1-1989

No Faith in Bad Faith

Michael Cohen

Follow this and additional works at: https://repository.uchastings.edu/hastings_law_journal

Part of the Law Commons

Recommended Citation
Available at: https://repository.uchastings.edu/hastings_law_journal/vol41/iss1/7

This Note is brought to you for free and open access by the Law Journals at UC Hastings Scholarship Repository. It has been accepted for inclusion in Hastings Law Journal by an authorized editor of UC Hastings Scholarship Repository. For more information, please contact wangangela@uchastings.edu.
No Faith In Bad Faith

by

MICHAEL COHEN*

Insurance is boring. In our thirty-second-attention-span world, it is hard to appreciate the benefits and implications of an insurance policy until we need one. Yet surprisingly, insurance was a hot topic of discussion among Californians in the fall of 1988 and, despite a massive media campaign financed by the insurance industry, California’s voters stunningly won the right to increased regulation of insurance companies by passing Proposition 103.1 These same voters undoubtedly would be surprised to learn that other, far reaching changes have occurred regarding the regulation of insurance companies, and that these changes in the law deprive many Californians of an important check against unregulated insurer misconduct while granting a “royal bonanza” to insurance carriers.2

These changes involve judicial reconsideration of California’s bad faith laws as they apply to insurance companies. Under bad faith law, an insurer that fails to deal with a policyholder fairly or reasonably may be liable for large damage awards far exceeding the dollar value of a particular policy.3 In this way, the courts bestowed upon each individual policyholder a powerful tool against unfair insurance practices.

Since 1958, the California judiciary has recognized the importance of preventing insurer misconduct by steadily developing this common law action of bad faith.4 But three recent judicial decisions, two by the California Supreme Court5 and one by the United States Supreme Court,6 combine to severely limit the scope and applicability of bad faith actions against insurance companies.

---

* B.A. 1986, Univ. of Wisconsin; Member, Third Year Class.
These decisions effectively bar a substantial portion of the population from bringing bad faith actions against insurance companies. Specifically, these cases prevent individuals receiving insurance through employee benefit plans from bringing bad faith actions against their insurers. Instead, these people are restricted to the rather limited remedy provisions of the Employee Retirement Income Security Act (ERISA). This Note, after reviewing the development of bad faith actions against insurance companies, analyzes the reasoning behind these three recent cases and demonstrates how and why they should be reconsidered.

I. The Development of Bad Faith Law in California

To understand the full impact of the decisions barring individuals receiving insurance through employee benefit plans from pursuing bad faith actions it is important to review the development of bad faith law in California. This section first discusses the purposes behind, and the evolution of, bad faith actions. The section then briefly outlines the nature of the duty owed, the damages available when an insurer acts in bad faith, and the development of a private cause of action under California's statutory law.

A. Evolution of the Duty to Act in Good Faith

In order to understand the development of the law of bad faith as applied to insurance companies, it is necessary to consider some of the unique characteristics of an insurance contract. In California, the judiciary treats the insurer-insured relationship differently than other contractual relationships. The reasons for this disparate treatment are varied.

Insurance contracts, because of the tremendous inequality of bargaining power between the parties, are considered contracts of adhesion. A consumer has little or no opportunity to bargain over the terms of an insurance contract and must either accept the terms of the agreement as established by the insurer or risk economic ruin.

Another distinguishing characteristic of an insurance contract is that it transcends that of normal contractual relations and is characterized as being quasi-public in nature. As a consequence of this public duty, the courts look to the reasonable expectations of both the insured

---

11. Egan, 24 Cal. 3d at 820, 598 P.2d at 457, 157 Cal. Rptr. at 487.
and the public at large in evaluating the insurer's performance of its contractual duties. The insurance carrier thus is held to a higher standard of conduct "commensurate with the public nature of its business."

Finally, the terms of the insurance contract itself justify deviation from traditional contract law principles. Under traditional contract law, damages for breach of contract are limited to those contemplated at the time the contract is formed. A strict reading of this rule might limit the damages available in actions against insurers to the amount due under the policy. In a bad faith action, however, the insured is suing for damages proximately caused by the insurer's breach, as well as the proceeds allegedly owed to him. If the insurance carrier's "punishment" for wrongly refusing to pay a claim, for example, merely is being forced to pay that which was owed to the insured in the first place, there would be no incentive for the insurer to act in good faith.

California courts also recognize that extra-contractual damages in bad faith actions, particularly damages for emotional distress, are a foreseeable consequence of an insurer's unwarranted breach of an insurance contract. This policy stems from the fact that most consumers purchase insurance to protect themselves from financial loss and the emotional suffering related to such loss. Thus, insurers should know that refusing to pay a valid claim could result in emotional distress. This recognition further distinguishes the insurance contract from more typical commercial contracts, and argues against mechanical application of traditional contract law principles to bad faith breaches.

The substantive law of bad faith in insurance cases reflects careful judicial consideration of the special nature of the insurer-insured relationship and an awareness that traditional contract law is inadequate in this context. In response, the courts of this state developed a common-law theory that commingles tort law with the principle implying a covenant of good faith and fair dealing in every contract entered into in this state.

In the insurance context, this covenant prohibits either party from "impairing the right of one party to receive the benefits of the agree-

13. Id.
15. Egan, 24 Cal. 3d at 809, 598 P.2d at 452, 157 Cal. Rptr. at 482; see also Seaman's Direct Buying Serv. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984) (Tort damages of emotional distress available in bad faith actions, as well as punitive damages, provide the most effective means of deterring insurer misconduct.).
Moreover, because of the special nature of an insurance contract, this duty of good faith places an affirmation duty on the insurer to act reasonably in dealing with its insureds.19

The mix of tort and contract principles governing insurer liability first arose in the case of Communale v. Traders and General Insurance Co.20 In Communale, the insurance carrier refused to accept a settlement offer or defend an action on behalf of its insured, who was being sued for negligence. A verdict was rendered against the insured for an amount exceeding his policy limits, and he sued his insurance carrier to recover the portion of the judgment that exceeded the policy coverage.21

The court held that the insurer failed to consider adequately the interests of its insured by refusing to defend the action or pursue settlement opportunities. In so doing, the insurer had violated the covenant of good faith and fair dealing.

Significantly, the Communale court distinguished an insurance carrier's liability for merely breaching a term of the contract from its liability for failing to fulfill its obligations under the covenant of good faith and fair dealing.22 Though derived from the parties' contractual relationship, the duty of good faith and fair dealing goes "deeper than the mere surface of the contract,"23 encompassing liabilities that sound in tort as well as contract.24

The California Supreme Court expressly recognized the tortious nature of a bad faith breach of the duty to accept reasonable settlement offers in the landmark case Crisci v. Security Insurance Co.25 The facts in Crisci are similar to those of Communale. The plaintiff was an insured who sued her insurance company for unreasonably refusing to accept a settlement offer in a suit brought against her for negligence.26 The court, relying on Communale, reaffirmed the insurance carrier's duty to accept reasonable settlement offers in behalf of its insured, even though the express terms of the insurance policy imposes no such duty.27

The court stated that the covenant of good faith and fair dealing obligates an insurer to "give the interests of the insured at least as much consideration as it give to its own interests."28 The court's test for deter-

18. Id.
20. 50 Cal. 2d 654, 328 P.2d 198 (1958).
21. Id. at 658, 328 P.2d at 200.
22. Id. at 659, 328 P.2d at 201.
23. Id. at 658, 328 P.2d at 200-01.
24. Id. at 663, 328 P.2d at 203.
26. Id. at 427, 426 P.2d at 175, 58 Cal. Rptr. at 15.
27. Id. at 429, 426 P.2d at 176, 58 Cal. Rptr. at 16.
28. Id.
mining whether these interests have been considered properly was “whether a prudent insurer without policy limits would have accepted the settlement offer.”

