FRAUD
LITIGATION
IN
PENNSYLVANIA

FRAUD LITIGATION IN PENNSYLVANIA

By:

Louis C. Long
Robert W. Cameron
Meyer, Darragh, Buckler, Bebenek & Eck
2000 Frick Building
Pittsburgh, Pennsylvania

William B. Mallin
Patrick R. Kingsley
Eckert Seamans Cherin & Mellott
600 Grand Street, 42nd Floor
Pittsburgh, Pennsylvania

10K11018

FRAUD LITIGATION IN PENNSYLVANIA

FRAUD LITIGATION IN PENNSYLVANIA

TABLE OF CONTENTS

FRAUD LITIGATION IN PENNSYLVANIA

I. INITIAL CONSIDERATIONS

Fraud is easy to plead but hard to prove. Thus, in initially assessing the fraud case, particular attention should be paid to the evidence you will ultimately rely on to substantiate your allegation.

If you have a cause of action other than fraud, consider pursuing that action alone, without making a claim for fraud. Your client may be better served by obtaining a judgment on a clear contract claim than muddling through a fraud case that has less merit. A good contract case can be turned into a bad fraud case for a least two reasons.

First, fraud carries a greater evidentiary burden than other civil claims. Each element of your fraud claim must be proven by clear and convincing evidence. Pittsburgh Live, Inc. v. Servov, 419 Pa. Super. 423, 615 A.2d 438 (1992). Meeting the standard is not easy. As Superior Court has recently explained:

> For the evidence to be clear and convincing, the witnesses must be credible. This means that the witnesses must both distinctly remember the facts to which they testify, and narrate the details exactly. If the witnesses [sic] testimony fails to meet this exacting standard, an action for fraud cannot be maintained.

Servov, 419 Pa. Super. at 479, 615 A.2d at 441 (citations omitted).

Second, fraud charges may reek havoc with the jury. You are charging the defendant with quasi-criminal activity. Such unpleasant allegations may take the sympathy out of a simple breach of contract action. A plaintiff that might otherwise appear to be an innocent victim of a contractual breach now may appear to be an aggressor. Additionally, it may distract the jury's attention from matters you could otherwise easily win. Why confuse the jurors' deliberations with fraud, when a simple breach of contract matter might be easier for them to decide?

When you initially interview your client, pay particular attention to his credibility and demeanor and evaluate how he may appear to the jury as a witness. Fraud cases usually turn on the credibility of individual witnesses, therefore, your client's ability to testify on his own behalf is crucial.

To properly assess the case you will need from your client a list of witnesses who might appear at trial. For example, other people who heard the fraudulent statement. You may wish to briefly interview these witnesses to establish their credibility.

Ask the client to identify any documentary evidence that might exist which would demonstrate fraud on the part of the defendant. It is unlikely you will ever get an admission of fraud. However, the defendant may have laid a paper trail which clearly establishes it.

You may also wish to briefly speak to your, opponent to assess the case, before you bring fraud charges.

When initially assessing the case, be mindful of the applicable statute of limitations. The limitations period for a fraud action in Pennsylvania is two years. 42 Pa.C.S. § 5524(7). A cause of action for fraud accrues when the fraud is discovered. Bhata v. Resort Development Corp., 720 F. Supp. 501 (W.D. Pa. 1989).

Consider filing a praecipe for writ of summons to initiate your fraud case. An action in Pennsylvania can be commenced by filing and serving a praecipe for writ and summons. Pa.R.C.P. 1007(1). Thereafter, the plaintiff can engage in pre-complaint discovery. Pa.R.C.P. 4001(c); Lapp v. Titus, 224 Pa. Super. 150, 302 A.2d 366 (1973) ("It is clear that pre-complaint discovery is contemplated and allowed by the Rules of Civil Procedure"). Of course, at the close of discovery it should be clear whether pursuing a fraud action is worthwhile.

In investigating a fraud case a primary focus should be on gathering evidence of fraudulent .intent or evidence that will create an inference of fraudulent intent. The discovery of prior statements by the defendant inconsistent. with the fraudulent representation is, of course, a windfall. Documentary evidence is an excellent source of such statements.

II. PLEADINGS AND MOTION PRACTICE

A. SPECIFICITY REQUIREMENTS

Averments of fraud must be made with particularity. Pa.R.C.P. 1019(b). The particularity requirement has not been precisely defined, but the Supreme Court has stated that two conditions must always be met: the pleadings must adequately express the nature of the claim to the opposing party so as to permit him to prepare a defense and the pleadings must be sufficient to convince the court that the averments are not merely subterfuge. Bata v. Central-Penn National Bank, 423 Pa. 373, 224 A.2d 174 (1966), cert denied, 386 U.S. 1007 (1967). Thus, allegations of fraud must consist of more than mere legal conclusions. Bash v. Bell Telephone, 411 Pa. Super. 347, 601 A.2d 825 (1992). Generally, the plaintiff must set forth the exact statements or actions allegedly constituting the fraudulent misrepresentations. McClellan v. Health Maintenance Organization of Pennsylvania, 413 Pa. Super. 128, 604 A.2d 1053, alloc. denied, 532 Pa. 664, 616 A.2d 985 (1992); McGinn v. Valloti, 363 Pa. Super. 88, 525 A.2d 732 (1987), alloc. denied, 517 Pa. 618, 538 A.2d 500 (1988).

Notwithstanding the particularity requirement, malice, intent, knowledge and other conditions of the mind may be averred generally. Pa.R.C.P. 1019(b).

B. VARIOUS THEORIES OF FRAUD UNDER STATE LAW

1. General Definition

Fraud embraces a wide variety of actionable wrongs and is accomplished through a wide variety of conduct. See Matter of Estate of Evasew, 526 Pa. 98, 584 A.2d 910 (1990).

Generally, fraud is practiced when there is a deception of another to his damage. 16 P.L.E. Fraud § 1 (1959). Fraud consists of anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, either by direct falsehood or by innuendo, by speech or sentence, word of mouth, or look or gesture, and may be made up by any artifice by which a person is deceived to his disadvantage. Summ. Pa. Jur. 2d Torts § 16:1 (1991).

2. Traditional Fraud

Under Pennsylvania law the following elements must be pled and proven in an action to establish a claim for common law fraud:

(1) a misrepresentation,

(2) a fraudulent utterance thereof,

(3) an intention by the maker that the recipient will thereby be induced to act,

(4) justifiable reliance by the recipient upon the misrepresentation, and

(5) damages to the recipient as the proximate result.

Scaife Co. v. Rockwell-Standard Corp., 446 Pa. 280, 285 A.2d 451 (1971), cert. denied, 407 U.S. 920 (1972); Sevin v. Kelshaw, 417 Pa. Super. 1, 611.A.2d 1232 (1992); Bash v. Bell Telephone Co. of Pennsylvania, 411 Pa. Super. 347, 601 A.2d 825 (1992).

A representation is fraudulently uttered if the maker knows of its falsity when uttering it, or, in other words, knows the matter to be otherwise than as represented. Neuman v. Corn Exchange National Bank & Trust Co., 356 Pa. 442, 51 A.2d 759 (1947); Woodward v. Dietrich, 378 Pa. Super. 111, 548 A.2d 301 (1988).

It is unnecessary that the person defrauded be the one who was specifically intended by the maker of the misrepresentation to rely thereon, so long as that person's reliance was reasonably foreseeable. Woodward v. Dietrich, 378 Pa. Super. 111, 548 A.2d 301 (1988).

A misrepresentation intended for the public is sufficient to support an action sounding in fraud since it is not necessary that the misrepresentation be made directly to the plaintiff. Obenski v. Brooks, 7 D. & C.3d 253 (C.P. Phila. Co. 1978).

3. Reckless Misrepresentations

The reckless assertion of a fact in conscious ignorance of its truth or falsity amounts to actionable fraud. Rodgers v. Prudential Insurance Co. of America, 803 F. Supp. 1025 (M.D. Pa. 1992), aff'd 998 F.2d 1004 (3d Cir. 1993); In re Berringer, 125 B.R. 444 (W.D. Pa. 1991); Cashdollar v. Mercy Hospital of Pittsburgh, 406 Pa. Super. ,606, 595 A.2d ,70 (1991); Adams v. Euliano, 299 Pa. Super. 348, 445 A.2d 788 (1982).

4. Innocent Misrepresentations

Fraud may be established even where there is an innocently made misrepresentation so long as it relates to a matter material to the transaction involved. LaCourse v. Kiesel, 366 Pa. 385, 77 A.2d 877 (1951); Boyle v. Odell, 413 Pa. Super. 562, 605 A.2d 1260 (1992). "If the misrepresentation is innocently made, then it is actionable only if it relates to a matter material to the transaction involved; while if the misrepresentation is knowingly made, or -involves a non-privileged failure to disclose, materiality is not requisite to the action." Smith v. Renaut, 387 Pa. Super. 299, 564 A.2d 188 (1989); Mancini v. Morrow, 312 Pa. Super. 192, 458 A.2d 580 (1983). Pleading the materiality of the misrepresentation substitutes for pleading the fraudulent utterance thereof.

5. Concealment

Fraudulent concealment is simply a type of fraudulent misrepresentation, the concealment substituting for false words. Mancini v. Morrow, 312 Pa. Super. 192, 458 A.2d 580 (1983) ("active concealment of defects known to be material to a purchaser is legally equivalent to affirmative misrepresentation") (citations omitted) (sellers of house fraudulently concealed cracked walls by nailing plywood over the defective area). All of the elements of fraudulent misrepresentation must be proven to support such a claim, plus the plaintiff must establish that the matters concealed were material to the transaction. In re Cara Corp., 148 B.R. 760 (E.D. Pa. 1992).

However, mere silence does not constitute concealment sufficient for a finding of fraud if there is no duty to speak. Wilson v. Donegal Mutual Insurance Co., 410 Pa. Super. 31, 598 A.2d 1310 (1991).

6. Silence

Mere silence is not fraud if there is no duty to speak. Wilson v. Donegal Mutual Insurance Co., 410 Pa. Super. 31, 598 A.2d 1310 (1991); Smith v. Renaut, 387 Pa. Super. 299, 564 A.2d 188 (1989). An exception to the rule that mere silence is not fraud exists when circumstances impose upon a person the duty to speak and he deliberately remains silent. Scaife Co. v. Rockwell-Standard Corp., 446 Pa. 280, 285 A.2d 451 (1971), cert. denied, 407 U.S. 920 (1972).

To constitute actionable fraud, the nondisclosure of information must be intentional and must relate to information which is material to the transaction. Roberts v. Estate of Barbagallo, 366 Pa. Super. 559, 531 A.2d 1125 (1987). Where the omitted information is not material to the transaction, there is no fraud. Sevin v. Kelshaw, 417 Pa. Super. 1, 611 A.2d 1232 (1992). Of course, where a party knows of a dangerous and latent defect, such information is material and he has an affirmative duty to disclose that information. Quashnock v. Frost, 299 Pa. Super. 9, 445 A.2d 121 (1982) (termite infestation of house). However, where the alleged defects are neither dangerous nor latent, but, in fact, are easily discoverable, there is no duty to speak. Gozon v. Henderson-Dewey & Associates, Inc., 312 Pa. Super. 242, 458 A.2d 605 (1983) (cracks in a swimming pool).

