

The Emergence and Potential Consequences of First-Party Insurance Bad-Faith Liability*

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Abstract

This article discusses the approaches to first-party insurance bad-faith law that have been taken by the states, using legal and economic reasoning to illuminate the potential benefits and costs of different approaches. Theory suggests that allowing policyholders to recover damages over and above the value of the insurance benefit owed will provide insurers with added incentives to engage in fair claims settlement. However, excessive or uncertain liability for insurance bad faith might create incentives for policyholders to file questionable claims and disincentives for insurers to investigate claims for fraud. The article analyzes a large dataset of first-party automobile insurance claims to investigate whether

* This research was funded by the National Association of Mutual Insurance Companies (NAMIC). The Insurance Research Council (IRC) provided data for the empirical analysis. The authors remain solely responsible for the content of the work and any opinions expressed therein.

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these adverse effects appear to have empirical relevance. The data show that claim characteristics in states that permit tort-based bad faith differ from those in other states. The findings are consistent with the idea that permitting tort-based first-party insurance bad-faith settlements might reduce insurer incentives to challenge disputable claims.

Introduction

Historically, insurers were not penalized under common law for unfair claim settlement practices including, for example, unnecessarily delaying the payment of a policy benefit or withholding payment of a rightful policy benefit.³ Under traditional common-law rules,⁴ a policyholder was allowed to recover only those damages that were in the contemplation of the parties to the contract at the time the policy was purchased. This meant that damage awards could not exceed the amount specified in the insurance policy. Even if the breach of contract was intentional on the part of the insurer, the policyholder was not entitled to prejudgment interest on the amount due under the policy, legal expenses incurred in pursuing a breach of contract remedy, or consequential (incidental) damages for economic loss and mental distress. With perhaps the exception of large commercial insureds, this legal structure provided little incentive for most policyholders to challenge an insurer over an unpaid claim.

In the early 1900s, state legislatures began to respond to this situation by enacting statutes that provided for the recovery of prejudgment interest and legal expenses in those cases where the insurer acted unreasonably in the processing of a claim. While enactment of these statutes constituted the first recognition that an imbalance existed, only about one-fourth of the states had enacted statutes providing for prejudgment interest and legal expenses as late as 1951. However, by 1959, all states had adopted the model Unfair Trade Practices Act developed and promulgated by the National Association of Insurance Commissioners (NAIC). This model act primarily addressed the marketing practices of insurers, and it was not until 1972 that an amendment pertaining to unfair claim settlement practices was incorporated into the model legislation. This model legislation, or some variant of it, has been adopted by all states.

The Unfair Trade Practices Act prohibits certain acts by an insurer only when committed flagrantly and in conscious disregard of the statute, or with such frequency as to indicate a general business practice. Prohibited acts include, for example, knowingly misrepresenting to insureds policy provisions relating to coverage at issue; failing to acknowledge promptly a communication from a policyholder relating to a claim; failing to adopt and implement reasonable

3. This historical perspective concerning the evolution of bad faith law is based on Stempel (2008).

4. See *Hadley v. Baxendale*, 156 Eng. Rep. 145 (Ex. 1854).

standards for the prompt investigation and settlement of claims; and not attempting in good faith to effectuate prompt, fair and equitable settlement of submitted claims in which liability has become reasonably clear.⁵

The model legislation was silent as to whether it creates a private cause of action. This meant that the insured's only recourse was to file a complaint with the state insurance department. Given that the insured could not file a suit for monetary damages, hiring an attorney and compelling discovery to obtain proof that the insurer had "flagrantly, and in conscious disregard of the statute committed a prohibited act" was often not practical.⁶ In the absence of such proof, state insurance departments were unlikely to undertake remedial action unless numerous, similar complaints were received that indicated the prohibited act was being committed by the insurer with such frequency as to indicate a general business practice.