Finally, the Crisci court, consistent with characterizing a breach of the covenant of good faith as a tort, approved the plaintiff’s recovery of damages for emotional distress. In approving these extra-contractual damages the court noted that consumers do not purchase insurance “to obtain commercial advantage,” rather they purchase insurance mainly for “peace of mind and security.”

In Gruenberg v. Aetna Insurance Co., the California Supreme Court further extended its special treatment of the insurer-insured relationship beyond cases of wrongful refusal to settle, and applied the principle to an insurer’s unreasonable refusal to pay the policy claims of its insured. The court viewed the duty to accept reasonable settlements and the duty to handle the claims of its insured in good faith as two different aspects of the same duty. The court stated:

[T]he insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, [if] it fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of the implied covenant of good faith and fair dealing.

Judicial interpretation of bad faith law after Gruenberg has involved an essentially harmonious process of clarifying the insurer’s duties under the implied covenant of good faith and fair dealing, and of establishing standards for awarding damages in successful bad faith actions.

B. The Nature of the Duty Owed

Unreasonable conduct by the insurer is the gravamen of bad faith claims. Although there is no strict test for breach of the covenant of good faith, the factors that tend to show insurer bad faith include: failure to thoroughly investigate a claim; failure to evaluate a claim objectively; interpreting policy provisions in an unduly restrictive manner; purposeful delay in the payments of claims; abusive or coercive practices

29. Id.
30. Id. at 434, 426 P.2d at 179, 58 Cal. Rptr. at 19.
31. Id.
33. Id. at 573-74, 510 P.2d at 1036-37, 108 Cal. Rptr. at 484-85.
34. Id. at 574, 510 P.2d at 1037, 108 Cal. Rptr. at 485.
36. Id., 598 P.2d at 456, 157 Cal. Rptr. at 486.
to compel the compromise of a claim; and unreasonable conduct during litigation.\textsuperscript{37}

The insurer's duty of good faith, however, is not limitless. An erroneous denial of a claim for benefits, in itself, does not result in extra-contractual liability. The denial must be in bad faith (\textit{i.e.}, unreasonable) to be actionable.\textsuperscript{38} Moreover, traditional contract law limitations, such as the statute of limitations and the requirement of standing to sue, apply.\textsuperscript{39} An insurer also can plead as an affirmative defense that the insured has acted in bad faith or has made proper performance of the insurer's contractual duties impractical.\textsuperscript{40}

C. Damages

The damages that are recoverable in bad faith actions further reflect the judiciary's cognizance of the special nature of the insurer-insured relationship. A successful plaintiff in a bad faith action is entitled to recover the insurance policy proceeds.\textsuperscript{41} Moreover, in first party actions, which often involve disability payments or other long term benefits to be paid in the future, future policy benefits may be recovered under a tort theory, even though such benefits would not be available under contract law.\textsuperscript{42}

In addition to recovering the proceeds of the policy, a successful litigant may be compensated for other economic harm caused by the insurer's bad faith. In cases like \textit{Communale} and \textit{Crisci}, this rule may include compensation for excess judgments rendered against the insured arising from the insurer's wrongful refusal to settle.\textsuperscript{43}

Perhaps the most powerful aspect of California's bad faith law is the availability of damages for emotional distress. The availability of these damages recognizes the emotional repercussions that may flow naturally from a bad faith breach of an insurance contract.\textsuperscript{44}

Finally, if the tortious bad faith of the insurer rises to levels of extreme indifference to the insured's interests, the court may impose punitive damages.\textsuperscript{45} The justification for the imposition of exemplary dam-

\textsuperscript{37} S. Ashley, \textit{Bad Faith Liability \$ 2.2 (1987).}
\textsuperscript{38} \textit{Egan}, 24 Cal. 3d at 818-19, 598 P.2d at 456, 157 Cal. Rptr. at 486.
\textsuperscript{41} Jacobs, \textit{Bad Faith Considerations}, in \textit{Bad Faith Litigation and Insurer vs. Insurer Disputes} 81 (R.D. Williams, Chairman, ed. 1987).
\textsuperscript{42} \textit{Id.}
ages is that in cases of particularly egregious bad faith, the insurer commits "a wrong not only to his insured but . . . also . . . a breach of its public duty." Punitive damages thus serve as a powerful means of deterring socially unacceptable business practices within the insurance industry.

D. Statutory Bad Faith Claims

The emerging common-law action for bad faith has served as an important check against unregulated insurer misconduct. Insurance carriers in California also are subject to regulation via the Unfair Trade Practices Act, which is codified in the Insurance Code. Section 790.03 of the Act describes certain insurance practices that are prohibited for being either unfair methods of competition or unfair or deceptive business practices. In 1972, subdivision (h) was enacted enumerating a number of claims practices that are prohibited expressly under the Act:

1. Misrepresenting to claimants pertinent facts or insurance policy provisions relating to any coverages at issue.
2. Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
3. Failing to adopt . . . reasonable standards for the prompt investigation and processing of claims . . . .
4. Failing to affirm or deny coverage . . . within a reasonable time after proof of loss requirements have been completed and submitted . . . .
5. Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.
6. Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered . . . .
7. 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 . . . .
8. Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured, his representative, agent or broker.
9. Failing, after payment of a claim, to inform insureds or beneficiaries . . . of the coverage under which payment has been made.
10. Making known to insureds . . . a practice of the insurer of appealing from arbitration awards in favor of insureds . . . for the purpose of compelling them to accept settlements . . . .

46. Note, supra note 10, at 714.
47. Egan, 24 Cal. 3d at 819-21, 598 P.2d at 457-58, 157 Cal. Rptr. at 482-88.
49. CAL. INS. CODE § 790.03 (West 1989).
(11) Delaying the investigation or payment of claims.

(12) Failing to settle claims promptly, where liability has become apparent, under one portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

(13) Failing to provide a reasonable explanation... for the denial of a claim or for the offer of a compromise settlement.

(14) Directly advising a claimant not to obtain the services of an attorney.

(15) Misleading a claimant as to the applicable statute of limitations.50

These unfair claims practices bear a striking resemblance to the common-law elements of bad faith.51 A violation of subdivision (h) of the Unfair Practices Act almost assuredly also would constitute a violation of the covenant of good faith and fair dealing. Yet despite these obvious parallels, the insurance industry "believed and relied upon the proposition" that the statute was enforceable only by the Insurance Commissioner.52 As early as 1973, however, some appellate courts were willing to imply a private cause of action under the statute.53 In 1979, the California Supreme Court handed down its landmark decision in Royal Globe Insurance Co. v. Superior Court.54 There, the court rejected the argument that the insurance commissioner had the exclusive authority to enforce the Act and held that a private litigant may maintain a cause of action under section 790.03(h).55 In so holding, the court not only recognized an insured's right to sue his insurer under the statute, but also extended the implied private cause of action to third party claimants who are essentially strangers to the contract.56

Because Royal Globe guaranteed the insured's right to maintain a statutory action sounding in bad faith, and extended this right to third party claimants, it represents the zenith of judicial recognition of consumer rights in the field of insurance law. But Royal Globe also led to considerable confusion in California's lower courts57 and provoked a

50. Id.
51. See supra notes 35-37 and accompanying text for indicators of bad faith under the common law.
52. Jacobs, supra note 41, at 79, 96.
55. Id. at 885-88, 592 P.2d at 332-34, 153 Cal. Rptr. at 845-47.
56. Id. at 888-91, 592 P.2d at 334-36, 153 Cal. Rptr. at 847-49 (A third party claimant is an individual who has been injured by the insured. A first party claimant is the insured.).
rash of scholarly criticisms. Thus, while *Royal Globe* undoubtedly pushed the law of bad faith to its furthest reaches, it also spelled the beginning of bad faith's descent. The judiciary's recent restrictions of bad faith have been, at least in part, in response to the perceived excesses of *Royal Globe*. In order to understand the full extent of these recent judicial limitations on California's bad faith law, however, one must first turn to the United States Supreme Court and the complicated issue of ERISA preemption.