Finally, the nondisclosure must be intentional and so there can be no liability for failing to disclose an unknown condition. Smith v. Renaut, 387 Pa. Super. 299, 564 A.2d 188 (1989).

7. Negligent Misrepresentation

Pennsylvania had a0gpted the definition of negligent misrepresentation found in the Restatement (Second) of Torts. It is as follows:

> (1) One who, in the course of his business, profession or employment, or in any other transaction in which he has a pecuniary interest, supplies false information for the guidance of others in their business transactions, is subject to liability for pecuniary loss caused to them by their justifiable reliance upon the information, if he fails to exercise reasonable care or competence in obtaining or communicating the information.
>
> (2) [Such liability] is limited to loss suffered
>
> > (a) by the person or one of a limited group of persons for whose benefit and guidance he intends to supply the information or knows that the recipient intends to supply it; and
> >
> > (b) through reliance upon it in a transaction that he intends the information to influence or knows that the recipient so intends or in a substantially similar transaction.

Restatement (Second) of Torts S 552 (1977); Mill-Mar, Inc. v. Statham, 278 Pa. Super. 296, 420 A.2d 548 (1980)(adopting this definition); Rempel v. Nationwide Life Insurance Co., 471 Pa. 404, 370 A.2d 366 (1977)(adopting similar definition found in the Restatement (First) of Torts); see also Woodward v. Dietrich, 378 Pa. Super. 111, 126 n.5, 548 A.2d 301 (1988).

Negligent misrepresentation and fraudulent misrepresentation have as common elements a misrepresentation, justifiable reliance, causation and pecuniary loss. Temp-Way Corp. v. Continental Bank, 139 B.R. 299, 325 (E.D. Pa.), aff'd., 981 F.2d 1248 (3d Cir. 1992).

The only distinguishing factor between the two forms of misrepresentation is that, as to negligent misrepresentation, the state of mind of the actor to intentionally harm the plaintiff need not be pled or proven. Constitution Bank v. DiMarco, 155 B.R. 913 (E.D. Pa. 1993); In re Cara Corp. 148 B.R. 760 (E.D. Pa. 1992); Monkelis v. Scientific Systems Services Inc., 677 F. Supp. 378 (W.D. Pa. 1988).

8. False Promises

A promise to do something in the future, which promise is not kept, is not fraud. Krause v. Great Lakes Holdings, Inc., 387 Pa. Super. 56, 563 A.2d 1182 (1989), alloc. denied, 524 Pa. 629, 574 A.2d 70 (1990). However, "a statement of present intention which .is false when uttered may constitute a fraudulent misrepresentation of fact." Brentwater Homes, Inc. v. Weibley, 471 Pa. 17, 369 A.2d 1172 (1977). Such statements must be of present fact or intention not merely opinion or speculation regarding future conduct. Berda v. CBS. Inc., 800 F. Supp. 1272 (W. D. Pa.), aff'd, 975 F.2d 1548 (3d Cir. 1992).

Consistent with the general rule that an unfulfilled promise is not fraud, there is no presumption from an unperformed promise that the promisor intended not to perform when the promise was made, and a fraudulent intention will not be inferred merely from its nonperformance. Summ. Pa. Jur. 2d Torts § 16:3 (1991).

9. Constructive Fraud

The breach of a confidential or fiduciary relationship constitutes "constructive" or "implied" or "legal" fraud. Matter of Estate of Evasew, 526 Pa. 98, 584 A.2d 910 (1990). Because intent is not an element of constructive fraud, a party whose actions constitute constructive fraud might still have acted in good faith. Lichtenstein v. Kidder, Peabody & Co., 777 F. Supp. 423 (W.D. Pa. 1991). Thus, pleading the existence of the fiduciary or confidential relationship substitutes for pleading fraudulent intent.

A party in whom the trust and confidence of another are reposed must act with scrupulous fairness and good faith in his dealings with the other, and refrain from using his position to the other's detriment and his own advantage. Young v. Kaye, 443 Pa. 335, 279 A.2d 759 (1971). Thus, transactions between persons occupying confidential relationship are prima facie voidable, and this presumption of fraud must be rebutted by the party seeking to enforce the transaction. Young, supra.

> Thus, if in a transaction between the parties who stand in a relationship of trust and confidence, the party in whom the confidence is reposed obtains an apparent advantage over the other, he is presumed to have obtained that advantage fraudulently; and if he seeks to support the transaction, he must assume the burden of proof that he has taken no advantage of his influence or knowledge and that the arrangement is fair and conscientious.

Matter of Estate of Evasew, 526 Pa. 104, 584 A.2d at 912-13 (1990) (citations omitted).

A confidential relationship exists "whenever one occupies toward another such a position of advisor or counsellor as reasonably to inspire confidence that he will act in good faith for the other's interest." In re Estate of Mihm, 345 Pa. Super. 1, 497 A.2d 612 (1985); see also Evasew, 526 Pa. at 105, 584 A.2d at 913 (a confidential relationship "is deemed to exist, whenever the relative position of the parties is such that one has power and means to take advantage of or exercise undue influence over the other"); In re Estate of Clark, 467 Pa. 628, 635, 3.59 A.2d 777 (1976) (a confidential relationship will be found as a factual matter "whenever one person has reposed a special confidence in another to the extent that the parties do not deal with each other on equal terms, either because of an overmastering dominance on one side, or weakness, dependence or justifiable trust, on the other").

The mere existence of a family relationship does not create a confidential relationship, but is merely a factor to be considered. Mihm, supra.

10. Fraudulent Conveyances

There are five types of conveyances under Pennsylvania's Fraudulent Conveyances Act, 39 P.S. §§ 351-63, that are considered fraudulent. A conveyance made or obligation incurred will be considered fraudulent if:

(1) there is actual intent to hinder, delay or defraud present or future creditors, 39 P.S. § 357;

(2) the conveyance is made or the obligation is incurred without fair consideration by a person who is, or will thereby be, rendered insolvent, 39 P.S. § 354;

(3) the conveyance is made without fair consideration and the person making the conveyance is or will engage in a business which will thereby be rendered undercapitalized, 39 P.S. § 355;

(4) the person makes a conveyance or enters into an obligation without fair consideration and intends or believes that he will incur debts beyond his ability to pay them as they mature, 39 P.S. § 356;

(5) the conveyance is made or the obligation is incurred by a partnership which is or will thereby be rendered insolvent and the transaction either (i) involves a partner or (ii) was entered into without fair consideration, 39 P.S. § 358.

As you can see, actual fraudulent intent is an element of only one of the five types of fraudulent conveyances.

C. AFFIRMATIVE & CONSTITUTIONAL DEFENSES

1. Constitutional Defenses

a. Ex post facto legislation, U.S. Const., art. I, § 9, c. 3, § 10, cl. 1; Pa. Const., art. 1, § 17 -- Retroactive Effect of 42 Pl'.C.S.A. § 8371

Concentrating on bad faith conduct occurring after the effective date of this section, July 1, 1990, section 8371 has no retroactive effect. Seeger v. Allstate Insurance Co., 776 F. Supp. 986 (M.D. Pa. 1991). A defendant has fair warning that conduct occurring after July 1, 1990 will be subject to section 8371. Id. at 989; see Coyne v. Allstate Insurance Co., 771

F. Supp. 673 (E.D. Pa. 1991). As long as prospective conduct alone is sanctioned, there is no ex post facto violation, because there is no possibility that the legal consequences of an act committed before July 1, 1990 will be changed or that section 8371 will impose a more onerous punishment than existing law. Seeger, 776 F. Supp. at 989.

b. Impairing Obligation of Contracts, U.S. Const., art. I, § 10, cl. 1; Pa. Const., art. I., § 17

Application of section 8371 does not violate clauses of the federal and state constitutions prohibiting laws impairing the obligation of contracts. Seeger, 776 F. Supp. at 988; Coyne, 771 F. Supp. at 675. While an insurer has the right to rely upon the substantive provisions of its policy, it has never had the right to act in bad faith toward its insured. Coyne, 771 F. Supp. at 675. As the district court in Coyne noted, "[the insurer] cannot rely on contractual language agreed to before the effective date of the statute in order to insulate itself from statutory liability for bad faith conduct alleged to have occurred after that date." Id. Therefore, section 8371 does not have the effect of impairing contractual obligations existing prior to the statute's effective date.

c. Due Process, U.S. Const., amends. V, XIV; Pa. Const., art. 1, § 11

i. Vagueness

The failure of section 8371 to define bad faith does not render it constitutionally infirm. Coyne, 771 F. Supp. 673; W. W. Management & Development Co. v. Scottsdale Insurance Co., 769 F. Supp. 178 (E.D. Pa. 1991). The courts of this jurisdiction have held that the term bad faith in section 8371 is not unconstitutionally vague. Coyne, 771 F. Supp. at 679; W. W. Management & Development Co., 769 F. Supp. at 180; see Part VI. E., infra.

To show that a statute is void for vagueness, a party must demonstrate that the statute is impermissibly vague in all of its possible applications. W. W. Management &

Development Co., 769 F. Supp. at 179. In making this analysis, it is necessary to ensure that the statute provides both fair notice to those regulated and adequate enforcement standards to those doing the regulating. Id. at 180. The acceptable level of vagueness varies with the subject of the regulation and the type of penalty. Id. Economic regulations are subject to a less restrictive vagueness test, because their reach is relatively narrow and the businesses regulated can be expected to consult relevant legislation before acting. Id. In addition, the Supreme Court of the United States has applied a less rigorous vagueness test to statutes with civil penalties because "the consequences of imprecision are qualitatively less severe." Id., quoting Village of Hoffman Estates v. Flipside, Hoffman Estates, 455 U.S. 489, 499, 102 S. Ct. 1186, 1193, 71 L.Ed.2d 362, 372 (1982). Thus, because section 8371 is a business regulation with civil penalties, the vagueness inquiry will be less stringent. W. W. Management & Development Co., 769 F. Supp. at 180.

Pennsylvania courts have determined that in the insurance context, the phrase bad faith has acquired a peculiar and universally acknowledged meaning. Coyne, 771 F. Supp. at 677; see Part VI.E., infra.

Based on the fact that section 8371 is a business regulation with civil penalties and on the fact that the term bad faith has acquired a peculiar and universally acknowledged meaning, the courts of this jurisdiction have held that section 8371 is not void for vagueness. W. W. Management & Development Co., 769 F. Supp. at 180; Coyne, 771 F. Supp. at 677; see Part VI.E. infra.

ii. Punitive Damages

The punitive damages provision of section 8371 does not violate due process of law. Coyne, 771 F. Supp. 673; see Part V., infra. Even though section 8371 confers on the trial court significant discretion in its determination of punitive damages, that discretion is not unlimited. 771 F. Supp. at 680. As long as the discretion is exercised within the reasonable constraints required by Pennsylvania law, due process is satisfied. Id. Additionally, appellate courts may provide a check on the trial court's discretion. Id.

2. Affirmative Defenses

a. Advice of Counsel

If an insurer, acting through its agents, fails to conform to the standards imposed by law, it may be liable for bad faith. Under these circumstances, it would seem illogical to relieve an insurer of liability for its failure to perform its duty merely because the agent who made the mistake was an attorney retained to assist the insurer in adjusting a claim. Ashley, Bad Faith Actions, § 7:13 (1992). Thus, most courts have taken the view that an insurer may not defend its failure to do its duty on the ground of advice of counsel. Id.

