenant of good faith and fair dealing. The only justification given is that the implied covenant claim arises "[i]n the insurance context." (*Id.* at p. 899.) This justification is inadequate. Under this court's decisions, the rationale for tort liability for breach of the implied covenant of good faith and fair dealing in the insurance context applies only to cases in which the insurer unreasonably refuses to perform its basic commitment to provide insurance protection. (See *ante*, Part I.) The above-cited cases are incorrectly decided. In each, liability for breach of the implied covenant in assessing premiums should have been limited to *contract* remedies.

9/ *Notrica* also cited *Courtesy Ambulance Service v. Superior Court* (1992) 8 Cal.App.4th 1504, 1509, 1511-1519 (*Courtesy Ambulance*), and *Maxon Industries, Inc. v. State Compensation Ins. Fund* (1993) 16 Cal.App.4th 1387, 1390-1394 (*Maxon*). (*Notrica*, *supra*, 70 Cal.App.4th at p. 925.) As the Court of Appeal below recognized, however, these two cases have to do with claims of immunity from tort liability, not with the underlying basis for tort liability. (Slip opn. p. 30, fn. 4.)

Rather than disagree with these cases, the Court of Appeal below purported to distinguish them. [10/] The Court of Appeal said: "[I]n workers' compensation insurance, the premium is directly tied to the insured's claims experience, and that claims experience is controlled in significant part by the insurer's exercise of discretion in settling claims (or not). Thus, in the workers' compensation setting the insurer's bad-faith motivation in handling claims is alleged to be the establishment of a basis for charging higher premiums . . . . [T]he operative exercise of discretion by the insurer is in the narrow area of settling claims and defending its insured." (Slip opn. p. 29.) In contrast, the court explained, the instant case does not involve "the insurer's underlying duty to pay, settle, and defend the insured against claims." (*Id*. at p. 30.)

But the mere fact that the insurers' conduct in the workers' compensation cases related to *claims handling* was not sufficient to support *tort* liability for breach of the implied covenant of good faith and fair dealing. The insurers "duly perform[ed] [their] basic commitment: to provide

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10/ Perhaps the Court of Appeal did so because it concluded that this court, in *State Comp. Ins. Fund v. Superior Court* (2001) 24 Cal.4th 930, 937-938, "discussed with approval the line of workers' compensation bad-faith cases" (slip opn. p. 20). We do not read this court's opinion in *State Comp. Ins. Fund* to express approval of tort liability for breach of the implied covenant in assessing worker's compensation insurance premiums. (See *State Comp. Ins. Fund v. Superior Court*, *supra*, 24 Cal.4th at p. 944 ["we are not asked to and do not reach any conclusion as to whether [the insured] has stated a valid cause of action against [the insurer]"].)

In any event, even if this court did intend to express some approval of the line of workers' compensation cases, the issue of tort liability for breach of the implied covenant was not squarely presented. Here, the issue is squarely presented. This court now has the opportunity, on further reflection, to disapprove the line of workers' compensation bad faith cases.

insurance." (*Barrera*, *supra*, 71 Cal.2d at p. 669.) [11/] Accordingly, there was no justification for allowing *tort* liability for breach of the implied covenant.

This court should disapprove *Mission*, *Security Officers Service*, *Tricor*, *Lance Camper I*, *Notrica*, and *Lance Camper II*, *supra*, to the extent they allowed tort liability for breach of the implied covenant of good faith and fair dealing in assessing insurance premiums. [12/]

B. Other cases.

This section of our amicus brief concerns the following two Court of Appeal decisions:

Spindle v. Travelers Ins. Companies (1977) 66 Cal.App.3d 951, 957-

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11/ "[A]lthough the manipulation of the premium calculation process [in the workers' compensation cases] originated from the insurer's claim function, there was no 'breach' of any policy provision dealing with claims, i.e., there was no wrongful refusal to defend, failure to indemnify or other failure to pay a covered claim. Instead, the 'breach' was of the premium provisions of the policy. The lost 'policy benefit' causing harm to the insured was *not the lack of payment of a covered claim*; rather, the 'benefit' lost was the proper premium, based on an honest audit and calculated according to the policy's terms." (Opening Brief of Defendants Fred Jones, et al., pp. 24-25, emphasis added.)

12/ To the extent *Courtesy Ambulance*, *supra*, 8 Cal.App.4th 1504, and *Maxon*, *supra*, 16 Cal.App.4th 1387, implicitly support tort liability for breach of the implied covenant in assessing workers' compensation insurance premiums, they, too, should be disapproved.

One other case involving workers' compensation insurance premiums bears mention. In *MacGregor Yacht Corp. v. State Comp. Ins. Fund* (1998) 63 Cal.App.4th 448, the claim for tortious breach of the implied covenant was dismissed based on the statute of limitations. (*Id*. at p. 453.) *MacGregor* involved only *contractual* breach of the implied covenant. (*Ibid*.) We do not quarrel with the workers' compensation cases to the extent they allow contract liability for breach of the implied covenant of good faith and fair dealing. Our quarrel is with *tort* liability.

959 (allowing tort liability for unreasonable cancellation of existing insurance policy; "We are unable to discern any logical basis for distinguishing between an insurer's conduct in settling a claim made pursuant to the policy and that involved in an insurer's cancelling a policy if bad faith conduct is the basis for the cancellation" [p. 958]) (*Spindle*); and

Barney v. Aetna Casualty & Surety Co. (1986) 185 Cal.App.3d 966, 976-981 (allowing tort liability for unreasonable derogation of insured's right to prosecute a counterclaim; "The effect upon the insured . . . is the same whether the detriment is in the form of liability in excess of policy limits, as in the more typical cases, or in the form of derogation of a collateral right, as in the instant case" [pp. 977-978]) (*Barney*).

To the extent these cases allow tort liability for an insurer's breach of the implied covenant of good faith and fair dealing, they were incorrectly decided and should be disapproved. As we have explained, tort liability for breach of the implied covenant is limited to cases in which the insurer unreasonably refuses to honor its basic commitment to provide insurance protection. (See *ante*, Part I.) An insurer that cancels an insurance policy for improper reasons but before any insured loss has occurred (*Spindle*), or that unreasonably impedes an insured's ability to prosecute a counterclaim (*Barney*), may breach the policy's implied covenant. But the insurer does not thereby deny the insured the basic insurance protection that the insured purchased "for peace of mind and security in the event of an accident or other catastrophe" (*Cates*, *supra*, 21 Cal.4th at p. 44). Accordingly, these acts cannot support tort liability.

CONCLUSION

Under this court's decisions, the rationale for allowing *tort* liability for breach of the implied covenant of good faith and fair dealing in the insurance context applies only to cases in which the insurer unreasonably refuses to settle within policy limits or unreasonably withholds payment of the insured's claim. Accordingly, this court should affirm the Court of Appeal's decision that a liability insurer's breach of the implied covenant by "abus[ing] . . . its rights to audit the financial records of its insured and to collect an additional premium under an approved rate structure" (slip opn. p. 23) does not give rise to liability in tort.

In addition, this court should disapprove the line of workers' compensation insurance cases that allows tort liability for breach of the implied covenant in assessing insurance premiums and dividends. And, this court should disapprove two other cases that allow tort liability for breach of the implied covenant even though the insurers did not fail to honor their basic commitment to provide insurance protection.