II. Bad Faith Law and ERISA Preemption

The Employee Retirement Income Security Act (ERISA) is a comprehensive piece of legislation regulating the administration of employee benefit plans. To effectuate an orderly and uniform administration of ERISA's mandates, the statute contains a broad preemption clause. Traditionally, the United States Supreme Court has interpreted this preemption clause liberally, invalidating state laws that "relate to" employee benefit plans because they intrude on Congress' exclusive jurisdiction over this subject.

The United States Supreme Court, while further interpreting the scope of ERISA preemption, dealt the right of insureds to demand fair treatment from their insurance carriers by maintaining a cause of action for bad faith a serious setback when it decided *Pilot Life Insurance Co. v. Dedeaux*. In *Pilot Life*, the plaintiff sought to bring an action, based on Mississippi's common law of bad faith, alleging improper processing of a claim for benefits under an ERISA-regulated employee benefit plan. A unanimous Supreme Court held that the plaintiff's action against the plan's insurer was preempted by ERISA and the case was dismissed.

The effect of this holding cannot be overstated. Over 100 million Americans receive some of their insurance through ERISA-regulated

---

59. See infra notes 73-74 and accompanying text.
61. See infra note 67 and accompanying text.
64. Id. at 57.
employee benefit plans. In California, over ninety percent of all workers obtain some significant insurance coverage through their employee benefit plans. Under *Pilot Life*, none of these individuals may bring actions for bad faith. Instead, they must content themselves with suing under federal law using ERISA's rather limited remedy provisions.

A. ERISA Preemption: *Pilot Life Insurance Co. v. Dedeaux*

The scope of preemption of state laws is described in three sections of ERISA. ERISA begins with the broad statement that its provisions "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." This sweeping language is limited by a "saving" clause, which provides that ERISA shall not be "construed to exempt or relieve any person from any law of any State which regulates insurance." This saving clause is, in turn, limited by the "deemer" clause, which provides that no employee benefit plan "shall be deemed to be an insurance company or other insurer . . . for purposes of any law of any State purporting to regulate insurance." Thus, under ERISA's preemption provisions a state law is preempted if it "relates to" an employee benefit plan. The saving clause provides an exception to this broad rule to state laws regulating insurance. But a state cannot simply "deem" a plan to be an insurer in order to bring the plan within the state's regulatory jurisdiction.

In deciding whether ERISA preempted Mississippi's common law of bad faith in the context of an employee benefit plan, the *Pilot Life* Court focused on three issues: whether the plaintiff's bad faith cause of action "related to" an employee benefit plan within the meaning of the preemption provision; whether Mississippi's bad faith law is a law that "regulates insurance" within the meaning of the saving clause and thus is exempt from preemption; and what effect should be given to Congress' apparent intention that ERISA's civil enforcement provisions provide the sole remedies available to aggrieved employee benefit plan participants and beneficiaries.

Relying on two previous Supreme Court cases that construed the boundaries of the preemption clause very broadly, the *Pilot Life* Court summarily concluded that the Mississippi common law of bad faith

---

raised in the plaintiff's complaint sufficiently related to an employee benefit plan to fall within ERISA's general preemption provision.\textsuperscript{72}

The Court noted that under its earlier holdings the preemption clause was given an "expansive sweep . . . such that a state law 'relate[s] to' a benefit plan . . . if it has a connection with or reference to such a plan."\textsuperscript{73} The Court also emphasized that "the preemption clause is not limited to 'state laws specifically designed to affect employee benefit plans.'"\textsuperscript{74} Thus, due to the breadth of its earlier holdings the Court was able to conclude that the plaintiff's action was preempted because of its proximate relation to an employee benefit plan.

The Court then considered the primary issue before it: whether the bad faith cause of action was a means of regulating insurance within the meaning of the saving clause and thus not preempted by ERISA. In determining this question, the Court relied on its earlier holding in Metropolitan Life Insurance Co. v. Massachusetts.\textsuperscript{75}

In Metropolitan Life, the Court established a two-part test for determining whether a law regulates insurance within the meaning of ERISA's saving clause. First, the Court considered whether, from a "common sense" point of view, the law in question regulated insurance.\textsuperscript{76} Second, the Court applied a three-part analysis that had been developed for determining whether a law regulates insurance in connection with the McCarran-Ferguson Act, which exempts insurance companies from federal antitrust laws.\textsuperscript{77} The three McCarran-Ferguson factors are: whether the insurance practice transfers or spreads policyholder risk; whether the practice is an integral part of the insurer-insured relationship; and whether the practice is limited to entities within the insurance industry.\textsuperscript{78} Examination of Metropolitan Life's application of these factors reveals that no single factor is dispositive; if application of this test indicates that a law regulates insurance, then the law is properly within the saving clause and is not preempted by ERISA.\textsuperscript{79}

In applying this test, the Pilot Life Court first concluded that a "common sense" understanding of the phrase "regulates insurance" does not support the conclusion that Mississippi's law of bad faith falls within

\textsuperscript{72} Pilot Life, 481 U.S. at 47-48.
\textsuperscript{73} Id. at 47 (citation omitted).
\textsuperscript{74} Id. at 47-48 (quoting Shaw v. Delta Air Lines, Inc., 463 U.S. 85 (1983)).
\textsuperscript{75} 471 U.S. 724 (1985).
\textsuperscript{76} Id. at 740-41. In Metropolitan Life, the Massachusetts law at issue required that health insurance companies provide certain minimum health care benefits. The Court rejected defendant Metropolitan Life's assertion that ERISA preempted the statute. 471 U.S. at 746.
\textsuperscript{77} Id. at 743. The McCarran-Ferguson Act also guarantees the exclusive jurisdiction of the states over the regulation of insurance companies. 15 U.S.C. §§ 1011-1015 (1982 & Supp. IV 1988).
\textsuperscript{78} Id. at 743 (citing Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 129 (1982)).
\textsuperscript{79} Id.
the saving clause. The Court interpreted "common sense" and the third McCarran-Ferguson factor to constitute essentially the same requirement: to be classified as a law regulating insurance, a law must not merely affect the insurance industry, it also must be "specifically directed toward that industry." The Court conceded that Mississippi's law of bad faith had been identified with the insurance industry, but it noted that the roots of the law were "firmly planted in the general principles of Mississippi tort and contract law." Thus, because Mississippi's law of bad faith was not directed specifically at the insurance industry, it failed to satisfy the requirements of both the "common sense" test and the third McCarran-Ferguson factor.

Without any supporting discussion, the Court proceeded to declare that the law in question did not affect the spreading of policyholder risk. Consequently, Mississippi's law of bad faith also failed to satisfy the second McCarran-Ferguson factor.

The Court was a bit more judicious as to whether the state's common law of bad faith had an integral effect on the insurer-insured relationship. Because an insurer may incur liability for breach of contract under bad faith law, the Court determined that the bad faith cause of action affected the insurer-insured relationship. The Court was unwilling, however, to characterize the law as having an integral effect, and described its effect on the insurer-insured relationship as being "attenuated at best."

The Court summed up by stating that, at most, the Mississippi law satisfied only one of the three McCarran-Ferguson factors and, according to Metropolitan Life, could not be characterized as a law regulating insurance. Thus, the plaintiff's cause of action was not within the saving clause, and consistent with the Court's earlier finding that the law "related to" an employee benefit plan, it was preempted by ERISA.

