Third Party Causes of Action:

Effects on West Virginia Insurance Markets

Provided by the
Offices of the Insurance Commissioner

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Executive Summary

This report is written pursuant to H.B. 4004, passed by the West Virginia Legislature during its 2004 session. The bill, among other things, asked the Insurance Commission to study and report on the legal and economic consequences of West Virginia's third party cause of action and the resulting effects on insurance rates and availability.

The report is organized around three themes: legal history and comparison of West Virginia's law with other states; the economic theory and consequences of the third party cause of action; and the Commissioner's recommendations about the suitability of the law.

Legal analysis indicates that West Virginia is in the decided minority in its approach to the third party doctrine. Only five other states in the nation offer similar protections to extra-contractual insurance parties. The economic consequences of this law are formidable. Economic theory predicts the law will change economic incentives in a way that is unfavorable to the insurance industry and empirical evidence supports this theory. West Virginia is shown to have higher bodily injury claims costs when compared to both national and regional averages. Additionally, West Virginia is shown to have a higher level of litigation on this cause of action when compared to national and regional benchmarks.

As a result of this theory and evidence, the Commissioner recommends the elimination of the private third party cause of action. Consumer and third party protections, however, would continue to exist as the Insurance Commission becomes the preferred jurisdiction for Unfair Claims Settlement Practices claims.

I. Introduction

Insurance contracts, by their very nature, are made between two parties. The insured party desires protection from unforeseeable risks, and the insurance carrier provides that protection for a fee. A classic example of insurance protection occurs when a hailstorm damages a home's roof: the homeowner files a claim against his insurance carrier and payment is made to the homeowner to indemnify him for the loss. Occasionally, the nature of these two-party contracts extends protection to claims made by parties outside the contract. These protections are extended to "third party," or "extra-contractual" claimants, and their rights and protections are also a vital part of the insurance environment. An example of third party coverage occurs when a motorist collides with a parked car: the parked car owner has a claim against the motorist and, indirectly, against the motorist's insurance carrier. In a well-crafted insurance environment, all parties to an insurance setting are treated justly. But if the balance is disrupted, the insurance mechanism does not work efficiently. This report, prepared for the West Virginia Legislature, addresses the insurance environment with respect to third party rights, and makes recommendations about the proper role of the law in this context.

The efficiency of West Virginia's insurance environment with respect to the right of third party claimants has come under much scrutiny. This is a result of our state extending more legal rights to third party claimants than the vast majority of the states. Our courts have extended special rights to third parties by allowing them to directly sue an insurance carrier for unfair trade practices in the settlement process. In most states, this claim has an administrative remedy: the alleged injured party lodges his or her complaint with the insurance commissioner. Given the mixed approach in different jurisdictions, we ask about the ramifications of one approach versus the other. Those that argue for the continuation of

the current approach contend that, absent this protection, third parties can be coerced by the insurance carrier since the insurance company has no contract with the third party and thus no business interest in prompt and complete settlement. The other side argues that extending this right to parties outside of the traditional contract compromises the relationship between the carrier and its insureds. Further, it induces insurance carriers to practice "defensive" settlement practices to avoid getting sued. As a result of this combination of defensive settlements and unfair trade practices awards, the argument goes that the cost of doing insurance business is higher in West Virginia and the risk exposure to the carrier is greater. These higher costs are, in part, passed on to all insurance customers and the legal environment dissuades potential entrants from entering our market. The result, according to this argument, is an insurance climate in West Virginia that is unfavorable for consumers and companies alike.

This is not a new issue, but rather one that has been discussed for many years. The motivation for the present study and this report was provided by H.B. 4004, enacted by the Legislature in 2004. This bill requires, among other things, that the West Virginia Insurance Commissioner report to the Legislature on third party causes of action. This report, under W.Va. Code §33-2-15b, is required to include:

(1) The legal history of the creation of a third party causes of action brought pursuant to Unfair Trade Practices Act as codified in article eleven of this chapter;

(2) An analysis of the impact of third party causes of action upon insurance rates and the availability of insurance in this state;

(3) A summary of the types of data which the commissioner utilized in preparing the analysis: *Provided*, That the commissioner will not disclose information which is otherwise confidential: *Provided, further*, That if the commissioner is unable to obtain data which he or she considers necessary to preparing a full analysis, the commissioner shall state in the report;

(A) The reasons that he or she was not able to obtain the data;

(B) Recommendations or proposed legislation for facilitating the collection of necessary data and protecting proprietary information;

(4) Information on what other states have this cause of action;

(5) Based upon the findings of the commissioner, and if the findings so suggest, proposed legislation to address any reforms needed for third party claims under the Unfair Trade Practices Act;

(c) For the purpose of preparing the report, the commissioner may request from companies authorized to conduct business in this state any information that he or she believes is necessary to determine the economic effect of third-party lawsuits on insurance premiums. The companies shall not be required to provide the information. Any information which the company agrees to provide, shall be confidential by law and privileged, is exempt from disclosure pursuant to chapter twenty-nine-b of this code, is not open to public inspection, is not subject to subpoena, and is not subject to discovery or admissible in evidence in any criminal, private civil or administrative action and is not subject to production pursuant to court order. Notwithstanding any other provisions in this section, while the commissioner is to provide his or her general conclusions based upon the review of the data, the commissioner is not to disclose the information in a manner so as to violate the confidentiality of this section.

This report addresses all of the items the Legislature has requested. For organizational purposes, the report is partitioned into three general themes: legal history and countrywide evaluation of laws involving third party claimants; data collection, economic modeling and measurement of estimated economic impacts; and commissioner's recommendations.

II. Legal History and Countrywide Comparison of Laws

Origins of the Third Party Unfair Trade Practices Act Cause of Action

To understand a third party Unfair Trade Practices Act ("UTPA")[1] claim, we must be reminded of the differences between first party insurance and third party insurance. In first party insurance there are only two parties involved: the insurance company and the insured. With first party insurance, the insurer has a contractual obligation to reimburse the insured, up to the limits of the policy, for covered damages sustained by the insured. Examples of first party insurance include health insurance and automobile collision policies.

In contrast, third party insurance, which is often referred to as "liability insurance," involves three parties: the insurer, the insured and a third party. Under third party insurance, the insurer does not reimburse the insured for his or her own damages but rather pays covered claims brought against the insured by a third party claimant. Examples of third party coverage include automobile liability policies and commercial general liability policies.

It should be noted that under third party insurance, the insurer's contractual duties run only to the insured and not to the third party. The insured basically reaps two primary benefits from a liability policy. First, the insurer must indemnify the insured for settlements or judgments against the insured up to the policy limit. Second, the insurer must defend lawsuits brought against the insured, which includes paying the cost of the defense. In connection with these duties, an insurer usually enjoys the contractual right to settle the claim against the insured, along with the right to decide how any defense will be conducted.

In West Virginia, however, the contract of insurance does not exclusively control the responsibilities of the insurer. In *Jenkins v. J. C. Penney Cas. Ins. Co.*,[2] the West Virginia Supreme Court of Appeals recognized a private cause of action in claimants when insurers

[1] W.Va. Code § 33-11-1, *et seq*.
[2] 280 S.E.2d 252 (W. Va. 1981).

violated the UTPA. The *Jenkins* court specifically found that third party claimants were within the class of persons intended to be protected by certain unfair claim settlement practices provisions of the UTPA. *Jenkins* and some of its progeny are discussed in more detail later in this report.

Before turning to the UTPA, another brief clarification is warranted. In reviewing the pertinent case law, it is commonplace that the phrase "bad faith claim" is being used to describe an action brought by a third party under the UTPA. This is likely due to the fact that every reported third party UTPA case to date has contained an allegation that the defendant violated W. Va. Code § 33-11-4(9)(f), which states: "No person shall commit . . . the following: . . . Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear." While this abbreviated means of describing the statutory action may be customary and convenient, its use may unintentionally cause confusion. The expression "bad faith claim" is also used to describe a common law action that is entirely separate from the statutory action. Thus, it becomes difficult to distinguish between the two actions when only the phrase "bad faith claim" is being used. Complicating this matter further is the fact that the West Virginia Supreme Court of Appeals has found that a third party claimant has no right to maintain a common law bad faith action against an insurer given that no contractual relationship exists between a third party and a liability insurer.[3] Moreover, the labeling of the action as a "bad faith claim" does not take into account that the third party claimant may have asserted, or has a right to assert, other violations of the UTPA that contain no "good faith" requirement. For these reasons, this report refrains from referring to UTPA actions as "bad faith" claims.

[3] *See Elmore v. State Farm Mut Auto. Ins. Co.*, 504 S.E.2d 893 (W. Va. 1998) holding that the common law duty of good faith and fair dealing is a duty based in contract.