To strengthen the position of insureds and further deter insurer misconduct, courts and state legislatures across the country began to allow the filing of private causes of action against insurers alleging unfair claim settlement practices. This move was based on the "private attorney general" concept, which holds that insureds are in the best position to police the insurance industry with respect to unfair claim settlement practices. The ability of the insured to obtain compensatory damages (including consequential, or incidental, damages for economic loss and mental distress) created an incentive for policyholders who believed they were treated unfairly to bring lawsuits against insurers.

Today, many states allow for recovery of consequential or incidental damages, attorney's fees and prejudgment interest, as well as the benefit owed under the policy, in a first-party insurance bad-faith case. Indeed, a majority of states that recognize insurance first-party bad-faith liability allow actions under tort law rather than contract law, despite the existence of a contract and without requiring the policyholder to allege a traditional tort, such as fraud or intentional infliction of emotional distress. Moreover, in recent years, many state legislatures have enacted, or considered enacting, legislation that creates or expands the legal avenues available to policyholders to pursue actions against their insurers for bad faith in claims settlement (GenRe, 2008).

This article discusses the approaches to first-party insurance bad-faith law that have been taken by the states, using legal and economic reasoning to illuminate the potential benefits and costs of different approaches. Theory suggests that allowing policyholders to recover damages over and above the value of the insurance benefit owed will provide insurers with added incentives to engage in fair claims settlement, and that this might enhance the efficiency of contracting in insurance markets. However, theory also identifies a number of potential adverse

5. For an identification of all 14 of the prohibited acts, see, e.g., Laureen Regan and Paul M. Rettinger, "Private Rights of Action Under State Unfair Claims Settlement Practices Acts," *Journal of Insurance Regulation*, Spring 1998, pp. 296–297.

6. This language, or the functional equivalent of it, is contained in the Unfair Claims Practices Act that has been adopted in all states. See, for example, Cal. Ins. Code Section 790.03(h)(s), (h)(14)(West 2006)(California Unfair Claims Practices Act).

effects of excessive or uncertain tort liability for insurance bad faith, most notably the creation of incentives for fraudulent claiming and the creation of disincentives for insurers to investigate claims that are potentially fraudulent. The article analyzes a large dataset of automobile insurance claims to investigate whether these latter effects appear to be of empirical relevance. The empirical evidence is consistent with the idea that permitting tort-based first-party insurance bad-faith settlements might change claim-filing and claim-investigation incentives in the manner predicted by theory.

Legal Standards for First-Party Bad-Faith Liability

The states have adopted varying standards for determining insurer bad faith in first-party claims settlements. Specifically, courts and state legislatures across the country have adopted three distinct procedures and standards to facilitate the filing of private causes alleging unfair claims-settlement practices.⁷

Tort Action Based Solely on Bad Faith

Today, a majority of jurisdictions permit a tort action based solely on breach of the implied covenant of utmost good faith (i.e., bad faith). Policyholders are not required to allege an independent tort—such as fraud or intentional infliction of emotional distress—in order to recover under tort laws. The general rule of damages in tort is that the injured party may recover for all harm or injuries incurred, regardless of whether they could have been anticipated. Assuming that the conduct giving rise to liability was particularly egregious, punitive damages may be awarded.

Among jurisdictions that permit a tort action based solely on bad faith, at least 12 have adopted a “negligence” standard for determining whether an insurer has acted in bad faith. Courts following this approach have reasoned that insurers must be held to a high standard because of their disproportionate ability to cause severe economic dislocation to a policyholder (e.g., a policyholder might be forced to file for bankruptcy as result of the unreasonable denial of a property insurance claim, or as a result of the unnecessary delay in the payment of a property insurance claim). This standard demands that an insurer not withhold unreasonably payment due under a policy (i.e., an insurer must have proper cause to deny payment for a claim submitted under a policy).