An insurer's reliance on the advice of counsel is only one factor the jury may consider in determining whether the insurer acted improperly or in bad faith. Id. If, because of an attorney's advice or conduct, an insurer incurs liability for bad faith, the insurer's remedy may be a malpractice cause of action against the attorney. Id.

Some jurisdictions have excused a liability insurer from liability for an excess judgment when the insurer reasonably believed it could successfully defend the insured. These jurisdictions impute the attorney's belief in the likelihood of success to the insurer, and, in this limited sense, reliance on the advice of counsel may be a valid defense. Id.; see Zumwalt v. Utilities Insurance Co., 360 Mo. 362, 228 S.W.2d 750, 754 (1950). But even if an advice of counsel defense is recognized, an insurer may not invoke the defense if it failed to properly inform its attorney of all the facts before receiving its advice. Ashley, Bad Faith Actions, § 7:13.

Another factor to consider is, if the insurer relies on an advice of counsel defense, it waives the attorney-client privilege as to its communications with the lawyer on whose advice it relied. Ashley, Bad Faith Actions, § 7:13 (Supp. 1993).

Finally, an insurer derives no protection from an advice of counsel defense if the advice of the attorney is patently unsound. Id.

b. Inapplicability of section 8371 to Insurance Agents and Adjusters

42 Pa.C.S.A. § 8371 provides:

> In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may take all of the following actions:
>
> (1) Award interest on the amount of the claim from the date the claim was made by the insured in an amount equal to the prime rate of interest plus 3%.
>
> (2) Award punitive damages against the insurer.
>
> (3) Assess court costs and attorney fees against the insurer.

42 Pa.C.S.A. § 8371.

Nowhere in the express language of section 8371 are insurance agents or adjusters mentioned. The statute only provides that, in any action arising under an insurance policy, an insurer may be liable to an insured for any bad faith action. 42 Pa.C.S.A. § 8371. Additionally, agents and adjusters should be excluded from the reach of section 8371 because they are not parties to the insurance contract. Since section 8371 only applies to actions arising under an insurance policy, it would follow that the only persons who may be liable are those who are parties to the policy. Therefore, insurance agents and adjusters may have an affirmative defense against a section 8371 action, should one be brought against them, on the ground that they are not proper defendants for purposes of section 8371 liability.

c. No Bad Faith Liability in the Absence of Coverage

Courts have ordinarily based insurer liability for bad faith on an insurer's unreasonable conduct in denying or delaying the payment of benefits owed to the insured under an insurance contract. If the insurer owes no benefits, it clearly follows that the insurer cannot incur liability for bad faith. Paul E.B. Glad, William T. Barker, and Michael J. Elassen, Bad Faith Liability in the Absence of Coverage?, Bad Faith Law Report, Vol. VII, no. 1, February 1991, at 1. As those authors point out:

> Logic suggests that a deficiency in investigation or claim handling produces no legal injury unless a proper investigation would have shown that the insurer owed the insured some benefit under the policy. If the insurer owes the insured no benefits, then the insurer's poor investigation causes the insured no harm. It follows, therefore, that a determination of no coverage means that the insurer did not commit bad faith.

Id. at 3. Such rationale makes perfect sense. An insurer's denial of a claim after failing to investigate adequately, to communicate with the insured promptly, or to handle the claim properly does no damage to the insured if proper claim processing would have produced the same result. Id.

An exception to this general rule has been recognized. That exception recognizes the possibility of bad faith, absent coverage, if an insurer's wrongdoing injures an interest entirely independent of the insured's interest in the policy benefits. Id. at 4; see Rawlings v. Apodaca, 151 Ariz. 149, 726 P.2d 565 (1986) (by first discouraging its insured from obtaining a contemporaneous investigation and then denying him access to its own investigation report, the insurer made its insured worse off with respect to his claim than if he had had no insurance). However, this situation can occur only if an insurer exploits the relationship created by the policy to make the insured worse off in some respect than if there had been no insurance coverage. Id.

This is a very rare occurrence. Id.; see also Shamblin v. Nationwide Mutual Insurance Co., 396 S.E.2d 766 (W. Va. 1990) (Supreme Court of Appeals in practical effect adopted a strict liability standard in third-party cases in which an insurer failed to offer its policy limits and the third party recovered an excess judgment. Where an insurer fails to settle within policy limits where there exists the opportunity to so settle and where such settlement within policy limits would release the insured from any personal liability, the insurer has prima facie failed to act in its insured's best interest and such failure prima facie constitutes bad faith toward its insured.)

d. Insurance Consultation Services Exemption, 40 P.S. § 1841 et seq.

Section 1843 of the Insurance Consultation Services Exemption provides:

> (a) Exemption. -- The furnishing of, or failure to furnish, insurance consultation services related to, in connection with or incidental to a policy of insurance shall not subject the insurer, its agents, employees or service contractors to liability for damages from injury, death or loss occurring as a result of any act or omission by any person in the course of such services.

40 P.S. § 1843(a).

This statute was intended to exempt insurers from liability when they provide consultation services aimed at reducing the likelihood of loss, death, or injury. Oxford Presbyterian Church v Church Mutual Insurance Co., Civ. A. No. 90-3613, 1991 U.S. Dist. LEXIS 1896, *9 (E.D. Pa. February 19, 1991). Thus, section 1843 may be read to exempt insurers from liability when they render services aimed at reducing loss, death, or injury, even if the insured alleges that he did not receive adequate coverage. See 40 P.S. § 1843(a).

e. Defense of ERISA Preemption

ERISA expressly preempts all state law claims against pension and employee benefit providers. Gelzinis v. John Hancock Mutual Life Insurance Co., ___ F. Supp. ___, 1993 U.S. Dist. LEXIS 5483 (E.D. Pa. April 27, 1993); ERISA, 29 U.S.C. § 1144. A section 8371 bad faith action based on improper processing of a claim for benefits under an ERISA plan is preempted. Northwestern Institute of Psychiatry v. Travelers Insurance Co., Civ. A. No. 92-1520, 1992 WL

III. DISCOVERY CONSIDERATIONS

In a fraud case, unlike most other civil cases, the state of mind of the defendant is crucial. Where fraudulent intent is an element, defendants usually respond by asserting that whatever they said or did they did in good faith. It thus becomes necessary to obtain evidence which demonstrates this fraudulent intent. Evidence of this nature is best when it comes from the mouth of the defendant.

For that reason, consider employing the deposition as your first discovery device. Notice the defendant's deposition along with a document request, with the date for production preceding the deposition itself. Prior to the deposition, carefully review all documentary evidence for ammunition to be used at the deposition. A recalcitrant witness may be more likely to make admissions if confronted with the documentary evidence inconsistent with his story.

The advantage to using a deposition as the first discovery device is the ability to obtain spontaneous answers. See M. Michael Cramer, Discovery in Insurance Fraud Litigation: The Insured's Approach, The Brief, Fall 1989, p. 61. Since questions cannot always be anticipated, it is difficult to totally prepare a witness for what will come. The use of interrogatories as the first discovery tool subverts this advantage because it educates the opposing party about your theory of the case and the avenues of inquiry likely to be pursued at the deposition. Additionally, the interrogatory answers themselves are unlikely to prove helpful since they will be carefully crafted to avoid admissions.

Consider having your client present at the deposition of the opposing party or any other adverse witness. In a fraud case you can often anticipate that the opposing party or one of his witnesses will be dishonest. The presence of your client at the deposition, confronting the witness face to face, may make the witness more hesitant to lie, allowing you to elicit more favorable testimony. See David B. Baum, Art of Advocacy: Preparation of the Case § 8:32 (1992).

Regardless of the discovery device employed, an area of inquiry should be whether the defendant has engaged in transactions which are similar or identical to the transaction at issue. These prior transactions will be admissible to prove fraud. 14 P.L.E. Fraud § 103 (1959). If it turns out that the defendant has engaged in other similar transactions, demand that the defendant identify' each such transaction, the nature of each transaction, and the parties to those transactions.

In a fraud case you may be able to overcome the attorney/client privilege and discover the content of such communications. For example, if a client consults an attorney for advice that will serve him in the commission of a fraud, the communications between them are not confidential and may be elicited either from the client or the attorney. In re Investigating Grand Jury, 527 Pa. 432, 593 A.2d 402 (1991). The fraud defendant may raise the defense of the advice of counsel. If the court were to recognize such a defense, insist that by invoking the defense the defendant has waived the attorney-client privilege. See In re Sunrise Securities Litigation, 130 F.R.D. 560 (E.D. Pa. 1989); Moskowitz v. Lopp, 128 F.R.D. 624 (E.D. Pa. 1989) ("Plaintiff's cannot be stonewalled by the simultaneous assertion of the defense and the privilege.").

IV. TRIAL OF FRAUD CASE

Trial strategy will be discussed during the lecture.

V. THE STATUS OF PUNITIVE DAMAGES

A. PUNITIVE DAMAGES GENERALLY

1. Definition

Pennsylvania has adopted the rule for punitive damages set forth in section 908 of the Restatement (Second) of Torts (1977). Delahanty v. First Pennsylvania Bank, N.A., 318 Pa. Super. 90, 129, 464 A.2d 1243, 1263 (1983). Section 908(1) provides that: " 'Punitive damages' are damages, other than compensatory or nominal damages, awarded against a person to punish him for his outrageous conduct." Restatement (Second) of Torts § 908 (1977).

In addition, comment b to section 908 states that:

> [p]unitive damages are awarded only for outrageous conduct, that is, for acts done with a bad motive or with the reckless indifference to the interest of others. Although a defendant has inflicted no harm, punitive damages may be awarded because of and measured by his intent . . . . Such damages are not given for mere inadvertence . . . .

Restatement (Second) of Torts § 908, comment b, (1977).

2. Purpose

Under the traditional theory, punitive damages have a two-fold purpose: to punish the wrongdoer; and to deter both the wrongdoer and others from engaging in similar conduct in the future. Delahanty, 318 Pa. Super. at 129, 464 A.2d at 1263; Restatement (Second) of Torts § 908, comment a (1977). In addition, other purposes have been attributed to punitive damages. They include providing additional compensation, retribution, and an incentive to prevent injustices that might otherwise go unredressed. William M. Shernoff, Sanford M. Gage, Harvey R. Levine, Insurance Bad Faith Litigation, § 8.02, at 8-5 (1993). Nevertheless, the focus of punitive damages rests primarily on their punitive and deterrent effects. Id.

3. Unavailability of Punitive Damages in a Breach of Contract Action

Pennsylvania courts have consistently held that punitive damages cannot be recovered in a breach of contract action. Daniel Adams Associates v. Rimbach Publishing, Inc., 287 Pa. Super. 74, 77, 429 A. 2d 726, 728 (1981); Smith v. Harleysville Insurance Co., 275 Pa. Super. 246, 248, 418 A.2d 705, 706 (1980), aff'd, 494 Pa. 515, 431 A.2d 974 (1981). For example, in Daniel Adams, the court ruled that "punitive damages will not be assessed for a breach of mere contractual duties . . . . Only where the person who [breaches] a contract also breaches some duty imposed by society will . . . punitive damages be imposed against the wrongdoer in order to punish the wrongful act and in order to serve as a deterrent." 287 Pa. Super. at 77-78, 429 A. 2d at 728.