The Unfair Trade Practices Act

West Virginia's UTPA, codified at W. Va. Code §§ 33-11-1 to -10, was fashioned from model legislation created and adopted by the National Association of Insurance Commissioners ("NAIC").[4] The stated purpose of the UTPA is to regulate the insurance industry by defining and prohibiting such practices that are deemed to be "unfair methods of competition or unfair or deceptive acts or practices."[5] The Insurance Commissioner was granted the authority to enforce the UTPA. The Commissioner can impose monetary penalties or revoke the license of any company, broker or agent who violates the Act, and also has the ability to issue cease and desist orders.[6]

The most litigated portion of the UTPA is unquestionably the unfair claim settlement practices provisions. These provisions were incorporated into the UTPA in 1974 and are found at W. Va. Code § 33-11-4(9), the entire text of which is as follows:

> *Unfair claim settlement practices.* – No person shall commit or perform with such frequency as to indicate a general business practice any of the following:
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> (a) Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;
> (b) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;
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> (c) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;
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> (d) Refusing to pay claims without conducting a reasonable investigation based upon all available information;
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> (e) Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed;
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> (f) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;

[4] The NAIC is the organization of insurance regulators from the fifty states, the District of Columbia and the four U.S. territories.
[5] W. Va. Code § 33-11-1.
[6] W. Va. Code § 33-11-6.

(g) Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by the insureds, when the insureds have made claims for amounts reasonably similar to the amounts ultimately recovered;

(h) 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;

(i) Attempting to settle claims on the basis of an application which was altered without notice to, or knowledge or consent of, the insured;

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

(k) Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration;

(l) Delaying the investigation or payment of claims by requiring an 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;

(m) 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;

(n) 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;

(o) Failing to notify the first party claimant and the provider(s) of services covered under accident and sickness insurance and hospital and medical service corporation insurance policies whether the claim has been accepted or denied and if denied, the reasons therefore, within fifteen calendar days from the filing of the proof of loss: *Provided*, That should benefits due the claimant be assigned, notice to the claimant shall not be required: *Provided, however*, That should the benefits be payable directly to the claimant, notice to the health care provider shall not be required. If the insurer needs more time to investigate the claim, it shall so notify the first party claimant in writing within fifteen calendar days from the date of the initial notification and every thirty calendar days, thereafter; but in no instance shall a claim remain unsettled and unpaid for more than ninety calendar days from the first party claimant's filing of the proof of loss unless, as determined by the insurance commissioner: (1) There is a legitimate dispute as to coverage, liability or

> damages; or (2) the claimant has fraudulently caused or contributed to the loss. In the event that the insurer fails to pay the claim in full within ninety calendar days from the claimant's filing of the proof of loss, except for exemptions provided above, there shall be assessed against the insurer and paid to the insured a penalty which will be in addition to the amount of the claim and assessed as interest on the claim at the then current prime rate plus one percent. Any penalty paid by an insurer pursuant to this section shall not be a consideration in any rate filing made by the insurer.

The UTPA contains no language expressly providing a claimant with a private right of action against violators of the Act's provisions. Additionally, there is no legislative history of the UTPA, which means we cannot determinatively state whether our Legislature intended for the UTPA to provide a claimant with a private cause of action. We are, however, able to review the legislative history of the NAIC's model act by which West Virginia's UTPA was formed.

In 1971, when amendments to the Model Unfair Trade Practices Act were being drafted by the NAIC, it was suggested that consumer class action suits be permitted to allow consumers to seek damages resulting from violations of the Act. An advisory committee made up of industry representatives asserted to the NAIC that such a provision was unnecessary and undesirable for several reasons. Included among these reasons were:

> (1) There is less reason for such legislation as applied to such a heavily regulated industry as insurance;
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> (2) The regulator has the practical power to accomplish on behalf of the consumer what consumer class actions are designed to accomplish;
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> (3) Insurers would not then be able to rely on the decision of the regulator;
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> (4) Consumer class actions would result in "judicial" regulation of the insurance business; and
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> (5) Class actions impact on the entire industry and are not restricted to isolated acts by one insurer.[7]

[7] N.A.I.C. Proceedings II (1971) 350-51.

An NAIC subcommittee created to review the Model Act decided that a provision relating to class actions would be inappropriate, reasoning that the Act contained broad regulatory relief that afforded the consumer with effective protections. The subcommittee further believed that such a provision might restrict rather than expand the relief set forth in the Act. Consequently, a class action provision was never included.

In 1989, the NAIC appointed a subcommittee to consider revisions to the unfair claim settlement practices provisions of the Model Act. The subcommittee suggested, and the NAIC agreed, to create a separate model bill for unfair claim settlement practices. During the same period, a debate was held concerning the NAIC's position regarding whether a private cause of action was intended to be created by the newly-formed Unfair Claims Settlement Practices Model Act. The subcommittee determined that no such cause of action was intended and drafted proposed language to that effect. In 1990, the NAIC adopted an amendment to the "purpose" section of its Unfair Claims Settlement Practices Model Act that read: "Nothing herein shall be construed to create or imply a private cause of action for a violation of this Act."[8] A drafting note immediately following this language was also included:

> A jurisdiction choosing to provide for a private cause of action should consider a different statutory scheme. This Act is inherently inconsistent with a private cause of action. This is merely a clarification of original intent and not indicative of any change of position.

Accordingly, the legislative histories of the Model Acts unambiguously signify that the NAIC did not intend to create a right of action in claimants through the unfair claim settlement practice's provisions.

[8] West Virginia has not amended its Unfair Trade Practices Act to reflect this change.

Jenkins v. J. C. Penney Casualty Ins. Co.

By the end of the 1970s, the majority of states had adopted unfair claim settlement practice's provisions primarily based on the model legislation. During this time, a few courts around the country began to ask whether claimants could maintain a cause of action for an insurer's violation of the UTPA. In 1979, the California Supreme Court handed down a landmark decision in *Royal Globe Insurance Co. v. Superior Court*.[9] The *Royal Globe* court held that third party claimants were entitled to bring an action against insurers under California's version of the UTPA. Two years later, the West Virginia Supreme Court of Appeals followed California's lead with its decision in *Jenkins v. J. C. Penney Casualty Ins. Co.*[10] West Virginia thus became one of the first jurisdictions to address the rights of third party claimants within the context of the UTPA.

In *Jenkins*, the plaintiff alleged that her vehicle had been damaged by the negligence of another motorist. Rather than bringing suit against the suspected negligent party, the plaintiff sued the driver's insurer directly to seek redress for her damages. The plaintiff asserted that the insurer, through its claims adjustors, breached its statutory duty under W. Va. Code § 33-11-4(9)(f) by not attempting in good faith to effectuate a prompt, fair and equitable settlement of the claim after its insured's liability became reasonably clear. The trial court dismissed the action on the basis that the referenced code section could not be interpreted to provide a private cause of action. Although it affirmed the judgment, the West Virginia Supreme Court of Appeals believed that the trial court erred in its reasoning for the dismissal. The Supreme Court of Appeals held that a direct suit against an insurer could be

[9] 592 P.2d 329 (Cal. 1979), *overruled by Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 758 P.2d 58 (Cal. 1988) (holding that no private cause of action exists for insureds or third party claimants because California's UTPA did not expressly create one).
[10] 280 S.E.2d 252 (W. Va. 1981).

maintained under the statute, but only after the underlying civil action against the insured is concluded.

To find that W. Va. Code § 33-11-4(9) created an implied statutory cause of action in insurance claimants, the court turned to a test that it had developed a year earlier:

> The following is the appropriate test to determine when a State statute gives rise by implication to a private cause of action: (1) the plaintiff must be a member of the class for whose benefit the statute was enacted; (2) consideration must be given to legislative intent, express or implied, to determine whether a private cause of action was intended; (3) an analysis must be made of whether a private cause of action is consistent with the underlying purposes of the legislative scheme; and (4) such private cause of action must not intrude into an area delegated exclusively to the federal government.[11]

Before applying this test to the matter at hand, the court first noted numerous occasions in the past where it had recognized a right to bring a cause of action based on a statutory law violation. Of particular significance to the court was a statute giving it "some general legislative confirmation" that a cause of action could arise implicitly from a statute.[12] That statute, W. Va. Code § 55-7-9, provides:

> Any person injured by the violation of any statute may recover from the offender such damages as he may sustain by reason of the violation, although a penalty or forfeiture for such violation be thereby imposed, unless the same be expressly mentioned to be in lieu of such damages.

The court believed the purpose of this statute was to explicitly safeguard the right to bring a cause of action based on a statutory violation when the statute contained a separate penalty provision. Consequently, the court maintained that the statute precluded any argument that the mere presence of a statutorily-imposed penalty could bar the bringing of a cause of action.