At least 16 jurisdictions have adopted an “intentional tort” standard. Under this standard, an insurer is entitled to contest a claim so long as it has a reasonable basis grounded in law or fact. Whether the insurer ultimately is correct in its

7. For further details, see Stempel (2008), pp. 10–101.

position is of no consequence in resolving the bad-faith issue. Denying a claim whose validity is “fairly debatable” does not constitute bad faith. Under this standard, “the tort of bad faith is not a tortious breach of contract. It is a separate intentional wrong that results from a breach of duty imposed as a consequence of the relationship established by contract.”⁸

One state (Arkansas) has adopted a “quasi-criminal” standard. In adopting this standard, the court declared that “evidence of bad faith must be sufficient to show affirmative misconduct of a nature which is malicious, dishonest, or oppressive.”⁹

Contract Action with Broad Definition of Damages

At least nine states confine the good-faith/bad-faith inquiry to the realm of contract, but broadly define damages to include both general damages (i.e., those following naturally from the breach) and consequential, or incidental, damages (i.e., those reasonably within the contemplation of, or reasonably foreseeable by, the parties at the time the contract was made).¹⁰ Consequential damages may reach beyond the strict contract terms and include prejudgment interest and legal expenses, and damages for economic loss and mental distress. An independent tort, such as fraud or intentional infliction of emotional distress, must be alleged in order to make a claim for punitive damages.

Statute

At least 25 states recognize the right to file a private cause of action alleging bad faith based on a statute and judicial recognition of an implied, private cause of action under an Unfair Trade Practices Act that includes an unfair claims-settlement practices provision.¹¹ Damages may include prejudgment interest and legal expenses, consequential, or incidental, damages for economic loss and mental distress, and, in some instances, punitive damages.

There is considerable variation among statutes with respect to the standard of conduct, burden of proof and damages that can be recovered. Some statutes, for example, only allow for limited recovery of damages (e.g., prejudgment interest and attorney fees).¹² Other statutes contain language that has been broadly construed by courts to permit unlimited punitive damages in those cases where the

8. See *Anderson v. Continental Insurance Company*, 85 Wis. 2d 675, 691, 271 N.W. 2d 368 (1978).

9. See *Aetna Casualty and Surety v. Broadway Arms*, 281 Ark. 128, 664 S.W. 2d 463 (1984).

10. The nine states include Delaware, Maine, Maryland, New Hampshire, New Jersey, New York, Oregon, Utah and Virginia.

11. The 25 states include Alabama, Arkansas, Colorado, Connecticut, Florida, Georgia, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Montana, Nevada, New Mexico, New York, North Carolina, Pennsylvania, Rhode Island, Tennessee, Texas, West Virginia and Washington.

12. See, e.g., MCL 500.3148 (1) Section 6.29 and 6.30 (Michigan).

insurer has engaged in more than one listed prohibited practice with respect to the processing of a single claim.¹³

Moreover, the statutory basis for first-party insurance bad faith is still evolving. In recent years, a number of states have enacted, or considered enacting, new legislation that creates a substantial first-party bad-faith liability exposure for insurers. For example, Minnesota passed legislation in 2008¹⁴ that creates a new private cause of action for first-party insurance bad faith where one previously did not exist. The statute codifies the intentional tort standard and specifically precludes the possibility of punitive damages in the absence of an independent tort, such as fraud or intentional infliction of emotional distress. Recent Colorado legislation¹⁵ adopts the negligence standard, whereas the intentional tort standard previously applied under common law. The new legislation allows for the recovery of the cost of litigation, but caps damages awards at two times the policy benefit that was unreasonably denied.¹⁶ Legislation adopted in Washington¹⁷ expands the definition of first-party insurance bad faith and increases the damages awards available to policyholders in cases alleging insurer bad faith.

Incentive Effects of First-Party Bad-Faith Liability

Allowing the courts to impose extra-contractual liability on insurers in cases of intentional or unintentional bad-faith denial of claims not only serves the obvious purpose of compensating policyholders for their unwarranted losses, but also may serve the broader economic purpose of enhancing the efficiency of insurance contracting. Competitive markets will work to constrain insurers from unwarranted systematic bad faith in settlement activities, due to reputation penalties that will reduce demand for insurance from a company that engages in such practices. However, competition alone might not guarantee that insurers will never engage in bad-faith practices.