4. The Applicability of Punitive Damages in a Tort Action

In Pennsylvania, until the passage of 42 Pa.C.S.A. § 8371 in 1990, which provides for punitive damages against an insurer for its bad faith acts, punitive damages had not been available on claims of bad faith. Rodgers v. Nationwide Mutual Insurance Co., 344 Pa. Super. 311, 496 A.2d 811 (1985); Trustees of University of Pennsylvania v. Lexington Insurance Co., 815 F.2d 890 (3d Cir. 1987); Boland v. Nationwide Mutual Insurance Co., 9 Pa. D. & C.4th 27 (C.P. Blair Co. 1991). A plaintiff could recover punitive damages only by asserting the common law tort of fraud and deceit. Delahanty, 318 Pa. Super. 90, 464 A.2d 1243 (1983); Bleibera v. Insurance Company of North America, 50 Pa. D. & C.3d 570 (C.P. Allegheny Co. 1987). The rationale was primarily that punitive damages could not be awarded for breach of contract, even if the breaching party had acted in bad faith. Daniel Adams, 287 Pa. Super. at 77-78, 429 A.2d at 728. In addition, it was thought that existing statutory provisions provided sufficient deterrence to bad faith conduct. D'Ambrosio v. Pennsylvania National Mutual Casualty Insurance Co., 494 Pa. 501, 505, 431 A.2d 966, 969 (1981).

For example, the Supreme Court of Pennsylvania ruled that the Unfair Insurance Practices Act provided sufficient deterrence to insurance companies bad faith conduct. D'Ambrosio, 494 Pa. at 508, 431 A.2d at 970. The Court reasoned that although bad faith conduct by insurance carriers could not be ignored, the legislature had already made dramatic, sweeping efforts to curb the bad faith conduct by enacting the Unfair Insurance Practices Act; thus, a separate tort claim based on bad faith must be rejected. Id. at 508, 431 A.2d at 970.

To prevail in an action based on the common law tort of fraud and deceit, a plaintiff must allege and prove a fraudulent scheme. Bleiberg, 50 Pa. D. & C.3d at 579. Punitive damages may be available when the act is done with reckless indifference as well as bad motive. Delahanty, 318 Pa. Super. at 130, 464 A.2d at 1263. However, a court will not award punitive damages merely because a tort has been committed. Id. at 130, 464 A.2d at 1263. A plaintiff must demonstrate willful, malicious, wanton, reckless or oppressive conduct. Id. at 130, 464 A.2d at 1263. For example, a plaintiff may recover punitive damages by proving that the insurer was denying coverage far a loss that the insurer specifically represented would be covered. A plaintiff may also recover by showing that the insurance contract was part of an overall fraudulent scheme.

5. Status of Law on Punitive Damages After the Enactment of 42 Pa.C.S.A. 6 8371

Punitive damages became available in a bad faith action against an insurer when section 8371 was passed. Section 8371 provides:

> In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may take all of the following actions:
>
> (1) Award interest on the amount of the claim from the date the claim was made by the insured in an amount equal to the prime rate of interest plus 3%.

(2) Award punitive damages against the insurer.

(3) Assess court costs and attorney fees against the insurer.

42 Pa.C.S.A. § 8371.

The Legislature, in passing section 8371, intended to create a new cause of action which the courts previously had declined to recognize. Boland, 9 Pa. D. & C.4th at 31.

The Superior Court of Pennsylvania has held that if an insurer's alleged bad faith conduct occurs after the effective date of section 8371, July 1, 1990, the section applies regardless of when the insurance contract was issued. Okkerse v. Prudential Property and Casualty Insurance Co., ___ Pa. Super. ___, ___, 625 A.2d 663, 665-66 (1993). In so holding, the court reasoned that an insurer's obligation under a policy does not change as a result of the passage of section 8371. In addition, the court pointed out that section 8371 does not affect either the substantive requirements of the insurance contractor the parties' vested rights thereunder; it merely prohibits an insurer from acting in bad faith by refusing to pay benefits due under the policy. Id. at ___, 625 A.2d at 665-66. The court further explained that an insurer did not have a right to act in bad faith toward its insured at any time--either before or after the statute's enactment. Therefore, the court ruled that holding section 8371 applicable to a policy issued prior to the effective date would not constitute a retroactive application of the statute. Id. at , ___, 625 A.2d at 666.

B. TORT REFORM STANDARDS AND LIMITATIONS

1. Criticism of Punitive Damages

Critics have argued that large punitive damage awards would lead to higher premiums that, in turn, would harm the public. William M. Shernoff, Sanford M. Gage, Harvey R. Levine, Insurance Bad Faith Litigation, § 8.11, at 8-51 (1993). From an insured's perspective, it has been argued that statutory and administrative provisions regulating insurance rates would prevent the insurer from shifting burdens by raising premiums. Id. It has also been contended that an insurer should not be permitted to justify raising premiums based on punitive damages, since such damages are a penalty for wrongful conduct rather than a necessary expense of doing business. Id. at 8-51 to 8-52. Furthermore, even assuming that the insurer is not legally precluded from raising premiums, one may argue that an individual insurer who raises premiums to offset punitive damages would provide its competitors with a business advantage, and competitors would certainly capitalize on such an advantage to the individual insurer's detriment. Id. at 8-52; Neal v. Farmers Insurance Exchange, 21 Cal-3d 910, 582 P.2d 980, 148 Cal. Rptr. 389 (1978).

However, from an insurer's point of view, punitive damages may be inappropriate or detrimental for various reasons. These reasons include: (1) the close regulation of the insurance industry; (2) punitive damage awards are subject to the prejudice of unsympathetic or even hostile jurors; (3) there are no meaningful standards for assessment; and (4) the threat of solvency of insurance companies (and therefore, the security and well-being of their policy holders) by exposing them to unpredictable, catastrophic losses in the form of punitive damages is not consistent with the fundamental purpose of insurance, i.e., security against financial losses. William M. Shernoff, Sanford M. Gage, Harvey R. Levine, Insurance Bad Faith Litigation, § 8.11, at 8-52 to 8-53.

2. The Call for Tort Reform

The reality in the insurance industry has intensified the debate over the evils and merits of punitive damages. The insurance liability crises of the mid-1980's--the rising cost of liability insurance, and, in some cases, the difficulty of obtaining it--prompted the call for tort reform. The Liability System, Insurance Information Institute Reports, September, 1993. In particular, insurance trade associations, as well as the business community throughout the United States, have pushed for the elimination or limitation of punitive damages. Id.

Originally designed to punish defendants who display outrageous conduct, punitive damages are no longer limited to such cases and may amount to millions of dollars. Id. Many believe that the prospect of receiving a big bonus brings into court disputes that otherwise could be settled without going to trial, especially where the disputes are relatively minor. Id. Some argue that wrongdoers who have committed outrageous acts should be punished by criminal, not civil, courts. Others, although they believe that punitive damages belong within the domain of civil law, nonetheless argue that the winning party should not be the beneficiary (the punitive damages award should go to the state or to charity), and that the size of the award should bear some relationship to compensatory damages. Id.; see Martin v. Johns-Manville Corp., 508 Pa. 154, 494 A.2d 1088 (1985). It has also been contended that a single defendant should not be punished over and over again for the same defect each time a new case goes to trial. The Liability System, Insurance Information Institute Reports, September, 1993.

As an indication of the need for reform in tort law concerning punitive damages, a study prepared by Texaco, Inc., released in 1992, showed that the amount of punitive damages had increased 117 times in 20 years, even after adjusting for inflation. Id. By contrast, the gross national product less than doubled over the same period. Id.

3. The Possible Changes

Numerous changes to tort law concerning punitive damages have been advocated. They include: (1) requiring awards to be paid to the state; (2) setting limits on the amount; (3) limiting the type of cases in which they may be awarded; and (4) setting procedural requirements in awarding damages. The Liability System, Insurance Information Institute Reports, September, 1993.

4. Recent Developments Over Tort Reform Concerning Punitive Damages

Records indicate that twenty-nine states have enacted some degree of punitive damages reform law since 1986. The changes range from specific caps on awards, to higher standards of proof, to new procedural requirements, and to change of beneficiaries. Taking It to the States, Nat'l Underwriter, Life and Health/Fin. Serv. Ed., Aug. 2, 1993, at 33. While the degree of reform varies, the success demonstrates that support for the principle of punitive damages reform is widespread. Id. The main problem with the legislative, state-by-state approach is that, to achieve their goals, advocates must wage costly, time-consuming battles against special interest groups, such as trial lawyers, who spend enormous amounts .of money to either block or undo the reform efforts. Id.

In addition, 1993 is shaping up to be the biggest tort reform year since 1986. Sanity Is Back In Style, Forbes, Aug. 2, 1993 at 62. For example, Mississippi's new Model Product Liability Code provides that punitive damages may be awarded only if the defendant is proven to have acted with actual malice. Id. North Dakota has passed a bill to limit punitive damages to no more than double compensatory damages or $250,000, whichever is greater. Id.

5. Tort Reform in Pennsylvania

Although there have been numerous attempts, no major tort reform legislation has been passed in Pennsylvania. The Tort Movement's Progress Across the Nation, The Nat'l L. J., Nov. 9, 1991, at 35. Nevertheless, several bills pertaining to eliminating or limiting punitive damages are currently pending.

The first bill, 1993 Pa.S.B. 86, was introduced to the Senate Judiciary Committee on January 15, 1993. It amends Chapter 83 of the Judicial Code by adding a subchapter dealing with punitive damages. The proposed subchapter sets forth the definition of punitive damages and standards for recovery. It also provides when punitive damages may be awarded against a principal or master. Further, it lays out the procedures to be followed in determining whether to grant summary judgment on claims asserting punitive damages. Finally, it provides under what circumstances the defendant's wealth may be used as evidence in assessing punitive damages awards.

The second bill, 1993 Pa.S.B. 563, was referred to the Senate Judiciary Committee on February 19, 1993. It also amends Chapter 83 of the Judicial Code by adding a subchapter dealing with product liability. The new subchapter provides a limitation on liability for punitive damages for harm caused by products regulated by the Federal Food and Drug Administration.

Next, 1993 Pa.H.B. 1139 was introduced on April 20, 1993, by Representatives Gamble, Pesci, Lee, and other members. It amends 42 Pa.C.S.A. § 8553 (limitations on damages recoverable in actions against local parties) by adding an express prohibition of exemplary or punitive damages.

Finally, 1993 Pa.S.B. 1053 was introduced on April 29, 1993, by Senators Jubelirer, Hart, Corman, and others. It is similar to 1993 Pa.S.B. 563, liability for punitive damages for harm caused by products regulated by the Federal Food and Drug Administration.

C. CONSTITUTIONAL ISSUES AND DEFENSES

The constitutionality of punitive damages has recently been challenged in various contexts. The primary contentions in these cases have been: (1) an award of punitive damages violates the excessive fines clause of the eighth amendment; and (2) punitive damages infringe upon one's due process rights as guaranteed by the fourteenth amendment. However, courts, including the United States Supreme Court, have generally upheld the constitutionality of punitive damages.