The court then turned its attention to whether the plaintiff was a member of the class protected by the UTPA. After reviewing the entire Act, the court determined that the there

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[11] Syl. Pt. 1, *Hurley v. Allied Chemical Corp*., 262 S.E.2d 757 (W. Va. 1980).
[12] *Jenkins*, 280 S.E.2d at 254.

was clear legislative intent that all claimants were entitled to the protections provided. The court specifically pointed to the broadly worded language of W. Va. Code § 33-11-4(9)(a), (b), (c), (d), (f), (m) and (n), and to two other paragraphs, (k) and (*l*), of subdivision (9) that made specific reference to both "insureds" and "claimants." The court further noted that two other jurisdictions, California (in *Royal Globe*) and Illinois, had found that their unfair claim settlement practices statute was intended to cover third party claims.[13]

The next stage of the test was to determine whether the Legislature intended to create a private cause of action with its passage of the UTPA. The court first observed that the UTPA's non-existent legislative history would be of no assistance to it concerning this step.[14] However, the court did find that the stated purpose of the UTPA, to define and prohibit unfair trade practices, was a "strong policy declaration" and that this declaration suggested "the appropriateness of a private cause of action."[15]

It was then suggested that the administrative remedies found in W. Va. Code § 33-11-6 may preclude a private cause of action. The court determined this to be an unpersuasive argument due to the aforementioned language of W. Va. Code § 55-7-9 and because the administrative remedies provided no relief to the injured claimant. Moreover, the court pointed to certain language found within the administrative remedy statute that said that an order resulting from an administrative investigation or proceeding does not "absolve any person affected by such order or hearing from any other liability, penalty or forfeiture under law."[16] The court thus determined that the Insurance Commissioner's administrative actions were not intended to be the exclusive remedy for violations of the statute and concluded that

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[13] The Illinois Appellate Court concluded that the insurer's duty always ran only to the insured, therefore no right of action existed in third party claimants even though its unfair claim settlement practices statute was intended to cover third party claims. *See Scoggins v. Allstate Ins. Co.*, 393 N.E.2d 718 (Ill. App. Ct. 1st Dist. 1979).
[14] The court did not delve into the legislative history of the NAIC's Unfair Trade Practices Model Act.
[15] *Jenkins*, 280 S.E.2d at 257.
[16] W. Va. Code § 33-11-6(c).

the Legislature's intent was to create an implied private cause of action by the enactment of the UTPA.

The third step in the court's analysis was to decide whether the private cause of action was consistent with the underlying purpose of the UTPA. The court had little trouble in finding that a right of action would be consistent with the purpose of the Act given that such an action would deter potential violators of the Act's provisions. Notably within this portion of the opinion, the court alluded to an attendant benefit of the private cause of action: such actions would encourage the compromise and settlement of disputed claims.

The final aspect of the test was to determine whether the private cause of action intruded into an area exclusively delegated to the federal government. Because the regulation of insurance has been left to the states pursuant to federal law,[17] the court concluded that the statutory action was not a delegated federal concern.

Upon finding that a private cause of action existed for violations of W. Va. Code § 33-11-4(9), the *Jenkins* court next considered whether the direct action could be maintained before liability in the underlying claim was determined. The direct action should not be permitted, the court concluded, until the underlying claim is ultimately resolved. It was reasoned that in allowing the statutory claim to be filed before or concurrently with the underlying claim, duplicative litigation may result. Furthermore, the court maintained that the appropriate amount of damages in the statutory action will be unknown until the underlying suit is concluded.

The court then focused its attention on the introductory sentence of W. Va. Code § 33-11-4(9): "No person shall commit or perform with such frequency as to indicate a general business practice any of the following: . . .." This language was interpreted to clearly mean

[17] *See* 15 U.S.C.A. § 1011, *et seq*.

that "more than a single isolated violation of W. Va. Code, 33-11-4(9), must be shown in order to meet the statutory requirement of an indication of 'a general business practice,' which requirement must be shown in order to maintain the statutory implied cause of action."[18] In an attempt to clarify what constitutes "frequency as to indicate a general business practice," the court said that "several breaches . . . would be sufficient" and that "multiple violations . . . occurring in the same claim would be sufficient, since the term 'frequency' in the statute must relate not only to repetition of the same violation but to the occurrence of different violations."[19]

Development of Case Law After Jenkins

Since *Jenkins* was decided in 1981, a third party cause of action has existed in West Virginia for violations of W. Va. Code § 33-11-4(9).[20] Many reported West Virginia cases have even expanded upon the holding in *Jenkins*. This section attempts to briefly chronicle some of the more significant third party cases that have come before the West Virginia Supreme Court of Appeals. It should be mentioned that many reported first party cases are equally applicable to third party claims, but for the sake of brevity are not discussed here.

Resolution of Underlying Case Defined

In *Robinson v. Continental Cas. Co.*,[21] the court addressed the question of whether the resolution of the underlying case as expressed in *Jenkins* meant "resolved in a trial on the merits" or "resolved after any and all appeals." In *Jenkins*, the court found that liability and damages could not be established until the underlying case was ultimately resolved. The

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[18] *Jenkins*, 280 S.E.2d at 260.
[19] *Id*.
[20] In 2001, the Legislature somewhat limited third party UTPA claims by prohibiting third parties from filing an unfair claim settlement practices action when the action was based on the insurer's handling of a medical malpractice claim. *See* W. Va. Code § 55-7B-5(b).
[21] 406 S.E.2d 470 (W. Va. 1991).

Robinson court maintained that any resolution of the underlying action could not be relied upon by the parties involved until the conclusion of the appellate process. Accordingly, the court held that the commencement of the statutory action was premature until the appellate process had been exhausted in the underlying case.

Settlement is a Resolution

Three years later, the court touched on this subject again in *Poling v. Motorists Mut. Ins. Co.*[22] At issue in this case was whether a third party claimant could bring an unfair claim settlement practices suit against an insurer after the insurer settled the underlying claim. The court found that a settlement of the underlying claim constituted a resolution of the case within the meaning of *Jenkins*. Also noteworthy in *Poling* is that the court found that punitive damages could be awarded in actions filed under W. Va. Code § 33-11-4(9) and that a spouse could file a claim for loss of consortium for violations of the statute.

UTPA Action Can be Joined with Underlying Action

In the same year that *Poling* was decided, *Jenkins* encountered some disapproval. In *State ex rel. State Farm Fire & Cas. Co. v. Madden*,[23] the court partially overruled *Jenkins* by holding that a third party liability insurer could be sued and joined in the underlying case against the insured. However, the court required that the claims made against the insurer be kept separate from those against the insured. All proceedings against the insurer had to be stayed pending the resolution of the underlying claim. The basis for this decision was a concern that litigation costs, especially filing fees, were becoming overly burdensome on the average person.

[22] 450 S.E.2d 635 (W. Va. 1994).
[23] 451 S.E.2d 721 (W. Va. 1994).

Clarification of "Frequency" in a Single Claim Case

In *Dodrill v. Nationwide Mut. Ins. Co.*,[24] the court expounded on the definition of "frequency" in relation to a general business practice. It was first noted by the court that frequency could be shown by the repetition of the same violation in different claims or of multiple distinct violations in the same claim. In determining that *Jenkins* and subsequent related cases failed to adequately articulate what constitutes "frequency as to indicate a general business practice" in the context of a single claim case, the *Dodrill* court crafted a new syllabus point:[25]

> To maintain a private action based upon alleged violations of W. Va. Code § 33-11-4(9) in the settlement of a single insurance claim, the evidence should establish that the conduct in question constitutes more than a single violation of W. Va. Code § 33-11-4(9), that the violations arise from separate, discrete acts or omissions in the claim settlement, and that they arise from a habit, custom, usage, or business policy of the insurer, so that, viewing the conduct as a whole, the finder of fact is able to conclude that the practice or practices are sufficiently pervasive or sufficiently sanctioned by the insurance company that the conduct can be considered a 'general business practice' and can be distinguished by fair minds from an isolated event.

The illumination provided by *Dodrill* was a significant development for third party insurance law in West Virginia. With this holding, a claimant had clear authority to bring an unfair claim settlement practices action when multiple violations emanated solely from the handling of his or her claim. The *Dodrill* court also suggested many potential injuries for which a plaintiff could recover damages as a result of the statutory violations. These areas included: aggravation, inconvenience, emotional anguish, chagrin, depression, disappointment, embarrassment, fear, humiliation and attorney fees.

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[24] 491 S.E.2d 1 (W. Va. 1996).

[25] Syllabus points are created by the West Virginia Supreme Court of Appeals to articulate new points of law. *See Walker v. Doe*, 558 S.E.2d 290 (W. Va. 2001).

Independently Retained Defense Attorney Cannot Violate UTPA

More recently, the court confronted the question of whether a defense attorney retained by an insurer to defend its insured could violate the unfair claim settlement practices provisions. In *Rose v. St. Paul Fire & Marine Ins. Co.*,[26] the court concluded that an independently retained defense attorney is not subject to the UTPA provisions because the attorney does not engage in the business of insurance. The court did find, however, that an insurer could violate the statute by knowingly encouraging, directing, participating in, relying upon, or ratifying wrongful litigation conduct of the defense attorney.