Intentional bad faith might occur, for example, if an insurer strategically denies or delays the settlement of a particularly large insurance claim for the purpose of coercing the policyholder to accept a reduced claim settlement. Market sanctions might not deter this kind of behavior, because the potential cost-savings on the claim could outweigh the cost of reputation penalties meted out in the market in the form of reduced demand for insurance. The possibility of bad faith

13. See e.g., *Maier v. Continental Casualty Company*, 76 F. 3d 535 (4th Cir. 1999) (Applying West Virginia law.)

14. 2008 Minn. Laws § 604.18.

15. Colorado Rev. Stat. Ann. § 10-3-1113 (2008).

16. Moreover, the new legislation imposes a special penalty on health insurers that unreasonably delay the payment of the policy benefit (i.e., the penalty is 20 percent of the policy benefit, the payment of which was delayed 90 days or longer past the submission of the claim).

17. Wash. Rev Code § 48.30.010 (2007).

might help to commit insurers to avoid engaging in unwarranted claims denials by imposing a direct financial penalty for doing so (Sykes, 1996; Abraham, 1986). Such particularly is the case if damages awards are large in the event that a court finds in favor of the policyholder. The threat of extra-contractual liability will reduce the incentives of an insurer to deny, delay or underpay claims. Thus, insurer liability for bad faith in claims settlement might reassure consumers that valid claims will be paid, and this assurance will improve the insurance-contracting environment.

There are also circumstances in which insurers might engage in claims-settlement behaviors that lead to an unintentional bad-faith denial of settlement (see Sykes, 1996). Incomplete contracts and contractual complexity might lead to disputes regarding the compensability of a claim. One situation is when an insurer and a policyholder have different information about the circumstances of a loss that lead to differing conclusions about the value of the loss or whether the loss is covered by the insurance policy. Another case involves the potentially fraudulent or exaggerated claim, in which the insurer believes that the policyholder might have manufactured false information about the loss event or the amount of loss. Other contractual disputes involve differing interpretations of the language of the insurance policy by the insurer and the policyholder, leading to different beliefs about whether a loss should be covered. Disputes of these kinds between an insurer and a policyholder might result in claim denials or other claim-settlement behaviors that prove to be unwarranted in the eyes of an independent observer, such as the courts.

Claim investigations are an important tool that insurers have for preventing excessive claim payments or payment of illegitimate claims. An investigation can benefit the insurer if it results in claim denial or a reduction in claim payment, but the investigation process itself might lead to claim delays and other insurer actions that bring accusations of bad faith. Because investigating claims is costly, insurers will balance the expected gains from investigation against the costs. In the absence of potential extra-contractual liability, the insurer considers only the benefits of claims denial or underpayment, in terms of reduced claims costs and reduced fraud. The insurer does not have an incentive to take into account the costs imposed on (legitimate) policyholders from its investigation strategy. However, if faced with the possibility of damages awards in excess of the insurance claim amount, the insurer is given appropriate incentives to take into account the costs to policyholders associated with claim investigations and payment delays. When deciding on a claims-investigation strategy, insurers will balance the benefits of reduced costs with the costs of investigation, including the expected costs of litigation. This internalizes the externality, because the insurer realizes the benefits and the costs of its claims-investigation strategy (Crocker and Tennyson, 2002).

While tort actions to address insurer bad faith in claims settlement might be beneficial in theory, their implementation in law has important implications for whether the system is, in fact, producing those benefits. If the standards applied in the courts for a finding of insurer bad faith are too lax, and/or if damage awards

are too high relative to the actual costs incurred by policyholders whose claims have been denied, substantial incentive distortions might arise.