1. <u>Excessive Fines Clause of the Eighth Amendment</u>

The Supreme Court of the United States has held that the excessive fines clause does not apply to punitive damages awarded in cases between private parties. <u>Browning-Ferris Industries, Inc. v. Kelco Disposal, Inc.</u>, 492 U.S. 257, 109 S.Ct. 2909, 106 L.Ed.2d 219 (1989). In <u>Browning-Ferris</u>, an antitrust case, the Court reviewed the award of $51,146 in compensatory damages and $6,000,000 in punitive damages. The defendants contended that the punitive damage award violated the excessive fines clause. <u>Id.</u> at 262, 109 S.Ct. at 2912-13, 106 L.Ed.2d at 230. In upholding the award, the Court held that the excessive fines clause does not constrain punitive damages when the government neither has prosecuted the action nor has any right to a share of the damages awarded. <u>Id.</u> at 263-64, 109 S.Ct. at 2913, 106 L.Ed.2d at 231. It also reasoned that the purpose of the eighth amendment was to prevent government's abuse of its prosecutorial power, not to limit damages awarded in disputes between private parties. <u>Id.</u> at 265-66, 109 S.Ct. at 2914-16, 106 L.Ed.2d at 232-33.

2. <u>Due Process Clause of the Fourteenth Amendment</u>

The Supreme Court of the United States has held that punitive damages do not violate the Due Process Clause per se, because they rationally advance the state's goal of protecting the public by deterring future wrongdoing. <u>Pacific Mutual Life Insurance Co. v. Haslip</u>, 499 U.S. 1, 111 S.Ct. 1032, 113 L.Ed.2d 1, (1991). <u>Haslip</u> involved life and health insurance policies. <u>Id.</u> at ___, 111 S.Ct. at 1036, 113 L.Ed.2d at 1l. The Court held that the post-trial procedures for scrutinizing the punitive damages award and the Alabama Supreme Court's review insured that the damages awarded were reasonable in relation to the state's interests; thus, they did not implicate the Due Process Clause. <u>Id.</u> at ___, 111 S.Ct. at 1044, 113 L.Ed.2d at 20 21.

The Supreme Court of the United States has also ruled that the jury does not have unlimited discretion in assessing punitive damages. Id. at ___,111 S.Ct, at 1043, 113 L.Ed.2d at 20; TXO Production Corp. v. Alliance Resources Corp., ___ U.S. ___, 113 S.Ct.2711, 125, L.Ed.2d 366 (1993). Although the Court held, in TXO, that it cannot draw a mathematical bright line between constitutionally acceptable and unacceptable punitive damage awards that would fit every case, ___ U.S. at ___, 113 S.Ct. at 2719-20, 125 L.Ed.2d at ___, it has consistently held that the calculation of a punitive damage award must be reasonable, so that it is not "grossly excessive" as to violate the Due Process Clause. Haslip, 499 U.S. at ___, 111 S.Ct, at 1043, 113 L.Ed.2d at 20; TXO, ___U.S. at ___,113 S.Ct. at 2719, 125 L.Ed.2d at ___. In Haslip, the punitive damages award was more than four times the amount of compensatory damages. 499 U.S. at ___, 111 S.Ct. at 1046, 113 L.Ed.2d at 23. The punitive damages in TXO amounted to $10 million, even though the actual damage was only $19,000. ___ U.S. at ___, 113 S.Ct. at 2716, 125 L.Ed.2d at ___. Nonetheless, in both cases, the Court held that the punitive damages were not so "grossly excessive" as to violate the Due Process Clause. Haslip, 499 U.S. at ___, 111 S.Ct. at 1046, 113 L.Ed.2d at 23; TXO, ___ U.S. at ___, 113 S.Ct. at 2722, 125 L.Ed.2d at ___.

3. Constitutionality of 42 Pa.C.S.A. § 8371

Federal courts in Pennsylvania have also addressed the constitutionality of a punitive damage award under section 8371. In Santoro v. Allstate Insurance Co., Civ. A. No. 91-3304, 1991 WL 17419 (E.D. Pa. September 25, 1991), the district court held that section 8371 does not violate the due process clause. In Santoro, owners of a homeowner's insurance policy sued the insurer on grounds of breach of contract and acting in bad faith by unreasonably denying their damage claim. 1991 WL 197419, at *1. The plaintiffs sought punitive damages pursuant to section 8371. The defendant argued that section 8371 is unconstitutional. It contended that section 8371 was unconstitutionally vague, because it failed to define bad faith. The defendant also argued that section 8371 violated due process, because it provided no standards for determining the amount of punitive damages. Id. at *3.

The district court held that Pennsylvania courts, as well as courts of other jurisdictions, had defined bad faith on numerous occasions in the insurance context; thus, section 8371 was not unconstitutionally vague. Id. at *3; see Part VI.D.3., infra.

As to the defendant's due process claim, the district court pointed out that section 8371 does not grant the factfinder unlimited discretion in awarding punitive damages. Assessment of punitive damages is guided by state policies concerning deterrence and retribution. These policies, combined with other protections including appropriate appellate review, provide a sufficiently definite and meaningful restraint on discretion in awarding punitive damages. Id.; see Part VI.D.3, infra. Thus, the district court held that section 8371 satisfies due process. Id.; see Part VI.D.3., infra.

VI. FRAUD CLAIMS AGAINST INSURERS, AGENTS AND ADJUSTERS

A. FRAUD BY INSURANCE AGENTS AND INSURERS

1. The Common Law Cause of Action -- Fraud by Insurers and Insurance Agents

a. Fraud defined

The elements of a claim for fraud under Pennsylvania law are: (1) a misrepresentation, (2) an intent by the maker that the recipient be induced to act, (3) justifiable reliance by the recipient upon the misrepresentation, and (4) damage to the recipient as the proximate result. Olkowski v. Prudential Insurance Co. of America, 584 F. Supp. 1140, 1141 (E.D. Pa. 1984). With regard to the misrepresentation element, it need not be a positive assertion, but rather is any statement, act or omission by which a person is deceived to his disadvantage. Id. at 1141. Rule 9(b) of the Federal Rules of Civil Procedure and Pennsylvania Rules of Civil Procedure 1019(b) require that all averments of fraud be stated with particularity. Thus, a plaintiff must plead sufficient facts so as to advise a defendant of the claim and to give defendant a fair opportunity to frame an answer and prepare a defense. 584 F. Supp. at 1142.

b. The Fraud Action

Pennsylvania recognizes a common law action for fraud and deceit. Pekular v. Eich, 355 Pa. Super. 276, 513 A:2d 427 (1986), appeal denied, 516 Pa. 635, 533 A.2d 93 (1987); see also Gordon v. Pennsylvania Blue Shield, 378 Pa. Super. 256, 548 A.2d 600 (1988); Wright v. North American Life Assurance Co., 372 Pa. Super. 272, 539 A.2d 434 (1988); Hardy v. Pennock Insurance Agency, Inc., 365 Pa. Super. 206, 529 A.2d 471 (1987); Brownell v. State Farm Mutual Insurance Co., 757 F. Supp. 526 (E.D. Pa. 1991). In Pekular, the Superior Court concluded that a common law action for fraud and deceit was not barred by the Unfair Insurance Practices Act (hereinafter referred to as "UIPA"), 40 P.S. § 1171.1, et seq. Pekular, 355 Pa. Super. at 282, 513 A.2d at 430. The Supreme Court of Pennsylvania had previously held that an insurer who allegedly acted unreasonably and in bad faith could only be subject to the administrative sanctions specifically authorized by the UIPA, and refused to recognize a "new tort" which would grant an insured a right of action to recover for emotional distress resulting from an insurer's bad faith conduct. D'Ambrosio v. Pennsylvania National Mutual Casualty Insurance Co., 494 Pa. 501, 431 A.2d 966 (1981). The Superior Court in Pekular distinguished D'Ambrosio on the ground that the Supreme Court expressly refused to supplement the UIPA with a judicially created cause of action which had never before been recognized by Pennsylvania courts. Pekular, 355 Pa. Super. at 284, 513 A.2d at 431. However, the Superior Court determined that D'Ambrosio did not preclude existing common law remedies such as fraud and deceit. Pekular, 355 Pa. Super. at 284, 513 A.2d at 431. Thus, the Superior Court noted that the common law action for fraud and deceit survived the D'Ambrosio decision and is still the law in this Commonwealth.

In Pekular, the Superior Court found that a cause of action existed based on the following facts: the insureds instituted the action against an insurance agent and the insurer. The complaint averred that the insurance agent sold the plaintiffs four policies of automobile insurance. Mr. Pekular was allegedly advised by the agent. that the Pekulars could save money through reduced premiums by electing to make the no-fault medical benefits available under the policies secondary to other health benefits. According to the Pekulars, the agent knowingly and purposefully did not explain that such an election would effectively reduce the total amount of primary health benefits that the Pekulars could claim in the event of injury in an accident. The Pekulars claim that they were induced by their agent to have the no-fault benefits designated as secondary coverage, and they claimed that they relied on the agent's representations in doing so. After Mrs. Pekular was later injured while driving a vehicle, she was denied payments which would have been forthcoming had the Pekulars not elected to designate the no-fault benefits as secondary. Pekular, 355 Pa. Super. at 279, 513 A.2d at 428.

Likewise, in Wright v. North American Life Assurance Co., a cause of action was found to exist when the plaintiffs purchased five life insurance policies from James Monteverde, in his capacity as agent for North American Life Assurance Company; paid the premiums due on these policies which exceeded $39,000 for a period of almost two years; and were denied possession of the policies upon many requests during the two-year period. Upon finally receiving the policies, they purportedly discovered that Monteverde had misrepresented the coverage and the schedule of premiums for the policies. Plaintiffs promptly cancelled the policies and sought a refund of the premiums they had paid. In essence, they alleged that

Monteverde, on whom they relied to their financial detriment, misrepresented the actual cost of the policies to them and also misrepresented pertinent facts regarding coverage. 372 Pa. Super. at 276-78, 539 A.2d at 436-37.

In Brownell, plaintiff made out a cause of action for fraud and deceit by alleging that the .insurer undertook an affirmative course of action to defraud her of benefits to which she was entitled, and misrepresented to her that medical coverage was available for her injuries. Plaintiff alleged reliance on her insurer's misrepresentations, and she alleged that she suffered a detriment as a result of the misrepresentations. 757 F. Supp. at 532.

2. Unfair Trade Practices and Consumer Protection Law, 73 P.S. § 201-1 et seq.

A plaintiff who brings a common law cause of action for fraud and deceit may also be able to maintain a private cause of action under the Unfair Trade Practices and Consumer Protection Law, 73 P.S. S 201-1, et seq. ("UTPCPL"), when the allegations in plaintiff's complaint fall within the purview of the acts and practices prohibited by section 5 of the UIPA, 40 P.S. § 1171.5. Pekular, 355 Pa. Super. 276, 513 A.2d 427; Hardy, 365 Pa. Super. 206, 529 A.2d 471. The underlying foundation of the UTPCPL is fraud prevention. Pekular, 355 Pa.. Super. at 286, 513 A.2d at 432. The UTPCPL provides remedies for "unfair methods of competition" and "unfair or deceptive acts or practices." Pekular, 355 Pa. Super. at 287, 513 A.2d at 432; 73 P.S. 201-2(4). "Unfair methods of competition" and "unfair or deceptive acts or practices" include "[m]aking false or misleading statements of fact concerning the reasons for, existence of, or amounts of price reductions," "[k]nowingly misrepresenting that services . . . are needed if they are not needed," and "[e]ngaging in any other fraudulent conduct which creates a likelihood of confusion or of misunderstanding." 73 P.S. §§ 201-2(4)(xi), (xv), (xvii). The UTPCPL provides for private causes of action in which a person "who purchases or leases goods or services primarily for personal, family or household purposes and thereby suffers any ascertainable loss of money or property . . . as a result of the use or employment by any person of a method, act or practice declared unlawful" by the act, may recover actual damages, or, in the court's discretion, treble damages if the court deems additional relief necessary or proper. 73 P.S. § 201-9.2(a). Thus, if a plaintiff can establish an unfair or deceptive act or practice under the UTPCPL, that plaintiff may bring a private cause of action for fraud.