Having effectively decided the case, the court could have stopped there. Instead, it continued, stating: "[I]n the present case, moreover, we are obliged in interpreting the saving clause to consider not only the factors by which we were guided in Metropolitan Life, but also the role of

81. Id.
82. Id. (emphasis added).
84. Pilot Life, 481 U.S. at 50-51.
85. Id.
86. Id. at 51.
the saving clause in ERISA as a whole." The Court then proceeded to reinterpret radically the saving clause by asserting that Congress intended ERISA's remedies to be the sole form of recourse for aggrieved plan participants. In making this determination the Court explored ERISA's legislative history.

First, the Court suggested that the comprehensive nature of ERISA's civil enforcement scheme provides "strong evidence that Congress did not intend to authorize other remedies that it simply forgot to incorporate expressly." The Court further concluded that the availability of diverse state-law remedies for bad faith would undermine the creation of a uniform body of federal law and thus deter the formation of employee benefit plans. Finally, the Court found in ERISA's legislative history a congressional intent that the preemptive force of ERISA parallel that of the Labor-Management Relations Act (LMRA). Section 301 of the LMRA has a preemptive force so powerful that it displaces entirely any state law that requires a court to interpret a labor contract. By way of this analogy, the Court found additional support for concluding that Congress intended ERISA's remedy provisions to be exclusive in their application.

Because the Court's discussion of the exclusivity of ERISA remedies was not necessary to decide the case, the implications of its determination of congressional intent are unclear. Nonetheless, the Court's discussion suggests that the congressional policy behind making ERISA's remedies exclusive is powerful enough to preempt even state laws that otherwise would escape preemption by coming within the saving clause. This Note will now consider the impact of Pilot Life, first arguing that it should be given a restricted interpretation, and then examining how it has been interpreted in California.

B. Interpreting Pilot Life

Although the full effect of the Pilot Life decision remained unclear, numerous articles criticizing Pilot Life appeared soon after its publication. Nonetheless, due to the unanimity of the decision, Americans

87. Id.
88. Id. at 51-57.
89. Id. at 54 (emphasis in original) (citation omitted).
90. Id.
92. Id. at 55-56; see 29 U.S.C. § 301 (1982).
probably will have to cope with *Pilot Life* for some time. The key, then, in determining the final effects of *Pilot Life*, particularly on bad faith in insurance actions will depend upon the breadth of interpretation given the Supreme Court’s holding.

The first two issues decided by the *Pilot Life* Court, whether Mississippi’s bad faith law “relates to” an employee benefit plan and whether it is a law regulating insurance within the meaning of the savings clause, are not problematic. The Court’s resolution of these preemption issues by applying the *Metropolitan Life* test is consistent with other Supreme Court holdings and the text of ERISA itself.\(^{94}\) If one reads *Pilot Life* in this limited context, a state’s law of bad faith, which, unlike Mississippi’s law, is directed specifically at the insurance industry and is capable of satisfying the McCarran-Ferguson factors, would be able to escape preemption by coming within the saving clause. California’s bad faith law possibly would be safe from ERISA preemption had the Court stopped its analysis at this point.

On the other hand, the Court’s analysis of the exclusivity of ERISA remedies is entirely inconsistent with its own prior holdings, other important federal laws, and the terms of ERISA itself.

Throughout *Pilot Life* the Supreme Court purported to rely on its earlier decision in *Metropolitan Life Insurance Co. v. Massachusetts*.\(^{95}\) This premise is faulty. Despite expressly affirming *Metropolitan Life*, the decision in *Pilot Life* conflicts with *Metropolitan Life* on a number of important points.\(^{96}\) For example, the *Metropolitan Life* Court stated that, “[t]he presumption is against preemption, and we are not inclined to read limitations into federal statutes in order to enlarge their preemptive scope.”\(^{97}\) More importantly, *Metropolitan Life* stands for the proposition that if a state law meets the test for a law regulating insurance, it is exempt from preemption.\(^{98}\)

If *Pilot Life*’s discussion of ERISA remedies is interpreted broadly, the essential holding of *Metropolitan Life* is undermined. To argue that ERISA preempts any state law granting remedies to employee-plan participants, regardless of whether the state law regulates insurance or not, limits the vitality of *Metropolitan Life* to only those laws that do not provide remedies to employee-plan participants. A broad reading of *Pilot Life* would allow the Supreme Court to alter the meaning of ERISA’s saving clause; preemption of a state law would turn on whether it pro-

\(^{94}\) See infra notes 95-101 and accompanying text.

\(^{95}\) 471 U.S. 724 (1985).


\(^{98}\) Id. at 746.
vides a remedy, not, as contained within the statute, whether the law regulates insurance. Since it is difficult for a law to "regulate" without providing remedies, a broad reading of Pilot Life would completely undermine the holding of Metropolitan Life.

Furthermore, a broad interpretation of Pilot Life also would conflict with the McCarran-Ferguson Act. The McCarran-Ferguson Act was enacted to exempt insurance companies from federal antitrust laws and to confer upon the states jurisdiction for the regulation of insurance companies.99 The mandate of the Act is clear. First, the Act provides that the insurance industry shall be subject to state legislation.100 Second, the Act prohibits any federal law from intruding upon state jurisdiction in insurance regulation, "unless such Act specifically relates to the business of insurance."101

ERISA is not a law specifically related to the business of insurance, because it governs noninsurance aspects of employee benefit plans. Moreover, a broad interpretation of Pilot Life, clearly would allow ERISA to impair a state's right to regulate insurance companies through application of its bad faith law. Thus, a broad reading of Pilot Life would contravene the McCarran-Ferguson Act.

Additionally, the terms of ERISA itself suggest the inappropriateness of interpreting Pilot Life as allowing wide preemption of state bad faith law. Despite a rather selective legislative history, the Pilot Life Court was able to imply only that ERISA's remedies should be the sole form of recourse for a plan participant alleging bad faith processing of a claim.102 Contrast this conclusion with the text of ERISA's saving clause which states that ERISA "shall not be construed to exempt or relieve any person from any law of any state which regulates insurance."103

Two fundamental precepts of statutory construction are that courts are to interpret legislation, first and foremost, according to its plain meaning, and that the express terms of a statute supercede implied terms.104 The plain meaning of the saving clause prohibits any interpretation of Pilot Life that would allow the preemption of a state law regulating insurance.

Finally, there are important policy reasons for limiting the scope of Pilot Life. A broad reading of Pilot Life would sacrifice important consumer protections obtained through the law of bad faith. The Pilot Life Court suggests that the consumer's interest in prompt and fair claims

102. Pilot Life, 481 U.S. at 52.
procedures is outweighed by the public’s interest in encouraging the formation of employee benefit plans. The Court concluded that this congressional policy would be “completely undermined” if employee plan participants could access remedies under state law that were unavailable under ERISA. A brief consideration of the purposes behind ERISA’s preemption provisions sheds considerable doubt on this conclusion.

ERISA was enacted to require disclosure of and provide safeguards with respect to the establishment, operation, and administration of employee benefit plans. Congress sought to prevent abuses of the special responsibilities held by those dealing with the plans. Specifically, Congress sought to prevent self-dealing, imprudent investing, and misappropriation of funds by plan fiduciaries.

The initial formation of employee benefit plans, however, remains voluntary. Because ERISA does not compel the formation of such plans, Congress sought to encourage plan formation by easing the burdens of multi-state administration. Congress reasoned that a uniform body of federal law governing actions arising under employee benefit plans would accomplish this purpose because employers would not have to administer their plans differently in each state, in order to comply with varying state laws. This was the goal Congress sought to achieve by enacting ERISA’s broad preemption provision.