A major concern is the increased pressure on insurers to pay disputable claims (Abraham, 1986). We have discussed the fact that insurers balance the benefits of reduced fraud costs with the expected costs of litigation. If the expected costs of litigation to insurers from disputed claims exceed the expected cost savings from reducing fraud, insurers will have too little incentive to employ fraud-screening and deterrence strategies. Excessive liability will raise the costs of investigation and reduce investigations below what they should be. This will raise the costs of fraud in the immediate term, because fewer fraudulent claims will be detected, and over the longer term, because of reduced deterrence. By reducing insurer resistance to fraudulent claims and by increasing the payoffs from litigation, excessive liability for insurer bad faith will increase consumers' incentives to engage in claims fraud and exaggeration. Another potential problem is the increased incentive for policyholders to engage in litigation against insurers for bad-faith handling of a claim, even if the policyholder knows the claim is invalid (Abraham, 1986).

If, in addition, the standard for a finding of insurer bad faith is unclear, changing or prone to error, this can lead insurers to over-invest in avoidance of claim disputes (Shavell, 1987). This will lead to further pressures on insurers to pay disputable claims, with the resulting increase in consumer incentives for claims fraud described above. It might also lead to excessive investments in claims-processing bureaucracy, procedures or technology, raising insurers' costs. This would, in turn, drive up the cost of insurance to consumers.

The extent of uncertainty facing many insurers is exacerbated by the fact that laws vary across the states. Insurers operating in more than one state must be cognizant of these varying standards and must adopt procedures and policies that can account for the variation. This might lead to additional resource expenditure and perhaps excessive caution if insurers adopt behaviors that are tailored to the most stringent state(s) in which they operate.

As this discussion suggests, assignment of excessive liability to insurers for bad faith might create significant distortions to the behavior of insurers and create unwarranted costs in insurance markets. These costs could be manifested as higher claims costs due to insurers' reluctance to challenge disputable claims out of fear of liability, and/or as increases in insurer expenses due to increased investments in internal monitoring and legal expertise. If first-party bad-faith laws have these consequences, they will create inefficiencies in insurance markets and their benefits for insurance consumers will be lessened.

Empirical Evidence

While the impact of bad-faith law on insurance claim settlements has not been extensively studied, formal empirical analysis of first-party automobile insurance claims data has demonstrated that tort liability for insurer bad faith is associated with higher claims payments. Browne, Pryor and Puelz (2004) analyze a large dataset of first-party automobile insurance claims settled in 38 different states in 1992.¹⁸ They find that, even after controlling for a wide array of claim characteristics and for other features of states' legal and claims environments, claim payments are significantly higher in states that allow tort actions for insurer bad faith in claims settlement.

Of course, higher claim payments should not be construed negatively if, in the absence of bad-faith liability, a tendency exists for insurers to underpay or to wrongfully deny claims. However, if higher claims payments are occurring because insurers are paying unwarranted amounts or paying illegitimate claims in order to avoid potential bad-faith liability, this should be a source of concern to policymakers. We are not aware of any empirical studies that consider the implications of first-party bad-faith laws for insurer claim-settlement behavior, but there is anecdotal evidence from case law that tort liability standards are too lax and/or damage awards are too high in some cases (Powers, 1994; Sykes, 1996). Therefore, we examine insurance claims data to begin to explore the relationship between tort-based first-party bad-faith liability and claim-settlement behaviors.

We use individual claims data from the Insurance Research Council (IRC) on uninsured motorist (UM) claims in automobile insurance. Uninsured motorist (UM) insurance is part of the private passenger automobile insurance policy and provides indemnification of medical expenses to the policyholder in accidents in which the driver who is at fault does not carry liability insurance. In this case, the injured policyholder files a UM claim with his own insurer and may receive compensation for both economic and non-economic losses. UM insurance is a first-party insurance contract and courts in a number of states have specifically upheld the applicability of first-party bad-faith remedies in the UM context (Browne, Pryor and Puelz, 2004).¹⁹

The data are based on a national sampling of claims from insurance companies in 1997, the most recent year for which data are available to us. The original dataset includes nearly 6,000 uninsured motorist claims from 50 states, the District of Columbia and several U.S. territories. The survey reports a wealth of information for each claim, including the amount claimed and the amount paid; injury severity and type of injury; injury treatments; and the insurer's handling of the claim. We combine these data on UM claims with data on each state's legal

18. These authors study uninsured and underinsured motorist claims using data compiled by the Insurance Research Council from a 1992 survey of closed claims obtained from insurance companies.