B. FIDUCIARY RELATIONSHIP BETWEEN INSURER AND INSURED

1. Dercoli v. Pennsylvania National Mutual Insurance Co., 520 Pa. 471, 554 A.2d 906 (1989)

In Dercoli, a plurality of the Supreme Court of Pennsylvania indicated that an insurance company may owe some fiduciary duty to an insured.

a. This case arose from .a tragic automobile accident in which Mr. Dercoli, who was insured under two automobile insurance policies, was killed, and his wife was severely injured. In the claim process that followed, the wife relied upon the advice of the insurer's agents to receive the benefits due her under the applicable policies. She began to receive certain benefits paid by the insurers under the policies in force, and she continued to receive the benefit checks until approximately April of 1984. On July 14, 1981, approximately one year after the accident, the Supreme Court decided Hack v. Hack, 495 Pa. 300, 433 A.2d 859 (1981), which abolished the defense of interspousal immunity as a bar to an action for personal injuries caused by the negligence of the injured victim's spouse. The wife did not learn of the removal of this bar to suit until sometime after March, 1985. In January, 1986, she filed the complaint against the insurers averring breach of the duty of good faith and fair dealing. Dercoli, 520 Pa. at 473-74, 554 A.2d at 907.

b. The Court held that the insurer was bound to deal with the wife on a fair and frank basis and, at all times, to act .in good faith. Dercoli, 520 Pa. at 477-78, 554 A.2d at 909. "The duty of an insurance company to deal with the insured fairly and in good faith includes the duty of full and complete disclosure as to all of the benefits and every coverage that is provided by the applicable policy or policies along with all requirements, including any time limitations for making a claim." Id. at 478, 554 A.2d at 909. Under the circumstances, the 'Court found that the insurer had a duty to inform the insured of all benefits and coverage that-may be available and of any potential adverse interest, pertaining to the insurer's liability under the applicable policy or policies. Id. at 478, 554 A.2d at 909. Therefore, the insurer was under a duty to inform the wife of the Hack decision and its consequences, and the failure to do so breached the duty to act fairly and in good faith. Id. at 478; 554 A.2d at 909.

2. The impact that the Supreme Court's holding in Dercoli will have in the area of insurance fraud is unclear. However, the Superior Court has interpreted Dercoli to warrant grounds for liability based on three factors: (1) the insurer had assumed responsibility for processing its insured's claim; (2) the insurer knew that the insured was relying exclusively on the insured's advice and counsel; and (3) the insurer had knowledge regarding an additional claim for benefits to which the insured was entitled, and the insurer failed to disclose such information. Miller v. Keystone Insurance Co., 402 Pa. Super. 213, 586 A.2d 936, 941 (1991); see Provident Life and Accident Insurance Co. v. Charles, ___ F. Supp. ___, 1993 U.S. Dist. LEXIS 5030. *35 (E.D. Pa. April 14, 1993).

C. FRAUD BY INSURANCE ADJUSTERS

1. Privity

a. An insured can only bring an action against an independent adjuster if the insured establishes a contractual relationship between himself and the adjuster. Hudock v. Donegal Mutual Insurance Co., 438 Pa. 272, 264 A.2d 668 (1970).

In Hudock, the insureds contended, inter alia, that action by the adjusters outside the scope of their authority constituted a breach of the insurance contract and rendered the adjusters personally liable for the breach. The insureds alleged that the adjusters failed, by means of fraudulent and unreasonable acts and delays, to negotiate in good faith an adjustment of the claim. 438 Pa. at 278, 264 A.2d at 672. Such allegation was insufficient to state a cause of action, because it failed to allege or establish a contractual relationship between the adjusters and the insureds. Id. at 278, 264 A.2d at 672.

If' the adjusters had acted within the scope of their authority, their alleged failure to perform their principals' contractual duties could have been attributed to the principals, thereby rendering the insurance companies liable for breach of contract. But actions by adjusters beyond the scope of their authority could not result in the imposition upon them of contractual duties to the insureds which they had never assumed. Id. at 278-79, 264 A.2d at 672.

b. Tort Action

An independent adjuster hired by an insurer has no liability in tort to an insured for improperly withholding settlement on a claim. McCormick v. Yorktowne Mutual Insurance Co., 15 Pa. D. & C.3d 99 (C.P. Lawrence Co. 1980). Any action for the breach of the duty of good faith investigation by an adjuster is one in assumpsit, and the insured must establish a contract with the adjuster to pursue such a claim against him. Id. at 102.

However, under the proper circumstances, an adjuster may be liable for inducing a breach of contract. Id. at 103. Under Restatement (Second) of Torts, S 766 (1977), one incurs liability "by inducing or otherwise causing the third person not to perform the contract." To recover under this theory, however, an insured must plead improper inducement in the complaint. Id.

2. Fiduciary Relationship Between Adiusters and Insureds

Two courts have recognized that an adjuster, like an insurer, assumes a fiduciary position which obliges him "to act in good faith and with due care in representing the interest of the insured." Metro Transportation Co. v. Controlled Risk Services. Inc., 113 B.R. 874, 885 (E.D. Pa. 1990); Diamon v. Penn Mutual Fire Insurance Co., 247 Pa. Super. 534, 551, 372 A.2d 1218, 1227 (1977).

D. BAD FAITH CLAIMS HANDLING

1. Common Law Bad Faith

With one exception, the Pennsylvania Supreme Court has specifically barred private bad faith claims against insurers. D'Ambrosio v. Pennsylvania National Mutual Casualty Insurance Co., 494 Pa. 501, 431 A.2d 966 (1981); Smith v. Harleysville Insurance Co., 494 Pa. 515, 431 A.2d 974 (1981). In D'Ambrosio, the Supreme Court of Pennsylvania expressly refused to permit recovery of emotional distress and punitive damages based upon an insurer's bad faith conduct in denying a claim. 494 Pa. at 509, 431 A.2d at 970; see also Rodgers v. Nationwide Mutual Insurance Co., 344 Pa. Super. 311, 496 A.2d 811 (1985); Trustees of University of Pennsylvania v. Lexington Insurance Co., 815 F.2d 890 (3d Cir. 1987). Although the Supreme Court recognized the seriousness of bad faith conduct by insurance carriers, it concluded that the legislature had already made dramatic, sweeping efforts to curb the bad faith conduct by enactment of the Unfair Insurance Practices Act ("UIPA"). 494 Pa. at 505, 431 A.2d at 969. The Court determined that sections 4 and 5 of UIPA provided sufficient sanctions on "unfair methods of competition" and "unfair or deceptive acts or practices" by insurance carriers. Id. at 506, 431 A.2d at 969; 40 P.S. §§ 1171.4, 1171.5. Thus, the Court decided that "it is equally for the Legislature to determine whether sanctions beyond those created under the [UIPA] are required to deter conduct which is less than scrupulous." Id. at 508, 431 A.2d at 970.

The one exception is in the area of excess verdict cases. Cowden v. Aetna Casualty and Surety Co., 389 Pa. 459, 134 A.2d 223 (1957). In Cowden, the Supreme Court of Pennsylvania determined that an insurer may be liable for the entire amount of a judgment secured by a third party against the insured, regardless of any limitation or exclusion in the policy, "if the insurer's handling of the claim, including a failure to accept a proffered settlement was done in such a manner as to evidence bad faith on the part of the insurer in the discharge of his contractual duty." Id. at 468, 134 A.2d at 227. In this context, bad faith must be proven by clear and convincing evidence, and not merely insinuated. Id. at 472, 134 A.2d at 229. The Court emphasized, however, that the duty to settle a claim when a possible judgment against the insured may exceed the amount of the coverage was not absolute. The sole requirement is that the insurer consider in good faith the insured's interests as a factor in coming to a decision as to whether to settle or litigate a claim brought against the insured. Id. at 470, 134 A.2d at 228. The Court recognized:

> (s]ince it is obvious that the interest of one or the other party may be imperiled at the instant of decision, the fairest method of balancing the interests is for the insurer to treat the claim as if it were alone liable for the entire amount. But, that does not mean that the insurer is bound to submerge its own interest in order that the insured's interest may be made paramount. It means that when there is little possibility of a verdict or settlement within the limits of the

> policy, the decision to expose the insured to personal pecuniary loss must be based on a bona fide belief by the insurer, predicated upon all of the circumstances of the case, that it has a good possibility of winning the suit. While it is the insurer's right under the policy to make the decision as to whether a claim against the insured should be litigated or settled, it is not a right of the insurer to hazard the insured's financial well-being. Good faith requires that the chance of a finding of nonliability be real and substantial and that the decision to litigate be made honestly.

Id. at 470-71, 134 A.2d at 228.

It is to be presumed that insurers have acted fairly, honestly, properly, in good faith and without fraud, in the absence of any proof to the contrary. Id. at 476, 134 A.2d at 231. Thus, "the insurer must accord the interests of its insured the same faithful consideration it gives its own interest." Id. at 470, 134 A.2d at 228.

Cowden was filed in trespass and the case recognized that a bad faith tort cause of action existed. Subsequent case law, however, has characterized the obligation on the part of the insurer to deal in good faith as arising out of the contract, or at least out of the fiduciary relationship created by the contract of insurance. Gedeon v. State Farm Mutual Automobile Insurance Co., 410 Pa. 55, 188 A.2d 320 (1963); see Frederick N. Egler, Jr., Bad Faith Claims in Pennsylvania Prior to Passage of 42 Pa.C.S. Section 8371, Bad Faith Claims in -Pennsylvania, Pennsylvania Bar Institute, No. 1992-691, at 6.

The duty of good faith and fair dealing, recognized in Cowden, was also held to exist in Shearer v. Reed, 286 Pa. Super. 188, 428 A.2d 635 (1981). However, the courts of this Commonwealth have declined to extend the reach of this duty of good faith and fair dealing beyond the limited context of excess verdict cases. See D'Ambrosio, supra, 494 Pa. 501, 431 A.2d 966 (1981).

2. The Statutory Remedy -- 42 Pa.C.S.A. § 8371

a. 42 Pa.C.S.A. S 8371 states:

> In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may take all of .the following actions:
>
> (1) Award interest on the amount of the claim from the date the claim was made by the insured in an amount equal to the prime rate of interest plus 3%.
>
> (2) Award punitive damages against the insurer.
>
> (3) Assess court costs and attorney fees against the insurer.