Justice Maynard's Dissent in Rose

Another point of interest in *Rose* was Chief Justice Maynard's dissenting opinion where he reasserted his continuing objection to the court's recognition of the implied statutory action:

> As I previously made clear, I do not believe that a private cause of action, and especially a third-party cause of action, should exist under the Unfair Trade Practices Act. The Act itself does not expressly indicate that it supports a private cause of action. Rather, this Court, many years before any of its present members arrived, in a perfect example of judicial legislation, created such a cause of action from whole cloth. As I stated in footnote 10 of *State ex rel. Medical Assurance v. Recht*, 213 W.Va. 457, 469, 583 S.E.2d 80, 92 (2003), among the small minority of states that recognize a private cause of action arising from their unfair claim settlement statutes, only a handful recognize *third-party* bad faith claims. According to [*State ex rel. Allstate Ins. Co. v.*] *Gaughan*, 203 W.Va. [358], 369, n. 15, 508 S.E.2d [75], 86 [1998], 'most courts which have considered a third-party bad faith action have not allowed such a third-party claim against a tortfeasor's insurer.' This is in accord with Paul R. Rice, *A Quasi-Attorney-Client Privilege? West Virginia's Mislabeled Fiduciary Duty Exception*, 101 W.Va. L. Rev. 311, 314 (1998) which says, 'because the third-party action involves a plaintiff to whom the insurance company did not owe a contractual duty under the insurance policy, most state jurisdictions that have addressed the issue have refused to find an implied statutory duty under legislative schemes similar to those in West Virginia.'
>
> Because I do not believe that this Court should have created third-party

[26] 599 S.E.2d 673 (W. Va. 2004).

> statutory bad faith claims, I disagree with the expansion of such a cause of action by the majority in the instant cases.
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> The fact is that third-party bad faith claims, besides being wholly unsupported in statutory law, simply are a bad idea. First, they are unnecessary. Insurers already have a contractual and implied duty of good faith and fair dealing to their insureds to settle claims against the insureds.
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> Second, third-party bad faith claims create potentially conflicting duties of insurers toward both third-party claimants and their own insureds, to the detriment of those insureds.
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> Also, the majority opinions are blatantly anti-consumer (insurance consumer) in that they decrease the value of insurance policies by reducing the contractual duty of insurers to defend their insureds in litigation. Any challenge by an insured to the representation of his insurer-provided lawyer can now be answered with the claim that the insurer had an equal duty to the insured's adversary, the third-party claimant. Finally, by increasing frivolous third-party bad faith litigation and concomitantly the cost of litigation to insurance companies, the majority opinion will have the effect of increasing the cost of purchasing insurance for all West Virginia consumers. That means premiums will increase, and premiums are paid *only* by consumers.[27]

Clarification of When Liability Becomes Reasonably Clear

In *Jackson v. State Farm Mut. Auto. Ins. Co.*,[28] the Supreme Court of Appeals addressed the meaning of "reasonably clear" in order to shed light on that expression as it is used in W. Va. Code § 33-11-4(9)(f). It was determined that liability is reasonably clear "when a reasonable person, with knowledge of the relevant facts and law, would conclude, for good reason, that the defendant is liable to the plaintiff."[29] The court stressed that it is for the jury to decide whether liability is reasonably clear, as well as deciding if an insurer conducted a reasonable investigation as stated in W. Va. Code § 33-11-4(9)(d). Accordingly, the court concluded that a jury verdict in the underlying case where the insured is found liable is not dispositive

[27] *Rose*, 599 S.E.2d at 687-89 (alteration and emphasis in original).
[28] 600 S.E.2d 346 (W. Va. 2004).
[29] Syl. Pt. 2, *Jackson*.

of whether the insurer was reasonable in its investigation or determination of liability. A trial judge cannot therefore decide the issue of "reasonableness" by looking to the verdict in the underlying case because this requirement must be decided by the jury in the unfair claim settlement practices action.

Treatment of Third Party UTPA Claims in Other States: Majority Position

Forty-four of the 50 states do not currently recognize a private right of action by third parties against insurers for unfair claim settlement practices as defined in each state's version of the Unfair Trade Practices Act. The rationale of many states that have addressed this issue is perhaps best illustrated in the often cited California case of *Moradi-Shalal v. Fireman's Fund Ins. Cos*.[30] The plaintiff in this case was injured when her vehicle was negligently struck by another vehicle driven by the defendant's insured. After requesting a settlement of her claim and receiving no response from the insurer, the plaintiff filed suit against the insured. The action against the insured was ultimately settled.

The plaintiff subsequently sued the insurer for its alleged refusal to promptly and fairly settle her claim against the insured. The plaintiff based her cause of action on the California Supreme Court ruling in *Royal Globe Insurance Co. v. Superior Court*,[31] in which the court held that a third party could bring an action to impose civil liability on an insurer for engaging in unfair claim settlement practices as set forth by statute.

The *Moradi-Shalal* court re-evaluated the reasoning behind *Royal Globe* while focusing on several significant developments that had occurred since that decision was handed down. First, the court observed that nineteen states had confronted the issue of whether their versions of the model act created a private cause of action, with seventeen of

[30] 758 P.2d 58 (Cal. 1988).
[31] 592 P.2d 329 (Cal. 1979).

those nineteen states refusing to recognize such an action. Second, the court studied the legislative histories of the NAIC's model act and California's unfair claim settlement practices statute. The court determined that both histories clearly indicated that only administrative remedies were intended. Third, the court found that lower courts were having difficulty interpreting the *Royal Globe* decision.

Finally, the court discussed the scholarly commentary criticizing the *Royal Globe* court for its forced interpretation of the California Insurance Code and claiming that the decision brought about undesirable social and economic effects. The court made specific mention that several commentators had observed that the holding of *Royal Globe* "contemplates, indeed encourages, two lawsuits by the injured claimant: an initial suit against the insured, followed by a second suit against the insurer for bad faith refusal to settle."[32] The court referenced another critic's assessment that the holding had the effect of encouraging unwarranted settlement demands by claimants and coercing insurers to agree to inflated settlements in order to avoid the cost of a second lawsuit and exposure in the statutory action. This commentator, the court reports, concluded that it is the public who "ultimately will be affected by the additional drain on judicial resources" and who "will indeed suffer from escalating costs of insurance coverage, a certain result of inflated settlements and costly litigation."[33]

The court additionally remarked that many authors have raised another adverse consequence of *Royal Globe*: "It tends to create a serious conflict of interest for the insurer, who must not only protect the interests of its insured, but also must safeguard its own interests from the adverse claims of the third party claimant."[34] The ultimate result of this

[32] *Moradi-Shalal*, 758 P.2d at 66.
[33] *Id*.
[34] *Id*. at 67.

conflict, say the detractors of *Royal Globe*, could be a disruption in the settlement process with the insured being held at a disadvantage.

The developments after, and consequences of, the *Royal Globe* decision seemed "irrefutable" according to the *Moradi-Shalal* court.[35] Consequently, *Royal Globe* was overruled. The court cautioned, however, that its decision was "not an invitation to the insurance industry to commit the unfair practices proscribed by the Insurance Code" and went on to "urge the Insurance Commissioner and the courts to continue to enforce the laws forbidding such practices to the full extent consistent with [its] opinion."[36]

Other jurisdictions have simply construed the language of their unfair claim settlement practices statute to find that no third party cause of action exists. Wyoming may have summarized this position best in a 1992 decision by its highest court:

> As with the acts in other states, Wyoming penalizes unfair claims settlement practices that are committed or performed with such frequency as to indicate a general business practice. As such, it does not readily lend itself to enforcement by a private cause of action arising from a single claim. Second, the Wyoming Insurance Commissioner has power to examine and inquire into violations of the Insurance Code, enforce the Insurance Code with impartiality, execute the duties imposed upon him by the Insurance Code, and has the powers and authority expressly conferred upon him by or reasonably implied from this code. Finally, as illustrated by Wyo. Stat. § 26-15-124(c), the Wyoming Legislature knows how to expressly create a private right of action if it chooses to do so. Having reviewed Wyo. Stat. § 26-13-124 (unfair claims settlement practices), this court cannot conclude that the legislature intended to create a private right of action under this section.[37]

Treatment of Third Party UTPA Claims in Other States: Minority Position

Besides West Virginia, whose treatment of third party claims was discussed above, there are presently five other jurisdictions that recognize, to one degree or another, a private cause of action by a third party against violators of unfair claim settlement practices provisions. Due

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[35] *Id*. at 68.
[36] *Id*.
[37] *Herrig v. Herrig*, 844 P.2d 487, 493-94 (Wyo. 1992) (citations omitted).

to the nuances involved, it is practically impossible to collectively describe how these states reached their positions. Accordingly, the stances of the five states (Florida, Kentucky, Massachusetts, Montana, and New Mexico) are addressed individually below.