Considering Congress’ intention of encouraging plan formation, it is difficult to see how permitting state law actions for bad faith would undermine this policy. Bad Faith actions are directed at insurer misconduct, not the mismanagement of employee benefit plans. Thus, the existence of diverse state law actions for bad faith would not adversely affect the ease of employer administration of benefit plans or demand the continuous allocation of company assets: the two results Congress sought to avoid by enacting ERISA’s broad preemption provision.

Granted, because insurance, in this context, is obtained through an employee benefit plan it does “relate to” ERISA. Because bad faith actions address neither management or operation of such plans, however, this “relationship” is negligible.

This tenuous relationship between bad faith actions and the uniform, multi-state administration of employee benefit plans contrasts sharply with the very clear consumer protections that bad faith provides.

105. See Note, supra note 83, at 1374.
106. Id.
108. Id. at 15.
109. Id. at 12.
110. Id. at 8-11.
111. Id.
112. See supra note 35 and accompanying text.
Thus, the slight increase in the ease of administering ERISA plans would seem to be outweighed by the important regulatory function of bad faith.

In sum, a broad interpretation of *Pilot Life* would conflict with established federal laws, the Supreme Court's own precedent, the plain meaning of ERISA's saving clause, and a common sense balancing of the interests involved.

C. Interpretations of *Pilot Life* in Light of California Insurance Code Section 790.03(h)

It was inevitable that federal and state courts would be forced to resolve the question of how broadly *Pilot Life* should be interpreted. *Pilot Life*, and to some extent Congress itself, had created an unavoidable conflict. On one hand, Congress apparently intended ERISA's remedies to be the exclusive form of relief in actions by employee plan participants. On the other hand, a whole body of federal law, including ERISA itself, guaranteed states the right to regulate insurance companies.

In California resolution of this conflict was particularly important. Section 790.03(h) of the Unfair Practices Act gives Californians, unlike Mississipians, access to a statutory based law of bad faith. This is significant because the *Pilot Life* court had held that Mississippi's common-law action of bad faith was not a law regulating insurance, and thus not within the protection of the saving clause, because it was not directed specifically at the insurance industry.114

Section 790.03(h), on the other hand, appears in the insurance code and thus is specifically directed at the insurer-insured relationship. A private cause of action under section 790.03(h) would likely come within the saving clause's prohibition that "ERISA shall not be construed to exempt or relieve any person from any law of the state which regulates insurance."115

Federal and state courts split, however, as to whether ERISA preempts causes of action under section 790.03(h).116 Two cases in particular, Roberson v. Equitable Life Assurance Society of the United States117 and Goodrich v. General Telephone Co.,118 exemplify different ways that courts have tried to resolve this conflict.

114. See supra note 81 and accompanying text.
In *Roberson*, the plaintiff had brought an action against his group health insurer for wrongful denial of benefits. After removal from state to federal court, the federal district court granted the defendant's motion for summary judgment and concluded that ERISA preempts actions by plan participants brought under the Unfair Practices Act.119 The plaintiff in *Roberson* did not contest the assertion that his cause of action “related to” an employee benefit plan. Nor did he contest the theory that, under *Pilot Life*, all of his claims based on California’s common law of bad faith were preempted.120 The plaintiff did argue, however, that section 790.03(h) of the Unfair Practices Act is a law regulating insurance and, as such, escapes preemption by coming within the saving clause.121

Accordingly, the *Roberson* court began its discussion by applying the two-part saving clause analysis developed in *Metropolitan Life*.122 The court conceded that section 790.03(h) has an “obvious” connection to insurance regulation and that it would “strain logic” to argue that it is not directed specifically at the insurance industry.123 Thus, section 790.03(h) satisfied both the “common-sense” test, and the third McCarran-Ferguson factor of being specifically directed at the insurance industry.

The court determined, however, that “it is unlikely that section 790.03(h) meets either of the other two factors of the McCarran-Ferguson test.”124 The court distinguished the mandated mental health benefits law in *Metropolitan Life* and found that section 790.03(h) does not affect the transfer of policyholder risk. The basis of this distinction was that the Massachusetts law in *Metropolitan Life* had regulated the substantive terms of insurance policies, while section 790.03(h) merely regulated enforcement of claims grievances in a procedural manner.125 Thus, the court concluded that section 790.03(h) did not appear to transfer policyholder risk.

Next, the *Roberson* court decided that because section 790.03(h) provides specific standards for the processing of claims, “it affects the insurer-insured relationship more profoundly than the Mississippi bad faith law in *Pilot Life*.126 The court determined, however, that in enact-

---

120. *Id.* at 418-19.
121. *Id.* at 419.
122. *Id.* at 422-23.
123. *Id.* at 422.
124. *Id.*
125. *Id.*
126. *Id.*
ing the saving clause Congress was concerned with laws that “center around the contract of insurance.”\textsuperscript{127} Because section 790.03(h) does not “regulate the terms of the contract itself,” the court reasoned that it did not “regulate the business of insurance as that term is defined under the McCarran-Ferguson Act.”\textsuperscript{128}

But the court did not base its final determination of the issue on its saving clause analysis. Rather the court treated as dispositive the \textit{Pilot Life} ruling that Congress intended ERISA remedies to be exclusive in actions by employee benefit plan participants.\textsuperscript{129} In so doing, the \textit{Roberson} court interpreted \textit{Pilot Life} broadly and concluded that “even assuming that section 790.03(h) regulates insurance and is therefore within the scope of the saving clause, it must be preempted for infringing on the same exclusive civil remedy provisions that were dispositive in \textit{Pilot Life.”}\textsuperscript{130}

\textbf{(2) Goodrich—a limited reading of Pilot Life}

The facts in \textit{Goodrich v. General Telephone Co.}\textsuperscript{131} nearly duplicate those of \textit{Pilot Life} and \textit{Roberson}. Yet, a unanimous California Court of Appeals held that ERISA did not preempt an action by an employee benefit plan participant under section 790.03(h).\textsuperscript{132} As in \textit{Roberson}, the \textit{Goodrich} court applied the two-part saving clause analysis from \textit{Metropolitan Life} and \textit{Pilot Life} to section 790.03(h). The court similarly considered Congress’ apparent intention that ERISA remedies be exclusive, but by distinguishing the holding in \textit{Pilot Life} and by refusing to ignore the plain meaning of the saving clause, the \textit{Goodrich} court came to a different conclusion.

The \textit{Goodrich} court, in accord with \textit{Roberson}, determined that section 790.03(h) regulated insurance under a common-sense meaning of the phrase and was directed specifically at the insurance industry.\textsuperscript{133} The court noted that the Unfair Practices Act is described expressly as a law regulating insurance. Thus, the court stated that “common sense would be severely strained if we were to hold the act is not a law regulating insurance in the face of an explicit legislature declaration that it is.”\textsuperscript{134} Accordingly, section 790.03(h) passed both the common-sense test and the third McCarran-Ferguson factor. The court also agreed with \textit{Rober-
son, without explanation, that section 790.03(h) did not affect a transfer of policyholder risk and thus failed to pass the second McCarran-Ferguson test.\(^{135}\)

The court refuted, however, the Roberson court's claim that section 790.03(h) did not have an integral effect on the insurer-insured relationship. First, the Goodrich court noted that section 790.03(h) compels certain good faith claims practices within the insurance industry by "specifically regulating the obligations of an insurance company to its policyholders."\(^{136}\) Thus, section 790.03(h) directly and integrally affects the insurer-insured relationship.