19. First-party underinsured motorist (UIM) claims were also separately analyzed, and the results were similar.

regime for insurer first-party bad faith to facilitate a comparison of outcomes among states with different bad-faith regimes. The data on state laws is compiled from the GenRe (2008) report on state bad-faith statutes.

Based on the discussion above, we are interested in two aspects of the claims: 1) the use of investigative techniques by the insurer; and 2) characteristics of claims that might be indicative of fraud (so-called suspicion indicators or “red flags”). We provide evidence on each of these areas in turn by comparing mean (average) values of claim characteristics among states that have different legal regimes for first-party bad-faith actions.²⁰

We compare claims in states that allow tort-based causes of action for first-party bad faith to claims in states that do not allow tort-based causes of action (but might allow contract-based or statute-based actions).²¹ States are categorized into these two groups so that the important distinction between the two sets of states that are compared is whether the state allows unlimited punitive damages awards in bad-faith actions. That is, our comparisons are made for 1) states that permit tort-based first-party bad-faith actions vs. 2) states that do not (i.e., all other states).

For ease of presentation, we display the comparisons in graphical form (using bar charts). However, a more precise statistical comparison of means (averages) across the two sets of states is undertaken using a t-test. Statistical significance of the t-test depends both on how different the two means are, and how closely the mean of each group reflects the data for the individual states that are members of the group.²² The larger is the difference in means across the groups, and the smaller is the difference in values across the states within each group, the more likely it is that the difference in means is statistically significant.²³

20. Because we recognize that claims characteristics might differ for small vs. large claims and that insurers might handle claims differently if they are of different size, we also undertook the comparisons shown in Exhibit 1 – Exhibit 5 for claims of roughly the same size (in the same quarter of the claims distribution). Results are comparable to those shown here.

21. Although not shown here, results from comparing the two sets of states with the most disparate legal regimes (i.e., those that allow negligence-based torts vs. those that disallow all private actions) also reveal principally the same patterns.

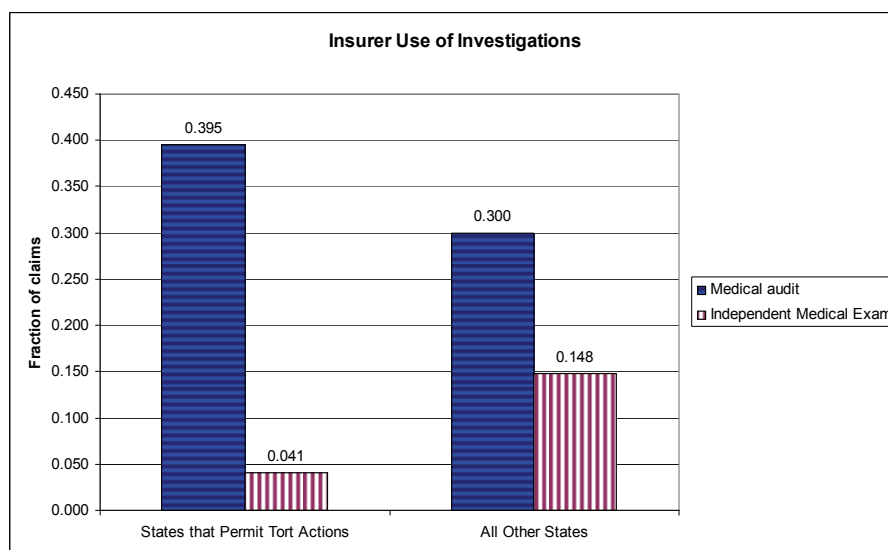
22. The t-test is also sensitive to the number of observations in each group, because larger numbers of observations make the results more reliable.