1. Florida

Florida's treatment of third party insurance claims is unique, even among the five other states that recognize a third party right of action. Statutory law in Florida provides that "[a]ny person may bring a civil action against an insurer when such person is damaged . . . by a violation of . . . Section 626.9541(1)(i)."[38] Fla. Stat. § 626.9541(1)(i) is where Florida sets forth its unfair claim settlement practices. In concluding that the above-quoted statutory language clearly authorizes a direct cause of action by a third party claimant against an insurer, the Supreme Court of Florida explained that "[b]y choosing this wording the legislature has evidenced its desire that all persons be allowed to bring civil suit when they have been damaged by enumerated acts of the insurer."[39] It is within these "enumerated acts of the insurer" that Florida's position begins to veer from the positions of the remaining states.

Unlike most states, Florida's unfair claim settlement practices statute does not include a provision requiring that the insurer settle claims in good faith.[40] Such a provision is, however, found in Fla. Stat. § 624.155, which is entitled "Civil remedy" and was partially discussed above as the starting point for a third party action based on unfair claim settlement practices. The "good faith" provision of that statute reads:

> (1) Any person may bring a civil action against an insurer when such person is damaged:

[38] Fla. Stat. § 624.155(1)(a)(1).
[39] *Auto-Owners Ins. Co. v. Conquest*, 658 So. 2d 928, 929 (Fla. 1995).
[40] As previously mentioned in this report, West Virginia includes the following language in its unfair claim settlement practices: "Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear." W. Va. Code § 33-11-4(9)(f).

> (b) By the commission of any of the following acts by the insurer:
>
> 1. Not attempting in good faith to settle claims when, under all of the circumstances, it could and should have done so, had it acted fairly and honestly toward its insured and with due regard for her or his interests.

In 1997, the Florida Supreme Court construed the language "acted fairly and honestly toward its insured and with due regard for her or his interests" to indicate that the insurer's duty to settle claims in good faith ran solely to the insured and not to third party claimants.[41]

The court, however, did not end its analysis there. Instead, Florida continued down a path which one commentator has described as "a progressive position in the world of third party insurance law."[42] The *Zebrowski* court opined:

> We believe the enactment of section 624.155(1)(b)(1) had the effect of codifying *Thompson v. Commercial Union Insurance Co.*, 250 So. 2d 259 (Fla. 1971) (plaintiff entitled to bring bad-faith claim on excess judgment against liability carrier as third-party beneficiary), and *Fidelity & Casualty Co. v. Cope*, 462 So. 2d 459 (Fla. 1985) (basis for action authorized by *Thompson* is damage to insured who suffers excess judgment as result of bad faith of insurer in failing to settle within policy limits). Thus, section 624.155(1)(b)(1) authorizes a third party to file a bad-faith claim directly against the liability insurer without an assignment by the insured upon obtaining a judgment in excess of the policy limits.[43]

While many states, including West Virginia, permit an assignment from the insured to the third party claimant after an excess judgment occurs, no state except Florida allows a third party judgment creditor to merely step into the shoes of the insured and bring a statutory "bad faith" action without an assignment.[44] It should be stressed, however, that Florida's unique position in this area does not somehow mean that the insurer owes a duty to the third party claimant. As the *Zebrowski* court explained, "In the absence of an excess judgment, a

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[41] *State Farm Fire & Cas. Co. v. Zebrowski*, 706 So. 2d 275, 277 (Fla. 1997).
[42] Gregory A. Bullman, *A Right Without a Potent Remedy: Indiana's Bad Faith Insurance Doctrine Leaves Injured Third Parties Without Full Redress*, 77 Ind. L.J. 787, 804 (2002).
[43] *Zebrowski*, 706 So. 2d at 277.
[44] Of course, the acquisition of an assignment from an insured is purely academic in those states that recognize a right in a third party to bring a statutory "bad faith" claim directly against the insurer.

third-party plaintiff cannot demonstrate that the insurer breached a duty toward its insured."[45] The duty of good faith in settlement negotiations therefore flows only from the insurer to the insured, with the third party still an adversarial claimant.

Accordingly, with respect to statutory bad faith claims, the rights of third party claimants in Florida are generally in line with the majority of jurisdictions that do not allow a direct cause of action against an insurer. It is only after an excess judgment when the rights of third parties in Florida differ from those of third parties in other states. If the judgment in the action against the insured is within the policy limits, or if the case is settled, a third party has no statutory right to bring an action against the insurer for not settling a claim in good faith. But as noted above, the claimant may file a direct action against the insurer for other unfair claim settlement practices under Fla. Stat. § 626.9541(1)(i) regardless of whether the underlying action results in an excess judgment.

2. Kentucky

Kentucky also looks to a related statute, albeit a more generic one, to find that a third party may maintain an action for damages resulting from an insurer's unfair claim settlement practices. KRS § 446.070 provides that a "person injured by the violation of any statute may recover from the offender such damages as he sustained by reason of the violation, although a penalty or forfeiture is imposed for such violation."[46] After reviewing KRS § 340.12-230, which is Kentucky's listing of unfair claim settlement practices,[47] the Supreme Court of Kentucky found that "the statute does not state that a violation of its terms is enforceable only by the insurance commissioner, and it does not prohibit a claim by an individual for

[45] *Zebrowski*, 706 So. 2d at 277.
[46] The language of this statute is substantially similar to that of W. Va. Code § 55-7-9, which is the statute that the West Virginia Supreme Court of Appeals discussed in *Jenkins* to assist it in finding that an implied statutory action existed for violations of the UTPA.
[47] Included among the enumerated unlawful practices is a duty to act "in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear." KRS § 340.12-230(6).

damages for its breach."[48] Thus, the *Reeder* court read KRS § 340.12-230 and KRS § 446.070 together and held that a third party could bring a cause of action against an insurer.

Since *Reeder* was decided in 1988, Kentucky has repeatedly affirmed that holding and has considerably developed its common law in this area. A notable development was that Kentucky's Legislature, in 1988, eliminated the requirement that unfair claim settlement practices be performed with such frequency as to indicate a general business practice. Since the effective date of that legislation, third party claimants need only prove a specific instance, tied obviously to the subject insurance claim, where the insurer did not comply with the unfair claim settlement practices statute in order to prevail in court.

3. Massachusetts

Like Florida, Massachusetts has also enacted a "civil remedy" statute expressly referencing its unfair claim settlement practices statute. G. L. c. 93A, § 9 (1) states that "[a]ny person whose rights are affected by another person violating the provisions of [G. L. c. 176D, § 3 (9)] may bring an action in the superior court." The statute referenced is that state's inventory of unfair claim settlement practices, which includes "failing to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear."[49]

The combined effect of the two statutes was first addressed by the Supreme Judicial Court of Massachusetts in a 1983 decision.[50] With the statutes as its guideposts, the state's highest court had little difficulty in finding that a third party claimant could bring an action against an insurer who allegedly committed an unfair claim settlement practice. In a later case, the court solidified its position by stating that "[t]he duty of fair dealing in insurance settlement negotiations is established by statute under G. L. c. 176D, § 3 (9), and the specific

[48] *State Farm Mut. Auto. Ins. Co. v. Reeder*, 763 S.W.2d 116, 117 (Ky. 1988).
[49] G. L. c. 176D, § 3 (9)(f).
[50] *See Van Dyke v. St. Paul Fire & Marine Ins. Co.*, 448 N.E.2d 357 (Mass. 1983).

duty contained in subsection (f) is not limited to those situations where the plaintiff enjoys contractual privity with the insurer."[51] The court explained:

> The statutes at issue were enacted to encourage the settlement of insurance claims . . . and discourage insurers from forcing claimants into unnecessary litigation to obtain relief. This goal of facilitating settlement is equally desirable whether the plaintiff is an insured or a third-party claimant, and c. 93A, § 9 (1), confers standing where there is injury resulting from another's unlawful acts. Standing does not depend on a party's status as an insured or a third-party claimant.[52]

4. Montana

By looking only to the provisions of its Unfair Trade Practices Act, the Supreme Court of Montana, in 1983, found that a third party could bring a cause of action against an insurer based on the insurer's statutory duty to settle in good faith when liability has become reasonably clear.[53] The *Klaudt* court reached its decision by concluding that the unfair claim settlement practices statute, when read as a whole, intended to protect third parties and that the inclusion of the word "claimant" in the statute demonstrated that insurers owe a duty to such parties. The court further pointed to language incorporated within the remedies section of its Unfair Trade Practices Act: "This section shall not be deemed to affect or prevent the imposition of any penalty provided by this code or by other law for violation of any other provision of this chapter."[54] Thus, the court believed it "evident that the insurance commissioner's action is not the exclusive remedy for an unfair trade practice violation."[55]