In addition, the court directly refuted Roberson's claim that section 790.03(h) is not substantive because it does not regulate the terms of an insurance contract. The court noted that, "'[i]t is well settled that insurance policies are governed by the statutory and decisional law in force at the time the policy is issued. 'Such provisions are read into each policy issued thereunder, and become part of the contract.'"\(^{137}\) Thus, the provisions of section 790.03(h) are incorporated into every policy drawn up in California and regulate the terms of the contract itself. In summing up its saving clause analysis, the court stated that section 790.03(h) "fits the other two criteria mentioned in Pilot Life so well we have no difficulty concluding it is a law relating to the business of insurance within the meaning of the McCarran-Ferguson Act and, therefore within the savings clause of ERISA."\(^{138}\)

Because the Goodrich court had determined that section 790.03(h) is a law regulating insurance within the meaning of the saving clause, it was able to distinguish Pilot Life's holding. Specifically, the court reasoned that Pilot Life's analysis, particularly in regard to ERISA remedies, had arisen in connection with a state law that the court had determined did not regulate insurance.\(^{139}\) Thus, the Pilot Life Court's conclusion that the exclusivity of ERISA remedies was dispositive in that case did not control a case in which the remedy involved a statute that, like section 790.03(h), regulates insurance and therefore is within the express protection of the saving clause.\(^{140}\)

The court, free from the compulsion of adopting Pilot Life in total, proceeded to consider the conflicting congressional policies of exclusive ERISA remedies and Congress' "long-standing policy of deference to state regulation of insurance."\(^{141}\) The court noted that Congress had re-

\(^{135}\) Id.

\(^{136}\) Id.

\(^{137}\) Id. at 688, 241 Cal. Rptr. at 647 (quoting Interinsurance Exchange v. Ohio Cas. Co., 58 Cal. 2d 142, 148, 373 P.2d 640, 643, 23 Cal. Rptr. 592, 595 (1962)).

\(^{138}\) Id. at 684, 241 Cal. Rptr. at 645.

\(^{139}\) Id. at 686-87, 241 Cal. Rptr. at 647.

\(^{140}\) Id.

\(^{141}\) Id. at 687, 241 Cal. Rptr. at 647.
iterated this policy in two separate sections of ERISA's preemption provision. First, the language of the saving clause was clear: laws that regulate insurance are exempt from preemption. Second, section 1144(d) of ERISA prohibited it from "impairing or superseding any law of the United States." The Goodrich Court reasoned that because the McCarran-Ferguson Act prohibits Congress from passing laws impairing state laws regulating insurance, unless the law is specifically directed at insurance, and because ERISA is not specifically directed at insurance, it cannot supersede section 790.03(h). Thus, because section 790.03(h) meets the McCarran-Ferguson test for regulating insurance, and correspondingly is within the saving clause, it cannot be preempted by ERISA.

The Goodrich court was aware that its holding conflicted with Congress' intention that ERISA remedies be the exclusive means of recourse for actions by plan participants. The court noted, however, that this conflict is "the inevitable result of inherently inconsistent goals expressed in the ERISA preemption provisions." In balancing these competing congressional policies, the Goodrich court found the clear and unambiguous mandates of the saving clause and the McCarran-Ferguson Act more persuasive than the Roberson court's finding of some "unspoken exception to the insurance saving clause." In reference to the Roberson court's conclusion that section 790.03(h) could be preempted despite being a law regulating insurance within the meaning of the saving clause, the court stated, "We have great difficulty with the concept section 790.03, subdivision (h) can be both within and without the scope of the preemption clause. The concept is not only illogical but in direct conflict with the unambiguous language of the statute."

The different conclusions reached by the Roberson and Goodrich courts result from conflicting interpretations of both the saving clause and the scope of Pilot Life’s discussion of ERISA remedies. The issues were defined clearly and the stage was set for the California Supreme Court to resolve this conflict.

III. California's Recent Denial of a Private Cause of Action Under Section 790.03(h) and Its Effect on Bad Faith

Three months before the California Supreme Court was scheduled to address this complicated problem, the issue was rendered moot by the

142. Id.
143. Id.
144. Id. at 684-85, 241 Cal. Rptr. at 645.
145. Id. at 686-87, 241 Cal. Rptr. 647.
146. Id. at 687, 241 Cal. Rptr. 647.
147. Id. at 688, 241 Cal. Rptr. 648.
148. Id.
court's opinion in *Moradi-Shalal v. Fireman's Fund Insurance Companies*. In *Moradi*, the court overturned its earlier decision in *Royal Globe Insurance Co. v. Superior Court* and declared that section 790.03(h) of the Unfair Practices Act no longer sustained a private cause of action in favor of either first or third party claimants.

The combined effect of *Moradi* and *Pilot Life* completely bars employee benefit plan participants from bringing bad faith actions. *Pilot Life* had prohibited plan participants from maintaining a common-law cause of action on a theory of ERISA preemption. *Moradi* now denies these individuals access to a statutory-based action for bad faith on an entirely different theory, without considering the implications of its holding on employee plan participants.

A. *Moradi-Shalal v. Fireman's Fund Insurance Companies*

The court's reasons for overturning *Royal Globe*, and with it the implied private cause of action under section 790.03(h), were varied. The major basis for the court's decision to overrule *Royal Globe* was a number of "adverse consequences" that the *Moradi* court believed *Royal Globe* had created.

Because *Royal Globe* permitted third parties who had been injured by the insured to sue the insurer under 790.03(h), the decision subjected insurance carriers to the threat of multiple litigation. The *Moradi* court reasoned that an insurer could be coerced into accepting inflated settlements, fearing a suit on behalf of its insured, and then a bad faith suit as well. This in turn would raise the cost of doing business in California, with the companies passing the added expense on to innocent consumers.

Another adverse consequence of *Royal Globe's* holding was that it pitted the insured's interests against those of the insurer.

[O]ur holding in *Royal Globe* that insurers owe a direct duty to third party claimants . . . tends to create a serious conflict of interest for the insured, who must not only protect the interests of its insurer, but also must safeguard its own interests from the adverse claims of the third party claimant. This conflict disrupts the settlement process and may disadvantage the insured.

The court also considered certain "analytical difficulties" faced by lower courts when presiding over actions under section 790.03(h).
Most of these difficulties arose as courts sought to define the scope of a *Royal Globe* action. For example, *Royal Globe* held that a third party claimant may not sue the insurer under the statute until the suit against the insured was concluded. Courts, however, came to conflicting interpretations of when a suit is concluded. The *Moradi* court reasoned that these and other difficulties in interpreting the scope of an action under section 790.03(h) involve a delicate balancing of competing policies best left to the legislature.

In addition, to those adverse consequences created by *Royal Globe*, the court reconsidered the legislative history of section 790.03(h). The *Moradi* court disagreed with *Royal Globe*’s conclusion that the wording of the statute clearly implied a private cause of action. Moreover, the court pointed out that the *Royal Globe* decision overlooked the fact that the state’s legislative analyst had described the statute as contemplating only administrative enforcement.

The court also noted that a bill expressly overruling *Royal Globe* had passed the California Senate, but became stalled in the Assembly Ways and Means Committee before being brought to a vote. The court refused to draw the inference requested by the plaintiff that these developments suggested the legislature’s approval of *Royal Globe*. Similarly, the court rejected the plaintiff’s argument that the legislature had tacitly consented to *Royal Globe* by amending subsection (h) without addressing the *Royal Globe* issues stating that, “the legislature may have passively acquiesced in *Royal Globe*, but it has never expressly or impliedly adopted the holding in that case.” In sum, the court found the legislative history was at best inconclusive, and left the correctness of *Royal Globe*’s holding in considerable doubt. Thus, the *Moradi* court concluded that the adverse effects and logical inconsistencies generated by *Royal Globe*, when considered in light of an inconclusive legislative intent to create a private cause of action under section 790.03(h), justified overturning its earlier decision.