The statute went into effect on July 1, 1990.

b. A plaintiff may properly pursue a cause of action for a defendant's alleged bad faith conduct after July 1, 1990. Okkerse v. Prudential Property and Casualty Insurance Co., ___ Pa. Super. ___, 625 A.2d 663 (1993); Coyne v. Allstate Insurance Co., 771 F. Supp. 673 (E.D. Pa. 1991); Shamusdeen v. Hartford Insurance Co., Civ. A. No. 91-0878, 1991 WL 108675 (E.D. Pa. June 17,1991); Dembowski v. Allstate Insurance Co., Civ. A. No. 92-43, 1992 WL 57931 (E.D. Pa. March 17, 1992); Colantuno v. Aetna Insurance Co., 980 F.2d 908 (3d Cir. 1992). Thus, section 8371 may be applied to an insurance contract issued prior to July 1, 1990 when the conduct constituting bad faith occurred subsequent to that date. The date of the initial denial by the insurer determines whether section 8371 wi11 be invoked. Santoro v. Allstate Insurance Co., Civ. A. No. 91-3304, 1991 WL 197419, *2 (E.D. Pa. September 25, 1991). When a refusal to provide coverage is made before the effective date of the statute, "[t]he fact that the alleged failure to timely pay continued after the effective date of [section] 8371 does not bring the claim within the purview of the statute. To hold otherwise would be to suggest that with each day of refusal is created a new and independent tort. The continued alleged bad faith acts are merely acts arising from the original claim of denial of coverage." Barbaro v. The Old Line Life Insurance Co., of America, 785 F. Supp. 70, 71 (E.D. Pa. 1992) (citation omitted).

A court may also apply section 8371 when the contract existed prior to the effective date of the statute, if the statute does not impinge upon a vested contractual right or obligation., Coyne, 771 F. Supp. at 675; Santoro, Civ. A. No. 91-3304, 1991 WL 197419; *2.. An insurer had no vested contractual right to act in bad faith toward an insured prior to the adoption of section 8371. Coyne, 771 F. Supp. at 675; Colantuno, 980 F.2d at 911.

c. When presenting a bad faith claim, a plaintiff is directed to present all evidence in support of the substantive claims of bad faith prior to any evidence in support of damages. Thus, a defendant will be free to move for judgment as a matter of law under F.R.C.P. 50(a) at the conclusion of the substantive evidence, thereby possibly avoiding the need to present damages evidence. MacFarland v. United States Fidelity & Guarantee Co., 818 F. Supp. 108, 112 (E.D. Pa. 1993). MacFarland seems to indicate that there must be a trifurcation of the issues presented at trial: first, a determination must be made on the underlying coverage dispute; second, the issue of bad faith liability on the part of the insurer must be decided; and, , third, only after the first two elements are satisfied in favor of the insured, a determination as to damages will be made. See id.

3. Bad Faith Defined

42 Pa.C.S.A. § 8371 does not define bad faith. However, by reference to the Pennsylvania rules of statutory construction, Pennsylvania courts have developed a common and approved meaning for the term.

> Words and phrases shall be construed according to rules of grammar and according to their common and approved usage; but technical words and phrases and such others as have acquired a peculiar and appropriate meaning

> or are defined in this part, shall be construed according to such peculiar and appropriate meaning or definition.

1 Pa.C.S.A. § 1903; Coyne, 771 F. Supp. at 677.

In the insurance context, the phrase bad faith has acquired a peculiar and universally acknowledged meaning. Coyne, 771 F. Supp. at 677.

> Insurance "Bad faith" on part of insurer is any frivolous or unfounded refusal to pay proceeds of a policy; it is not necessary that such refusal be fraudulent. For purposes of an action against an insurer for failure to pay a claim, such conduct imports a dishonest purpose and means a breach of a known duty (i.e., good faith arid fair dealing), through some motive of self-interest or ill will; mere negligence or bad judgment is not bad faith.

Black's Law Dictionary 139 (6th ed. 1990) (citations omitted). See, e.g., Washington v. Group Hospitalization, Inc., 585 F. Supp. 517, 520 (D.D.C. 1984) ("Many jurisdictions have recognized a cause of action in tort for the bad faith refusal of an insurer to pay . . . . To recover under the tort of bad faith refusal to pay, plaintiff must show that defendant did not have a reasonable basis for denying benefits under the policy and that it knew or recklessly disregarded its lack of a reasonable basis when it denied the claim"); Appelman & Appelman, Insurance Law & Practice, § 1612 at 368 (1967 and supp. 1990) (citing cases) ("bad faith means any frivolous or unfounded refusal to pay; it is not necessary that such refusal be fraudulent"); Coyne, ,771 F. Supp. at 677-78.

Bad faith may also be viewed in the context of its opposite counterpart, good faith. Ovens v. State Farm Mutual Automobile Insurance Co., Civ. A. No. 92-0536, 1992 WL 210036, *3 (E.D. Pa. August 20, 1992). In this respect, an insurer stands in a fiduciary relationship to its insured and must accord the interest of its insured the same consideration it gives its own interest. The good faith standard requires more than proof of sincerity. The evaluation by the insurance company must be honest, intelligent and objective. Owens, Civ. A. No. 92-0536, 1992 WL 210036, *3, citing Cowden, 389 Pa. 459, 134 A.2d 223.

The good faith standard was set out in detail in Shearer v. Reed, 286 Pa. Super. 188, 428 A.2d 635 (1981):

> "[A) decision not to settle must be a ,thoroughly honest, intelligent and objective one. It must be a realistic one when tested by the necessarily assumed expertise of the company." [Bowers v. Camden Fire Ins. Assoc., 51 N.J. 62, 71, 237 A.2d 857, 861 (1968)]. This expertise must be applied, in a given case, to a consideration of all the factors bearing upon the advisability of a settlement for the protection of the insured. While the view of the carrier or its attorney as to liability is one important factor, a good faith evaluation requires more. It includes consideration of the anticipated range of a verdict, should it be adverse; the strengths and weaknesses of all of the evidence to be presented on either side so far as known; the history of the particular geographic area in cases of similar nature; and the relative appearance, persuasiveness, and likely appeal of the claimant, he insured, and the witnesses at trial. Garner v. Am. Mut. Liab. Ins. Co., 31 Cal. App.3d 843, 107 Cal. Rptr. 604, 607-697 (1973).

Shearer, 286 Pa. Super. at 194, 428 A.2d at 638.

Even if the particular concepts encompassed within bad faith were not commonly understood in the legal community, the parameters of section 8371 may be discerned by reference to the Pennsylvania Unfair Insurance Practices Act ("UIPA"), 40 P.S. § 1171.1, et seq. In section 5, the UIPA delineates the "unfair or deceptive acts or practices" that it prohibits. See 40 P.S. § 1171.5. Subsection (a)(10) lists 15 acts which, if committed or performed with such frequency as to indicate a business practice, shall constitute unfair claim settlement or compromise practices. 40 P.S. § 1171.5(a)(10)(i)-(xv).

> Any of the following acts if committed or performed with such frequency as to indicate a business practice shall constitute unfair claim settlement or compromise practices.
>
> (i) Misrepresenting pertinent facts or policy or contract provisions relating to coverages at issue.

(ii) Failing to acknowledge and act promptly upon written or oral communications with-respect to claims arising under insurance policies.

(iii) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies.

(iv) Refusing to pay claims without conducting a reasonable investigation based upon all available information.

(v) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed and communicated to the company or its representative.

(vi) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which the company's liability under the policy has become reasonably clear.

(vii) Compelling persons to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts due and ultimately recovered in actions brought by such persons.

(viii) Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application.

(ix) Attempting to settle or compromise claims on the basis of an application which was altered without notice to or knowledge or consent of the insured of such alteration at the time such alteration was made.

(x) Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which payments are being made.

(xi) Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants to induce or compel them to accept settlements or compromises less than the amount awarded in arbitration.

(xii) Delaying the investigation or payment of claims by requiring the insured, claimant or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

(xiii) Failing to promptly settle claims, where liability has become reasonably clear, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage or under other policies of insurance.

(xiv) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.

(xv) Refusing payment of a claim solely on the basis of an insured's request to do so unless:

(a) The insured claims sovereign, eleemosynary, diplomatic, military service, or other immunity from suit or liability with respect to such claim;

(b) The insured is granted the right under the policy of insurance to consent to settlement of claims; or

(c) The refusal of payment is based upon the insurer's independent evaluation of the insured's liability based upon all available information.

In addition, the Insurance Department regulations list additional practices which will be deemed to constitute unfair claims settlement practices:

(a) An insurer or agent may not fail to fully disclose, to first-party claimants pertinent benefits, coverages or other provisions. of -an insurance policy or -.insurance contract under which a claim is presented.

(b) An insurer or agent may not fail to fully disclose to fist-party claimants benefits, coverages or other provisions of an insurance policy or insurance contract when the benefits, coverages or other provisions are pertinent to a claim.

(c) An insurer may not deny a claim for failure to exhibit the property without proof of demand and refusal by a claimant to do so.

(d) An insurer may not, except where there is a time limit specified in the policy, make statements -- written or otherwise -- requiring a claimant to give written notice of loss or proof of loss within a specified time limit and which seek to relieve the company of its obligations if a time limit is not complied with unless the failure to comply with the time limit prejudices the rights of the insurer.

(e) An insurer may not request a first-party claimant to sign a release that extends beyond the subject matter that gave rise to the claim payment.

(f) An insurer may not issue checks or drafts in partial settlement of a loss or claim under a specific coverage which checks or

> drafts contain language which expressly or impliedly releases the insurer or its insured from its total liability.

31 Pa. Code § 146.4. The Department regulations also define certain minimum standards which, if violated with a frequency that indicates a general business practice, will be deemed to constitute unfair claims settlement practices. These practices include: (1) failure to acknowledge all pertinent communications from the insured or the Department, (2) failure to promptly investigate claims, (3) improper denial or acceptance of a settlement offer, and (4).failure to disclose to claimants the basis in fact or in law for the denial or offer of settlement. 31 Pa. Code §§ 146.5 -146.10.

4. Examples of Recent Bad Faith Cases

a. An insurer's failure to consent to its insured's acceptance of a settlement offer based on its consent-to-settle clause in both its uninsured and its underinsured motorist policies was held to constitute bad faith within the meaning of section 8371. Owens, Civ. A. No. 92-0536, 1992 WL 210036, *4. The district court based its holding on the public policy behind the Pennsylvania Motor Vehicle Financial Responsibility Law's requirement that insurers provide one or the other underinsured motorist coverage. The Superior Court had previously held that this policy is contravened by operation of a consent-to-settle clause in an insurance contract. Id. at *3; Daley-Sand v. West American Insurance Co., 387 Pa. Super, 630, 564 A.2d 965 (1989).

b. An insurer does not act in bad faith when it has a reasonable basis for denying a claim. American Franklin Life Insurance Co. v. Galati, 776 F. .Supp. 1054 (E.D. Pa. 1991). When the insurer reduced the insured's benefits to reflect the benefits to which the insured would have been entitled given his true annual income and job duties, the insurer did not act in bad faith: Nor did the insurer act in bad faith in continuing to investigate the insured's claim or in offering a $15,000 lump sum in lieu of future benefits. Id. at 1064.

c. In Kauffman v. Aetna Casualty & Surety Co., 794 F. Supp. 137 (E.D. Pa. 1992), an insurer was held not to have acted in bad faith when: (1) it decided to proceed to arbitration of an underinsured motorist claim rather than to settle with the insureds for the full $1 million stacked limit; (2) it failed to pay the full amount of the $950,000 arbitration award until a determination of the effect to be given its stacking provision was made; (3) it contested a state court order to confirm the arbitration award on procedural grounds. Kauffman, 794 F. Supp. at 140-41. The district court based its decision on the ground that no reasonable factfinder could conclude that the insurer's decision to proceed to arbitration constituted bad faith. Id. at 141. In addition, the district court determined that the insurer was justified in contesting the state court order on procedural grounds, because the insurer was not required to accede to procedural deficiencies in an action against it. Id.

d. Section 8371 applies to the conduct of an insurer in the litigation arena after the denial of a claim. Rottmund v. Continental Assurance Co., 813 F. Supp. 1104 (E.D. Pa. 1992); see also Kauffman, 794 F. Supp. 137.