With legislation in 1987, Montana joined Florida and Massachusetts in having a separate "civil remedy" statute that specifically references its unfair claim settlement practices statute. MCA § 33-18-242, entitled "Independent cause of action -- burden of proof," contains the following language: "An insured or a third-party claimant has an

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[51] *Clegg v. Butler*, 676 N.E.2d 1134, 1139 (Mass. 1997).
[52] *Id*.
[53] *See Klaudt v. Fink*, 658 P.2d 1065 (Mont. 1983).
[54] MCA § 33-1004(5).
[55] *Klaudt*, 658 P.2d at 1067.

independent cause of action against an insurer for actual damages caused by the insurer's violation of subsection (1), (4), (5), (6), (9), or (13) of 33-18-201."[56] With this legislation effectively codifying the *Klaudt* decision, the Supreme Court of Montana, in *O'Fallon v. Farmers Ins. Exch.*,[57] easily found that a third party claimant can sue an insurer for particular unfair claim settlement practices. The court instructed that "[t]he purpose of these provisions in the Unfair Trade Practices Act is to protect members of the public from damage caused by an insurer's unreasonable efforts to avoid the obligations it assumed when it accepted premiums for insurance coverage."[58]

5. New Mexico

When New Mexico adopted the Unfair Trade Practices Model Act in 1984, it made significant changes to the NAIC's model law. One of those changes was to include a section entitled "Private right of action."[59] The statute provides that "[a]ny person covered by Chapter 59A, Article 16 NMSA 1978 who has suffered damages as a result of a violation of that article by an insurer or agent is granted a right to bring an action in district court to recover actual damages." Article 16 of Chapter 59A is equivalent to West Virginia's Unfair Trade Practices Act. Thus, New Mexico is included among those states having a "civil remedy" statute that is expressly coupled with a statute prohibiting unfair claim settlement practices.[60]

The question of whether a third party claimant could file a civil action against an insurer for violation of its unfair claim settlement practices statute did not reach New

[56] Subsection (6) of MCA § 33-18-242 requires and insurer "to attempt in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear."
[57] 859 P.2d 1008 (Mont. 1993).
[58] *Id*. at 1017.
[59] N.M. State. Ann. § 59A-16-30.
[60] New Mexico's unfair claim settlement practices can be found at N.M. Stat. Ann. § 59A-16-20. Not attempting to settle in good faith once liability has become reasonably clear is included among these prohibited practices.

Mexico's highest court until 2004. In *Hovet v. Allstate Ins. Co.*,[61] the Supreme Court of New Mexico found that the language "any person" in N.M. State. Ann. § 59A-16-30 included third parties and could not be interpreted to restrict recovery to insureds only. The court noted that "[i]n creating a separate statutory action, the Legislature had a remedial purpose in mind: to encourage ethical claims practices within the insurance industry."[62]

The court also looked to one of its prior decisions, *Russell v. Protective Ins. Co.*,[63] to base its holding. In *Russell*, the court held that a third party employee was an intended beneficiary of its Workers Compensation Act and therefore had a private right of action under the Act against an insurer who was providing insurance to the third party employee's employer. The court in *Hovet* applied the same reasoning to the unfair claim settlement practices statute in the context of an automobile accident claim and found that "[t]hird parties, having claims against drivers who are insured under compulsory automobile liability policies, are intended beneficiaries of those insurance policies no less than injured employees seeking compensation benefits from their employers' workers' compensation policies."[64]

The *Hovet* court placed certain limitations on the third party right of action that it had just recognized out of what was described as "considerations of sound public policy, as well as the text of the Code."[65] Specifically, the court stated that its holding applied only to automobile liability insurance, considering that such insurance is statutorily mandated by the state for the benefit of the public. The court also limited the availability of the claim by finding that the statutory cause of action could only be filed after the conclusion of the underlying negligence litigation in which there has been a judicial determination of fault against the insured and damages awarded to the claimant. Thus, if the parties settled during

[61] 89 P.3d 69 (N.M. 2004).
[62] *Hovet*, 89 P.3d at 73.
[63] 751 P.2d 693 (N.M. 1988).
[64] *Hovet*, 89 P.3d at 75.
[65] *Id*. at 76.

the underlying litigation, the statutory cause of action was precluded. The final limitation imposed by the court was that defense attorneys could not be named as defendants in the statutory cause of action.

III. Estimated Impact on Insurance Rates and Availability

The economic effects of the third party cause of action involve several layers of analysis. First, we discuss likely changes in economic incentives that this doctrine creates. Second, we review the insurance literature for other studies that have evaluated the economic effects of this doctrine. Third, we evaluate direct evidence that has come from West Virginia insurance carriers pursuant to a 2004 data call. Fourth, we summarize indirect evidence about the insurance environment in West Virginia, including interstate and regional comparisons. Finally, we use this evidence to summarize the economic effects of this doctrine.

Influence on Economic Incentives

Because insurance is bought to satisfy consumer needs, economists consider it another product in a consumer's bundle of goods and services. It is assumed that insurance responds to the same economic forces that govern other consumer products. Namely, insurance consumers try to optimize their purchase by choosing products that offer the best product for the money. Similarly, insurance producers are governed by incentives similar to other producers in the private market economy. Namely, they sell their product with the intent of maximizing profits and increasing the value of the firm. In a private market economy, these conditions generally create wide availability of product choices over a range of prices.

The distinction between private insurance markets and other goods and services is the close relationship of the legal community to insurance transactions, particularly during the settlement phase. The settlement of insurance claims is sometimes unclear because it is not always evident which party is liable, and to what extent the insured should be indemnified. Lawyers are often times involved, both for the claimant and company, in helping to make these determinations. Because of this involvement, we need to make assumptions about the

economic incentives they face too. We assume that lawyers are motivated by the same economic incentives as the other parties.

Assuming rational parties, economic theory predicts that the existence of a third party cause of action affects incentives. The following are the major incentives that change:

- There is an increased incentive to pursue weak claims. Under the third party doctrine, the expected value of a claim is increased because of the possibility of punitive damages. Additionally, weak claims can be more vigorously pursued because the likelihood of intimidating the insurance company is increased.
- There is an incentive to settle claims at higher amounts. Because of the threat of a lawsuit, it is sometimes more prudent for the carrier to settle than to put the case in front of a jury and take the risk of an unfavorable judgment. Also, there are additional costs to defend the more numerous cases that are contested.
- There is an incentive to retain a lawyer. As mentioned earlier, lawyers are motivated by economic forces the same as insurance companies and their insureds. Under the third party doctrine, lawyers have another available cause of action to litigate. Their motivation will induce them to advertise and market this legal protection.
- There is an incentive to perpetuate insurance fraud. This occurs because aggressive claims settlement practices by the insurance carrier will be discouraged, at the margin, because of the possibility that such practices can be interpreted as a UTPA violation. Because claims are subject to less scrutiny, the potential for fraudulent claims increases.
- There is an incentive to lower coverages and, in the limit, a propensity to become an uninsured motorist. As auto liability costs rise, they get passed on to insurance consumers as higher prices. These higher prices have a tendency to force some

people out of the market, and some of these people will continue to drive without insurance.

It is clear that several economic incentives are altered when a third party cause of action is recognized by law. It is assumed that the converse of these changes would occur when there is no third party cause of action. Absent strong regulatory oversights from the Insurance Commissioner's Office, we expect the following incentive changes:

- There is a disincentive to pursue weak claims by the third party claimant. While some of these claims may be legitimate, the cost and time involved would dissuade most of these claimants from pursuing them.
- There is a disincentive for lawyers to advertise and market their services. This may render some legitimate claimants unaware of their legal rights.
- There is a disincentive to use defensive claim settlement practices. This may cause some unsophisticated insurance claimants to settle for less than they deserve.

Clearly, this issue is hard to resolve on theory alone. Some empirical estimates of the incentive effects must be generated so that we can compare their sizes. In the next section, the relevant economic literature is reviewed and estimates are given for the size of these effects.

Literature Review

The economic influence of the U.S. tort system is prodigious. A recent report by Towers Perrin estimates the dollar amount of U.S. tort costs in 2005 at $278.7 billion, or 2.27 percent of GDP. As shown in Table 1, tort costs have grown significantly in the past 45 years, both in dollar terms and as a percentage of GDP. Namely, national tort costs are up nearly 52 times from their 1960 level, whereas GDP is up approximately 24 times. The legal area is a rapidly growing sector of our economy.