156. *Id.* at 303, 758 P.2d at 67, 250 Cal. Rptr. at 126.
157. *Id.* at 303-04, 758 P.2d at 68, 250 Cal. Rptr. at 126.
158. *Id.* at 300-01, 758 P.2d at 65-66, 250 Cal. Rptr. at 123.
159. *Id.* at 304, 758 P.2d at 68, 250 Cal. Rptr. at 126.
160. *Id.* at 300, 758 P.2d at 65, 250 Cal. Rptr. at 123.
161. *Id.* at 300, 758 P.2d at 65, 250 Cal. Rptr. at 123-24.
162. *Id.* at 301, 758 P.2d at 66, 250 Cal. Rptr. at 124.
163. *Id.*, 758 P.2d 66, 250 Cal. Rptr. at 126.
164. *Id.* at 304-05, 758 P.2d at 69, 250 Cal. Rptr. at 126. Interestingly, the court declared that its holding would be prospective only, and that actions filed before its decision became final would be decided under the old rule of *Royal Globe*. *Id.* at 305, 758 P.2d at 69, 250 Cal. Rptr. at 127. In the interest of those pending actions, the court then proceeded to resolve many of the analytical difficulties that plagued suits brought under section 790.03(h). *Id.* at 305-13, 758 P.2d at 69-75, 250 Cal. Rptr. at 127-33. The court determined that, for purposes of instigating a “*Royal Globe* action,” settlement is an insufficient conclusion of the underlying...
B. Commercial Life Insurance Co. v. Superior Court of San Diego

Three months later, the California Supreme Court, having agreed to decide the issue of ERISA preemption and actions by employee plan participants under section 790.03(h) before the Moradi decision, addressed the problem in Commercial Life Insurance Co. v. Superior Court of San Diego.\(^6\) In Commercial Life, the court sided with Roberson and declared that ERISA preempts actions brought under 790.03(h) when the action asserts a claim arising under an employee benefit plan.\(^6\)

Of course, the court's decision that ERISA prevents employee benefit plans participants from bringing a private cause of action against the plan insurer under section 790.03(h) was all but meaningless in light of its recent decision in Moradi barring all private actions under section 790.03(h).\(^6\)

Most of the majority's eleven page decision merely recounts the United States Supreme Court's earlier holdings in Pilot Life and Metropolitan Life\(^6\) and restates with approval the Roberson court's analysis of section 790.03(h) in this context.\(^6\)

Finally, the court turned to the crucial issue of how to reconcile the savings clause's mandate that ERISA shall not preempt state laws regulating insurance with the Pilot Life Court's sweeping statements regarding the exclusivity of ERISA's remedy provisions. Here the court, ignoring the Goodrich court's exhaustive rebuttal of Roberson, chose to interpret Pilot Life as broadly as possible. The Commercial Life court though technically superfluous in that case, was completely controlling in this, factually distinguishable, case.\(^6\)

Accordingly, the court held that the federal interest in plan uniformity served by ERISA preemption superseded the state's interest in regulating insurance.\(^6\) The court refused to acknowledge how in so holding it might conflict with ERISA's saving clause. Instead, the court distinguished between state laws that regulate the substance of insurance policies from state laws that provide procedural remedies; holding that the saving clause protects the former from ERISA protection but not the latter.\(^6\)

---

\(^{165}\) Id. at 306, 758 P.2d at 69, 250 Cal. Rptr. at 127.

\(^{166}\) Id. at 472-73, 764 P.2d at 1064, 253 Cal. Rptr. at 687.

\(^{167}\) Id. at 484-85, 764 P.2d at 1066, 253 Cal. Rptr. at 689.

\(^{168}\) Id. 474-81, 764 P.2d at 1059-63, 253 Cal. Rptr. at 682-86.

\(^{169}\) Id. at 481-82, 764 P.2d at 1063-65, Cal. Rptr. at 686-89.

\(^{170}\) Id. at 484, 764 P.2d at 1066, 253 Cal. Rptr. at 689.

\(^{171}\) Id., 764 P.2d at 1066, 253 Cal. Rptr. at 689.

\(^{172}\) Id., 764 P.2d at 1066, 253 Cal. Rptr. at 689.
IV. Rebuilding Bad Faith

The fall from grace of bad faith actions against insurance companies is now complete. The combined effect of *Pilot Life*, *Moradi*, and *Commercial Life* precludes a large percentage of Californians from bringing bad faith actions against their insurers. Both the common-law and statutory avenues of relief that had been available to employee plan participants now are closed.

Theoretically, this result could be avoided by applying a more coherent framework of analysis. Practically, reversing the effects of these judicial decisions will be extremely difficult. This Note proposes that a more sound process of judicial reasoning would better serve the citizens of California by restoring the scope of consumer protections afforded by the law of bad faith.

The fundamental premise of this proposal is that California's law of bad faith provides an important and equitable resolution to problems arising in the context of insurance contracts. Unless one views the law of bad faith as an important consumer right, any attempt at restoring its vitality, at best, is misguided.

Common sense suggests that the law of bad faith protects an important consumer right. The insurer-insured relationship is different than other contractual relationships. The insured is in many regards at the mercy of his insurance carrier. She is unable to negotiate the terms of her contract. Moreover, a bad faith breach of the contract not only deprives the insured of the peace of mind for which she contracted, it may also proximately cause a host of other, extra-contractual damages that would otherwise go unremedied.

Because of the unique bargaining position held by insurers, there is a strong public interest in preventing insurer misconduct. Commensurate with this public duty, insurers are properly held to a higher standard of conduct than parties to an ordinary commercial transaction. Without the sword of bad faith, consumers contract at the mercy of the corporate conscience of the insurance industry.

Cognizant of these realities, the California judiciary developed the law of bad faith. Yet, the present state of affairs presents an anomalous situation. For the sole reason that one receives her insurance through an employee benefit plan rather than through an individual contract, the insured is deprived of the rights of recompensation and the protections that bad faith law provides. One federal district court considering the incongruity of this result stated,

173. See supra note 65-66 and accompanying text.
174. See supra note 166 and accompanying text.
175. See supra notes 9-10 and accompanying text.
176. See supra note 16 and accompanying text.
177. See supra notes 11-13 and accompanying text.
[We] cannot believe that the consumer protections afforded California policyholders were meant to be withdrawn from those persons whose coverage was provided under an employee benefit plan. The interest in ERISA plan uniformity cannot be secured at the expense of the uniform state regulation of those insurers choosing to write policies in California. 178

The first step in restoring bad faith law in California necessarily involves a reconsideration of Moradi-Shalal v. Fireman’s Fund Insurance Companies. 179 Specifically, Moradi could and should have limited its overruling of Royal Globe to prohibit only those actions under section 790.03(h) brought by third party claimants.