The holding in Rottmund that conduct of an insurer in the litigation arena after the denial of a claim may give rise to a statutory bad faith action appears to conflict with 42 Pa.C.S.A. § 2503 and Federal Rule of Civil Procedure 11. If the courts of this Commonwealth afford precedential value to the district court's statement in Rottmund, section 8371 would provide an additional, potential sanction on the insurer that was not expressly contemplated in the language of the statute itself. Such a sanction would require that insurers be alert to act in good faith and in a reasonable manner at all times throughout the period of litigation, from the time the initial complaint is filed until the final appeal is taken.

Additionally, when the situation is presented, the question also arises as to whether the insured will be allowed to raise this claim in an amended complaint or whether the claim will give rise to a new suit.

E. DEFENSE OF ERISA PREEMPTION

1. ERISA Totally Preempts Section 8371

Under the Employee Retirement Income Security Act of 1974, 29 U.S.C. § 1001, et seq. ("ERISA") an "Employee Welfare Benefit Plan" is defined as "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer . . . to the extent that such plan . . . is maintained for the purpose of providing for its participants or their beneficiaries through the purchase of insurance or otherwise, (A) medical, surgical or hospital care . . . ." 29 U.S.C. § 1002(1). In enacting ERISA, Congress intended to "protect . . . participants in employee benefit plans and their beneficiaries, by requiring the disclosure and reporting to participants, and beneficiaries of financial and other information with respect thereto, by establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans, and by providing for appropriate remedies, sanctions, and ready access to the Federal courts." 29 U.S.C. § 1001(b). The Conference Report on ERISA, in addressing the exclusivity of remedies available under ERISA, makes clear that "[a]ll such actions in Federal or State courts are to be regarded as arising under the laws of the United States . . . ." H.R. Conf. Rep. No. 93-1280, p. 327 (1974), U.S. Code Cong. & Admin. News 1974, pp. 4639, 5107. To effectuate its policy, ERISA provides that "the provisions of the subchapter . . . shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plans." 29 U.S.C. § 1144(a). This broad preemption provision is tempered by two additional provisions. The first, commonly referred to as the "saving clause," provides that "[e]xcept as provided in subparagraph B [the deemer clause], nothing in this subchapter shall be construed to exempt or relieve any person, from any law of any State, which regulates insurance, banking or, securities." 29 U.S.C. § 1144(b)(2)(A). The second, commonly referred to ; as the "deemer clause," provides that "[n]either an employee benefit plan . . . nor any trust established under such a plan, shall be deemed, to be an insurance company or other insurer, bank, trust company, or investment, company or to be engaged in the business of insurance or banking for purposes of any law of any State purporting to regulate insurance companies, insurance contracts, banks, trust companies or investment companies." 29 U.S.C. § 1144(b)(2)(B). "State law" is defined as including "all laws, decisions, rules, regulations or other state action having the effect of law, of any State." 29 U.S.C. § 1144(c).

ERISA expressly preempts all state law claims against pension and employee benefit providers. Gelzinis v. John Hancock Mutual Life Insurance Co., ___ F. Supp. ___, 1993 U.S. Dist. LEXIS 5483 (E.D. Pa. April 27, 1993); ERISA, 29 U.S.C. § 1144. A bad faith action based on improper processing of a claim for benefits under an ERISA plan is preempted. Northwestern Institute of Psychiatry v. Travelers Insurance Co., Civ. A. No. 92-1520, 1992 WL 331521 (E.D. Pa. November 3, 1992).

The Supreme Court of the United States has held that state common law bad faith claims relating to an employee welfare benefit plan are preempted-by ERISA. Pilot Life Insurance Co. v. Dedeaux, 481 U.S. 41, 107 S. Ct. 1549, 95 L.Ed.2d 39 (1987). In Pilot Life, the Court applied a two-part test to determine whether Mississippi's common law fraud claim was preempted by ERISA. First, it sought guidance from an application of a "common-sense" view of the language of the savings clause itself. 481 U.S. at 48, 107 S. Ct. at 1553, 95 L.Ed.2d at 48.

The Court found that "[a] common-sense view of the word 'regulates' would lead to the conclusion that in order to regulate insurance, a law must not just have an impact on the insurance industry, but must be specifically directed toward that industry." Id. at 50, 107 S. Ct. at 1554, 95 L.Ed.2d at 49. Second, the Court looked to the case law interpreting the phrase "business of insurance" under the McCarran-Ferguson Act, 15 U.S.C. § 1011, et seq., in interpreting the savings clause. The Court noted that three criteria have been used to determine whether a practice constitutes "business of insurance": (1) whether the practice has the effect of transferring or spreading the policyholder's risk; (2) whether the practice is an integral part of the policy relationship; and (3) whether the practice is limited to entities within the insurance industry. Id. at 48, 107 S. Ct. at 1553, 95 L.Ed.2d at 48. The Court then concluded that the Mississippi common law of bad faith was not integral to the relationship between the insurer and the insured, because it did not define the terms of the relationship between the insurer and the insured. Id. at 51, 107 S. Ct. at 1555, 95 L.Ed.2d at 50. It merely declared that, whatever terms had been agreed upon in the insurance contract, the breach of that contract would in certain circumstances allow a policyholder to obtain punitive damages. Id. at 51, 107 S. Ct. at 1555, 95 L.Ed.2d at 50. Thus, the Court determined that "[t]he common law causes of action raised in Dedeaux's complaint, each based on alleged improper processing of a claim for benefits under an employee benefit plan, undoubtedly meet the criteria for preemption." Id. at 48, 107 S. Ct. at 1553, 95 L.Ed.2d at 48.

Northwest Institute of Psychiatry v. Travelers Insurance Co., Civ. A. No. 92-1520, 1992 WL 331521 (E.D. Pa. November 3, 1992), addressed Pennsylvania's statutory bad faith law, 42 Pa.C.S.A. § 8371, in light of the Pilot Life decision. The district court first determined that part two of the Pilot Life test was not met--section 8371 does not transfer or spread the policyholder's risk, and it does not define the terms of the relationship between the insured and the insurer. Northwest Institute of Psychiatry, 1992 WL 331521, *3. The district court then noted that "[s]everal courts have applied the reasoning of Pilot Life, which dealt with a common law cause of action, to statutory causes of action for bad faith damages in insurance cases, and they have found the statutory claims to be preempted by ERISA." Civ. A. No.92-1520, 1992 WL 331521, *3. See Kelley v. Sears Roebuck & Co., 882 F.2d 453 (10th Cir. 1989); Anschultz v. Connecticut General Life Insurance Co., 850 F.2d 1467(11th Cir.1988); Ramirez v. Inter-Continental Hotels, 890F.2d 760 (5th Cir. 1989); See also Roberson v Equitable Life Assurance Society of the U.S., 661 F. Supp. 416 (C.D. Cal. 1987), aff'd mem., 869 F.2d 1498 (9th Cir. 1989).Thus, based on the wealth of case law requiring preemption, the district court in Northwestern Institute of Psychiatry held that a section 8371 action based on improper processing of a claim for benefits under an ERISA plan is preempted. Northwest Institute of Psychiatry, 1992 WL 331521, *5.

2. Attorney's Fees Under ERISA

A plaintiff who has had his section 8371 action preempted by ERISA may be given the opportunity to amend his complaint and request attorney's fees and costs under ERISA. Gelzinis v. John Hancock Mutual Life Insurance Co., ___ F. Supp. ___, 1993 U.S. Dist. LEXIS 5483 (E.D. Pa. April 27, 1993).

F. PENNSYLVANIA MOTOR VEHICLE FINANCIAL RESPONSIBILITY LAW, 75 PA.C.S.A. SS 1797, 1798

Section 1797 of the Pennsylvania Motor Vehicle Financial Responsibility law ("MVFRL") applies whenever an insurance company has invoked a peer review to deny medical benefits to an injured person. 75 Pa.C.S.A. § 1797. Section 1797 gives a court the power to grant more relief, in the form of enhanced remedies to a medical provider or an insured, when it determines that medical treatment or rehabilitative services or merchandise were medically necessary, but were denied by the insurer. 75 Pa.C.S.A. § 1797(b)(6). Such enhanced remedies include a 12% interest rate on outstanding claims, as well as the costs of the challenge and all attorney fees. 75 Pa.C.S.A. § 1797(b)(6). Attorneys fees and costs may also be assessed against an insurer who is found to have acted with no reasonable foundation in refusing to pay the benefits under a claim when due under 75 Pa.C.S.A. § 1798.

The specific provisions set forth in 75 Pa.C.S.A. §§ 1797 and 1798 are inconsistent with the general punitive damage provision set forth in 42 Pa.C.S.A. § 8371. Elliott v. State Farm Mutual Automobile Insurance Co. 786 F. Supp. 487, 492 E.D. Pa. 1992); Knox v. Worldwide Insurance Group, 140 P.L.J. 185 (C.P. Allegheny Co. 1992). As a result, several courts have held that a plaintiff may not seek section 8371 punitive damages for the alleged denial of first party benefits by an insurer which fall under section 1797 of the MVFRL. Elliott, 786 F. Supp. at 492; Knox, 140 P.L.J. at 190; see, e.g., Livecchi v. Prudential Property and Casualty Insurance Co., Civ. A. No. 91-3712, 1992 WL 22233 (E.D. Pa. February 4, 1992); Williams v. State Farm Mutual Insurance Co., 763 F. Supp. 121, 127 (E.D. Pa. 1991); Danton v. State Farm Mutual Automobile Insurance Co., 1991 WL 52794 at *4 (E.D. Pa. April 4, 1991) ("[T]he legislature intended for the MVFRL Act 6 Amendments to provide the exclusive first party remedy for bad faith denials by insurance companies in regard to medical bills for automobile accident injuries"). In addition, in Carson v. ITT Hartford Insurance Group, 1991 WL 147469 (E.D. Pa. 1991), the district court stated "In claims for first-party benefits under the MVFRL, the detailed procedures and remedies set forth in Sections 1797 and 1798 are controlling." 1991 WL 147469, *2. Thus, based on the exclusive nature of the remedies set forth in section 1797 and 1798 of the MVFRL, the courts of this jurisdiction have held that a plaintiff does not have a viable claim for punitive damages under section 8371. Elliott, 786 F. Supp. at 492.

VII. TRENDS IN FRAUD AND BAD FAITH LITIGATION

Recent trends in fraud and bad faith litigation will be discussed during the lecture.

45-72