Table 1. U.S. Tort Costs over Time and Compared to GDP[66]

Year	U.S. Tort Costs ($ billions)	U.S. GDP ($ billions)	Tort Costs as % of GDP
1960	5.4	526	1.03
1970	13.9	1,039	1.34
1980	42.7	2,790	1.53
1990	130.2	5,803	2.24
2000	179.2	9,817	1.83
2005 (est.)	278.7	12,469	2.27

A nation's legal activity is especially important to monitor in businesses like insurance, where the influence of the law is strong. As society changes its tort laws, the costs and the benefits must be evaluated. But measuring the economic effects of tort reform is not easy, and the literature regarding the financial effects of the third party cause of action is especially sparse. Much of this difficulty in measurement comes from the fact that there are subtle changes in the insurance environment that are not amenable to direct measurement. Two studies are reviewed here, and these works are the only papers that estimate the economic consequences of the third party cause of action. Both studies deal with the results of the third party cause of action when it was in effect in California during the 1980's (the so-called Royal Globe years). The studies are relatively current and use econometric estimation techniques to predict the before-after consequences of the third party cause of action. The first study reviewed was done by the RAND Corporation, a non-partisan think tank based in California. This 2001 study was authored by Angela Hawken, Stephen J. Carroll and Allan F. Abrahamse. The second study reviewed was authored by William G. Hamm in 2000 for the Californians Against Fraud and Higher Insurance Costs.[67]

[66] "*U.S. Tort Costs: 2004 Update*," Towers Perrin, 2004.

[67] Mark J. Browne, Ellen S. Pryor and Robert Puelz wrote a manuscript entitled "The Effect of Bad Faith Laws on First-Party Insurance Claims Decisions" in 2003. Although limited to first party causes of action, some of its issues are similar to those in a third party context. We have not reported the conclusions.

1. The RAND Corporation Study

The RAND Corporation has a long tradition of scholarly research. The organization began during the Cold War and formerly specialized in military research. In the past twenty years it has broadened its research program to include other social policy issues. Its study on third party causes of action was an attempt to inform public policy makers about the changing tort system in California.

The RAND study used an econometric technique to estimate the effects of elimination of the third party cause of action when the Royal Globe doctrine was in effect. To review, this doctrine allowed third party causes of action from 1979 until 1988. In 2000, California was preparing to vote on a reinstatement of the doctrine, and the RAND study was done to inform public opinion for that vote. The study used an econometric technique called Ordinary Least Squares (OLS) regression analysis, the most popular econometric technique.[68] Regression is used when cause-effect models are postulated, and the intent of the analysis is to partition the total effects into their respective causes. In this way, regression *controls* for the many factors that vary at the same time. For example, if we wanted to model the cost of a house as a function of its attributes, we need to determine the effect of square footage, yard size, reputation of the neighborhood, number of rooms, condition, and so forth. Using a sample of many houses, we could estimate the *relative* influence of each of these attributes by using regression's statistical procedures. Regression produces a set of estimated *coefficients* that represent the relative influence of each of the several factors when the other factors are held constant.

The data used in the RAND regression equations came from auto bodily injury (BI) closed claims in 31 tort states over the period 1975-1999. The 24-year time series allowed

[68] Hereinafter, we will drop the distinction between OLS regression and other forms of regression analysis. We will simply call it "regression."

the authors to estimate the insurance climate of California before, during, and after the 1979-1988 Royal Globe period. The authors can make year-by-year comparisons with other tort states across this time interval.

Significant results from the RAND study are:

- The adoption of the Royal Globe doctrine increased both the severity and frequency of auto liability claims. It is conjectured that the increased severity of claims is a result of more aggressive medical treatments by injured claimants. The increased frequency of claims suggests that some injured parties were more apt to pursue their cases when the insurance company could be sued directly.
- A *Shadow Effect* on the insurance environment is discernable. The shadow effect means that insurance carriers practice defensive claims settlement practices when they know they can be sued for bad faith in the settlement process. This effect cannot be measured directly, but it results in a higher average settlement amount per claim and a higher number of claims being paid. This effect was estimated to increase bodily injury compensation costs by 29 to 35 percent.
- A *Representation Effect* in the insurance environment is discernable. This means that claimants had a higher probability of being represented by a lawyer when the Royal Globe doctrine was in effect. Additionally, it means that defense costs are higher per claim and the time-to-settlement is longer. This effect was estimated to increase bodily injury compensation costs by 11 to 30 percent.
- Assuming the usual ratio of property damage to personal injury losses in auto insurance lines, the total dollar effect for increased premiums due to the existence of the third party cause of action was in a range of 11 to 19 percent.

2. The Hamm Study

William Hamm also used econometric techniques to estimate the change in California's insurance environment during the Royal Globe years. His 1999 paper used regression to estimate coefficients on major variables that explain auto insurance rates. Like the RAND study, Hamm limited his inquiry to the auto industry.

Hamm used data from all 50 states to estimate a regression model to explain average auto liability premiums. Explanatory variables used are: hospital costs, gross state product, injury accident rate, percentage of drivers insured, cars per capita, urban driving ratio, interest rates, and a third party doctrine or not. For the third party doctrine variable, the study made a distinction between states that have a "strong" and a "weak" third party law. Strong law states are defined as those that rule against a company for only one violation. Weak law states are those that rule against a company if their violative actions were judged to be a regular business practice.[69] The estimated coefficients in this model indicate the direction and strength of each of these variables in the explanation of average auto liability premiums.

The data used for the Hamm study come from the period 1987-1997. This period includes some, but not all, of the Royal Globe years. The model also allows for the evaluation of the third party cause of action in all jurisdictions because the coefficient estimates can be generalized nationwide.

The results from Hamm's study support the notion that states giving third parties a private cause of action have higher average auto liability costs when other factors are controlled. His models meet all the customary tests of statistical adequacy (R^2 is 0.45; all the signs of the coefficients are in the right directions), so the results seem credible. If we isolate the third party variable, the magnitude of the effect is estimated to be from 4.6 percent in

[69] West Virginia was a weak state by this method.

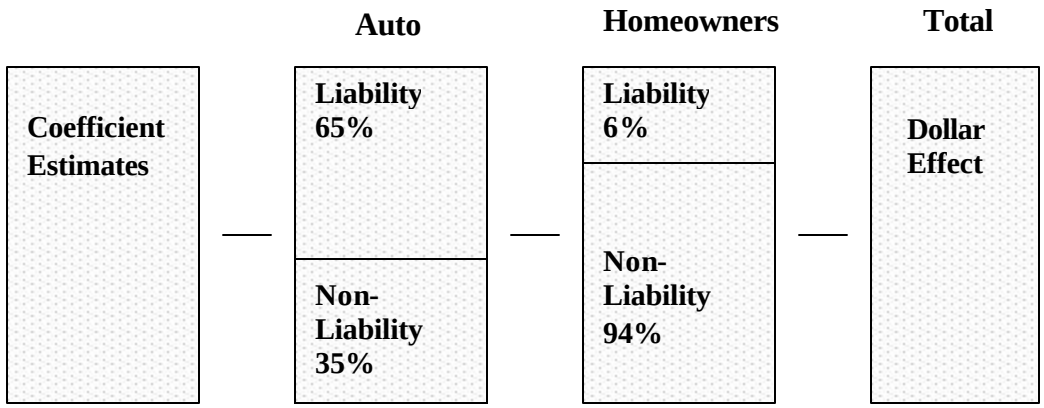
weak states to 14.5 percent in strong states. The interpretation is that average auto liability premiums have been increased by about 4.6 percent in West Virginia because of the existence of a third party law.

Applying the Econometric Results to West Virginia

The econometric results from the RAND and Hamm studies give a useful first approximation to estimating the economic consequences of the third party doctrine in West Virginia. These studies have sufficient rigor and completeness to make their coefficient estimates credible. Because these models were estimated for personal auto, we need to extend their scope to estimate the effect on other lines of insurance because the proportion of liability coverage in each line of insurance is different. Conceptually, this is modeled in the flow chart in Figure 1.

This multi-stage approach allows us to estimate the premium dollars attributable to the third party doctrine in West Virginia. As the schematic shows, we get these estimates

Figure 1. Using Auto Coefficients to Estimate the Total Dollar Effect



by applying the regression coefficients to the premium volume expended for liability insurance in the major personal lines of insurance (by extension, we could add commercial

liability costs the same way). The first step is to settle on the coefficient estimates. Since the RAND study estimated the third party effect using a slightly different method than the Hamm study, their results are not strictly comparable. Using a blend of their estimates, third party states face about 25 percent higher bodily injury claim costs when compared to non-third party states. Figure 1 shows the effects differ depending on which line of insurance is being considered. Auto lines are more affected by liability issues compared to homeowners lines, so we must make the proper adjustment. The size of the personal auto market in West Virginia, measured by premium written in 2003 (the last year complete data are available), is $1,057.1 million. The homeowners market is $243.9 million. The Insurance Information Institute estimates that the liability portion vis-à-vis the non-liability portions are 65:35 in auto lines and 6:94 in homeowners lines.[70] Thus, approximately $833.4 million is currently spent on personal lines liability coverage in West Virginia. If this number is 25 percent higher than it would be absent third party causes of action, the cost of this legal protection is about $166.7 million per year.