It is worthwhile to note that almost all of the “adverse consequences” upon which the Moradi court ultimately relied in overturning Royal Globe stem from third party actions. 180 The problems of multiple litigation and conflict of interest, which Royal Globe created, apply only to suits by third party claimants. It is the second suit against the insurer, brought by the third party claimant that coerces higher settlements, raises the costs of insurance, and compromises the loyalty of the insurer. 181

Similarly, the “analytical difficulties” created by Royal Globe concern the establishment of standards governing actions by third party claimants. 182 Conversely, the common-law action for bad faith provides ample guidance for courts adjudicating first party actions under section 790.03(h) because “violations of the statute against insureds also constitute bad faith under the common law and vice-versa.” 183

The majority’s legislative history analysis was inconclusive, and the dissent in Moradi makes a strong case for continuing to imply a private cause of action, based on both the language of section 790.03(h) and subsequent legislative actions. 184 Nonetheless, the court’s discontinuation of an implied private cause of action under section 790.03(h) clearly derives from those adverse consequences that Royal Globe created. By failing to distinguish first and third party claims, the important statutory right of

180. Id. at 301-02, 758 P.2d at 66-67, 250 Cal. Rptr. at 124-25.
181. Id.
182. Id. at 303-04, 758 P.2d at 67-68, 250 Cal. Rptr. at 125-26.
183. Jacobs, supra note 41, at 79 (emphasis added).
184. Moradi, 46 Cal. 3d at 313-21, 758 P.2d at 75-80, 250 Cal. Rptr. at 133-38 (Mosk, J. dissenting) (Justice Mosk refuted the majority’s claim that the legislature has not tacitly consented to Royal Globe by its subsequent actions. Citing considerable authority, Justice Mosk argued that in amending legislation, the legislature is presumed to know of judicial decisions affecting the amended statute. Thus, Justice Mosk concluded, the failure of the legislature to address Royal Globe in its subsequent considerations of section 790.03(h) “is indicative of an intent to leave the law as it stands in all aspects not amended.” Id. at 318, 758 P.2d at 78, 250 Cal. Rptr. at 136.).
insureds to sue their insurers was destroyed because of its association with the more troublesome claims of third parties.

The majority did not consider the distinction necessary because it felt that other forms of legal redress were adequate to deter insurer misconduct. The court referred to the enforcement powers of the Insurance Commissioner and to the continuing vitality of common-law actions of bad faith in support of this conclusion. These assurances, however, provide little comfort. Since the enactment of section 790.03 in 1959, there is no reported case in which the Insurance Commissioner has taken action against an insurer for unfair or deceptive claims practices. Moreover, one can assume that the Moradi court was aware of Pilot Life and the important issue pending before it as to whether ERISA preempted actions under section 790.03(h). Thus, the court's assurance that their decision does not impair common-law claims of bad faith simply does not apply to those Californians who receive their insurance through employee benefit plans.

It is not unreasonable to expect the court to consider these broader policy issues when making its decision, particularly when the basis of their decision is a policy against permitting a continuance of the adverse consequences of Royal Globe. By failing to distinguish first party claims in their decision and by ignoring the far reaching effect of denying all private causes of action under the statute, the court's judgment reflects an interest in the policy concerns of insurance carriers only. A more equitable and internally consistent resolution of the problems created by Royal Globe would be to overrule that case only in so far as it applies to actions by third party claimants.

If Moradi is limited to continue permitting first party actions by the insured against its insurer under section 790.03(h), the final step in restoring important consumer protections to employee plan participants would be the overruling of Commercial Life. Had Moradi not rendered the issue moot, Commercial Life's consideration of ERISA preemption and section 790.03(h) plainly would be inadequate. If the issue could be revived either by limiting Moradi or via an express legislative grant of a private cause of action under section 790.03(h), further analysis of the issue would suggest that Commercial Life should be overruled.

To understand why Commercial Life should be overruled, and why the Goodrich court's analysis of the issue is superior, a brief reconsideration of the primary issues involved is helpful. According to Pilot Life,

---

185. Id. at 304-05, 758 P.2d at 68-69, 250 Cal. Rptr. at 126-27.
186. Id.
187. Id. at 317, 758 P.2d. at 79, 250 Cal. Rptr. at 135 (Mosk, J. dissenting).
189. See supra notes 167-76 and accompanying text.
Congress intended for ERISA to provide exclusive remedies for actions arising under employee benefit plans. A contrary rule would undermine Congress' policy of promoting uniform laws governing benefit plans by creating the potential for conflicting standards of recovery. In ERISA itself, however, Congress reaffirmed its long-standing policy of deferring to state regulation of insurance companies. Thus, in determining whether section 790.03(h) is preempted under ERISA, courts are faced unavoidably with conflicting congressional policies.

The *Pilot Life* Court exacerbated this conflict by relying on Congress' intention that ERISA remedies be exclusive without counterbalancing Congress' clear intention in ERISA that state laws regulating insurance should be exempt from preemption. Since *Pilot Life* did not need to resolve this conflict in deciding the issue before the Court, the decision provided no guidance for reconciling these competing policies.

The *Roberson* and *Goodrich* courts reflect differing judicial approaches to this problem. The *Roberson* court interpreted *Pilot Life* broadly but ERISA's preemption provisions narrowly. In so doing, the court ignored the plain meaning of the saving clause and other important federal laws. The *Goodrich* resolution of this issue is superior for a number of reasons.

First, the *Goodrich* court's application of the two-part saving clause analysis to section 790.03(h) is more reasonable than the *Roberson* court's. Section 790.03(h) is directed specifically at the insurance industry under a "common sense" understanding of the phrase. Moreover, contrary to the *Roberson* court's conclusion, it has an integral effect on the insurer-insured relationship. This conclusion is supported by the profound regulatory effect of section 790.03(h) on the conduct of insurers in dealing with their insureds. Moreover, the *Roberson* court's specious claim that section 790.03(h) is not a content regulation, and thus not integral to the insurance contract, was refuted persuasively by the *Goodrich* court's recognition that the laws of the state, including section 790.03(h), are incorporated into every insurance policy. Thus, under the test developed by *Metropolitan Life* and applied by *Pilot Life* itself, section 790.03(h) is a law regulating insurance within the meaning of the saving clause.

191. *See supra* notes 88-92 and accompanying text.
192. *See supra* notes 102-03 and accompanying text.
193. *See supra* notes 129-30 and accompanying text.
194. *See supra* notes 133-34 and accompanying text.
196. *See supra* note 136 and accompanying text.
198. *See supra* note 137 and accompanying text.
This finding, however, does not completely resolve the issue. Following the lead set by *Pilot Life*, the *Roberson* court concluded that a state law that provides remedies to employee plan participants is preempted, despite being within the saving clause.\(^{199}\) This conclusion is flawed because it fails to acknowledge ERISA's express prohibition against impairing or invalidating state laws that regulate insurance.

In contrast with the *Roberson* court's single-minded analysis, "the *Goodrich* approach balances competing federal concerns with fidelity to both."\(^{200}\) The *Goodrich* decision recognizes that Congress intended ERISA remedies to be exclusively within the scope of ERISA preemption.\(^{201}\) The scope of ERISA preemption is established clearly in the saving clause. Thus, the *Goodrich* decision absorbs both competing policies in a manner consistent with the structure of ERISA itself.

This more internally consistent interpretation also better serves public policy. Little is accomplished, in terms of the purposes behind ERISA, by preempting bad faith actions arising under ERISA regulated plans. Permitting policyholders to maintain actions against plan insurers will not disrupt the uniform administration of employee benefit plans by employers.\(^{202}\) Preventing policyholders access to state laws of bad faith, however, severely damages the state's ability to regulate insurer misconduct. Thus, a weighing of public policy concerns also favors the *Goodrich* court's resolution of the issue.

**Conclusion**

In retrospect, the most striking aspect of the major cases considering this issue is the way in which the courts have employed questionable judicial reasoning to achieve socially undesirable results. Any one of these cases, taken individually, can be supported on the ground that other laws adequately protect the interests of employee plan participants. When considered together, however, these cases combine to create an unacceptable situation for all but the insurance industry.

The vast number of Californians who obtain insurance through employee benefit plans should not be denied the rights and protections bad faith law provides. There are neither powerful policy reasons, nor overwhelming legal arguments that compel this inequitable conclusion.

In fact, through application of a more coherent framework of analysis and recognition of the manner in which the issues involved relate to each other and to important federal and state laws, the law of bad faith can be restored to its rightful place as an important check.

---

199. *See supra* notes 129-30 and accompanying text.


202. *See supra* notes 112-13 and accompanying text.