Evidence from Insurance Companies Doing Business in West Virginia

In addition to the estimates of others, the Office of the Insurance Commission collected West Virginia-specific data to estimate the effects of the third party cause of action. This information was collected pursuant to a data call issued during the Fall of 2004 to property and casualty insurance carriers doing business in West Virginia. The data call requested information about alleged violations of the UTPA that had been lodged, over the period 2001-2003, against these carriers. These data allow us to measure direct effects on the carriers during this period. On the other hand, these data do not allow us to measure any

[70] *I.I.I. Factbook 2004, p. 65.*

indirect effects (the shadow effect or the representation effect). Due to the proprietary nature of these data, they are only reported in highly aggregated form.

The data indicated that an average of about 100 unfair claims settlement practices cases per year are filed against auto lines and about 20 against homeowners lines. This claims ratio follows the logic developed earlier: the auto lines have a much bigger fraction of liability coverages when compared with the homeowners lines. Simple random samples (without replacement) were taken from the population of all the cases filed in a three year period to estimate what a typical year might look like. The distribution of losses is heavily skewed by the larger losses. Namely, it looks like a distribution of any catastrophe loss. That follows from the nature of the event: there are many small losses and very few large losses. Because of the fewness of cases in the homeowners and commercial lines on insurance, the sample is limited to private passenger auto. Table 2 shows the quartile distribution.

Table 2. Sample of Annual UTPA Losses from West Virginia Auto Carriers

Quartile	*Ave. Loss ($)*	*Minimum Loss ($)*	*Maximum Loss ($)*
First	1,981	0	6,003
Second	15,177	7,000	21,625
Third	40,684	25,000	60,000
Fourth	369,509	67,422	4,100,000

Note: Sample size of 100 taken from all carriers' loss history during 2001-2003.

The distribution of this data suggests that most direct losses are small. This follows from the shadow effect mentioned earlier. Insurance carriers in West Virginia have adopted conservative settlement practices during the long period over which the third party cause of action has existed in this state. Nevertheless, in an average year there may be several large cases that are settled or adjudicated by the courts. It is the loss from these large cases that induces rational companies to settle more conservatively in West Virginia than they might in other states.

Other direct evidence from the data call shows that the propensity to defend an unfair trade practices claim is higher in West Virginia than in other third party states *and* in other non-third party states. Our evidence shows that the propensity, over the past three years, is 61.3 claims per million auto exposure covered. We can draw two important inferences from these data: 1) the propensity to defend a third party suit is higher in West Virginia than it is in states that have an administrative remedy, and 2) this tendency is robust across states that give third parties a private cause of action. The data also show a troubling tendency: the defense against claims is used much more readily in West Virginia than in other third party doctrine states.

Table 3. Multi-State Auto Carriers: Rate of Defending UTPA Claims

	West Virginia	*Other 3rd Party States*	*Administrative Remedy States*
2001 Claims	32	29	13
2001 Exposures	502,637	3,787,518	5,591,269
2001 Rate per Million	63.7	7.6	2.3
2002 Claims	31	17	15
2002 Exposures	520,486	3,759,934	5,745,734
2002 Rate per Million	59.6	4.5	2.6
2003 Claims	31	16	12
2003 Exposures	510,324	3,639,891	5,724,500
2003 Rate per Million	60.7	4.4	2.1
3 Year Average Rate	*61.3*	*5.5*	*2.3*

Source: Sample of West Virginia carriers writing personal auto coverage in several states, 2004 Data Call.
Third-party states include: FL, KY, MT, NM, WV; Administrative remedy states include: MD, OH, PA, VA.

Indirect Evidence about the Insurance Environment of West Virginia

There are other forms of indirect evidence which support the idea that the third party cause of action has increased insurance costs in West Virginia. One piece of evidence comes from a comparison of West Virginia's automobile bodily injury costs with countrywide and regional figures. These comparisons are discussed in turn.

A comparison of West Virginia's auto liability costs with national statistics is instructive. Since the third party cause of action has been in effect for nearly 25 years, we

trace a long series of data. This gives an indication of how bodily injury costs compare to national benchmarks and how costs have changed over time. Because no-fault states have fundamentally different legal rules than tort states, we limit this sample to tort states.

The inference from Table 4 is that West Virginia's bodily injury severity has been considerably above the national average for over 24 years. The size of the BI component of insurance coverage has been around twice the national average, and there is no evidence that the gap is narrowing.

Table 4. Countrywide vs. West Virginia Bodily Injury Severity Over Time[71]

Time Interval	*Countrywide ($)*	*West Virginia ($)*
2000-2003	6,312	14,239
1995-1999	5,859	12,524
1990-1994	6,573	13,223
1985-1989	4,742	9,016
1980-1984	3,017	5,775
Average	*5,301*	*10,955*

Regional comparisons are often helpful when looking at insurance claims data. These are fruitful for two reasons: people in border towns make rate comparisons and inform legislators of any differences, and regional comparisons use data from areas of the country that have similar geographical and social conditions to those in West Virginia. Using a regional approach, Table 5 provides data for bodily injury loss costs in West Virginia and its surrounding states. Loss costs are another good way to look at bodily injury statistics because they include both frequency and severity data. As a reminder, we conjectured earlier that both frequency and severity of claims would increase under the third party doctrine. Table 5 shows persuasively that West Virginia's bodily injury auto claims are higher per car,

[71] States excluded are: CO, DE, FL, HI, KS, KY, MD, MA, MI, MN, NJ, NY, ND, OR, PA, SC, and UT. Sources: National Assoc. Ind. Insurers, Insurance Services Office, Insurance Research Council.

per year than any of its surrounding states. Moreover, the difference is highly significant: 41.7 percent higher than its peer states over the past five years.

A Summary of the Economic Effects on Insurance Rates and Availability

At the beginning of this section, it was stated that precise estimates of tort reform are hard to render. General estimates are easier to develop, but we must be cautious so that the estimates are not so vague they become meaningless. This section has reviewed several

Table 5. Five-Year Average Bodily Injury Costs: Regional Comparison[72]

State	Average Loss Cost ($)	Percent of Regional Average
Kentucky	98.38	87.7
Maryland	136.39	121.6
Ohio	89.19	79.5
Pennsylvania	100.20	89.3
Virginia	89.83	80.1
West Virginia	158.97	141.7
Average	**112.16**	**100.0**

Note: Loss cost is the amount of loss per year per insured car, including cars not involved in accidents.

pieces of evidence that address measurement of the economic consequences of the third party cause of action.

The inference is that there is significant economic cost to granting the third party cause of action. This inference is supported by the following evidence:

- Economic theory about changing incentives;
- Published studies using statistical estimation techniques;
- Data collected from carriers doing insurance business in West Virginia;
- National comparisons of bodily injury claiming tendencies;
- Regional comparisons of bodily injury loss results; and

[72] Data from 1999-2003. Source: *Trends in Auto Injury Claims*, Insurance Research Council, 2004.

As a result, it is clear that the costs associated with third party causes of action are considerable.

IV. Conclusions and Recommendations of the Commissioner

The conclusions that follow from the evidence are that West Virginia's legal approach to third party causes of action is in the minority, and this minority position has deleterious effects on the insurance climate of the state. The result is an insurance climate that is overly litigious and premium rates that are higher because of it. The evidence in this report is robust and comes from several credible sources.

The legal analysis demonstrates convincingly that West Virginia's legal protections of the third party rights in an insurance context give protections that are beyond the original intent of the Unfair Trade Practices Act. This has resulted in a disproportionate number of UTPA filings under this protection of the law, and a fundamental shift in the business practices of insurance carriers. It appears that they have taken on a practice of defensive claims settlement practices and are spending a much higher than average effort defending themselves in court.

The economic evidence provided, supported by the academic community, has indicated that the costs associated with the third party doctrine increases the cost of insurance in the state, and particularly among auto lines. These higher costs are ultimately shifted forward to insurance consumers. This evidence comes from economic theory, econometric support, and comparisons of national and regional data on bodily injury claims. Additionally, the evidence shows that claims practices in West Virginia are tilted considerably toward unfair claims settlement violations when compared to other states.

As a result of this evidence, it is the opinion of the Commissioner that this situation be changed. We must return to the consumer protections originally intended by the Unfair

Trade Practices Act. These protections provide for prompt, fair and equitable treatment of consumers. However, these protections do not extend beyond complete indemnification or to enriching those outside of the insurance contract. We believe that the current interpretation of the law extends protections beyond its original intent.

We suggest a change that will move examination of insurance companies from the courts to the Insurance Commission. The Commission has the administrative authority, plus the specialized skills and knowledge about insurance transactions that cannot be duplicated by the court system. The Commission is the rightful place for the business practices of insurance carriers to be examined. To do this, the private third party cause of action must be eliminated.

The anticipated result will be better for insurance consumers and insurance carriers alike. It is reasonable to expect downward pressure on insurance costs and increased competition as carriers find West Virginia a better place to conduct the business of insurance.

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