23. Consider the case in which the average (mean) value of a variable across two different groups of states is different, but the values of that variable are widely dispersed for the individual states that are a member of each group. This dispersion across states within the group reduces the precision of the average in representing the states in the group. For this reason, the difference in means might not meet the standard of statistical significance. On the contrary, even if the average value of a variable does not appear to be very different across two comparison groups, the difference might, in fact, meet statistical significance if there is little dispersion within each group. Thus, while examining the raw magnitude of the difference in the mean values of variables across the two comparison sets of states might be informative, it is not sufficient to determine whether the difference is statistically significant.

Claim Investigations

Insurers have several methods at their disposal to investigate the validity of medical claims. One method is a medical audit, which entails having a medical professional (usually a nurse) review the medical treatment and bills submitted. The review will provide information from a medical perspective on whether the treatment and billed amounts are presumed to be appropriate. Another, more costly and detailed, investigative method is an independent medical exam (IME). An IME is an examination of the injured policyholder by a medical professional (usually a doctor) chosen by the insurance company. An IME provides a second medical opinion about the nature and severity of the injuries to the policyholder. An IME is more expensive than a medical audit and necessitates the cooperation and involvement of the policyholder. The IRC claims database reports information on whether a medical audit or an IME was undertaken for each claim.

Exhibit 1: Claim Investigations in States with Different Bad-Faith Laws



Note: The difference across states in the use of medical audits is statistically significant, as is the difference across states in the use of IMEs.

Exhibit 1 compares insurers' use of medical audits and IMEs, respectively, in states that allow tort-based actions for bad faith and states that do not. The comparisons show that insurers faced with potential tort actions are more likely to conduct a medical audit (on 39.5% of claims vs. 30% of claims in other states).

This difference across states is statistically significant, meaning that we can have a high degree of confidence that there truly are differences.²⁴ However, insurers request an IME for only 4.1% of claims in states that allow tort-based bad-faith actions, but for 14.8% of claims in states that do not allow tort-based bad-faith actions. T-test values show that this difference is also statistically significant.

These patterns are suggestive of larger resource investments in routine claims handling (medical audits) and smaller resource investments in fraud investigation (IMEs) by insurers in states that allow tort-based bad-faith actions. Because an IME requires the notification and cooperation of the insured, insurers might be particularly reluctant to undertake this type of investigation when bad-faith suits are decided under tort law.²⁵

Fraud “Red Flags”

Fraudulent and exaggerated claims are an important problem in the insurance industry—and in automobile insurance, in particular. As a result, there is a growing empirical literature that analyzes the nature of claims fraud and how it is handled by insurance companies.²⁶ Particularly influential in this area are studies undertaken by Weisberg and Derrig (1991, 1998), in which insurance claims professionals were engaged to review actual closed-claim files in order to gauge the likelihood that each claim was legitimate or fraudulent. In addition to providing a suspicion score for each file, the reviewers were asked to list specific elements of the claims that led to a higher or lower degree of suspicion. One outcome of these studies is a catalog of fraud suspicion indicators, or “red flags,” defined as those elements of a claim that most claims professionals found to indicate potential fraud. The claim characteristics identified as suspicion indicators encompass a wide variety of characteristics of the insured, the accident, the injury and the injury treatment.

Several caveats should be emphasized regarding these indicators. First, these characteristics of a claim are not proof of fraud, but instead signal to the insurer that additional investigation might be needed. Second, no single characteristic should be thought to indicate potential fraud; instead, if enough of the characteristics are present in a claim, together these indicate a higher likelihood of fraud and, therefore, a need for additional investigation.

However, because the IRC database includes only claims that are closed with some payment by the insurer, we can make use of these suspicion indicators to infer whether insurers handle suspicious claims differently in states that allow tort-

24. The statistical test employed is a t-test of differences in means across the two groups of states. Statistical significance is assessed at the 5% confidence level, 2-sided test.

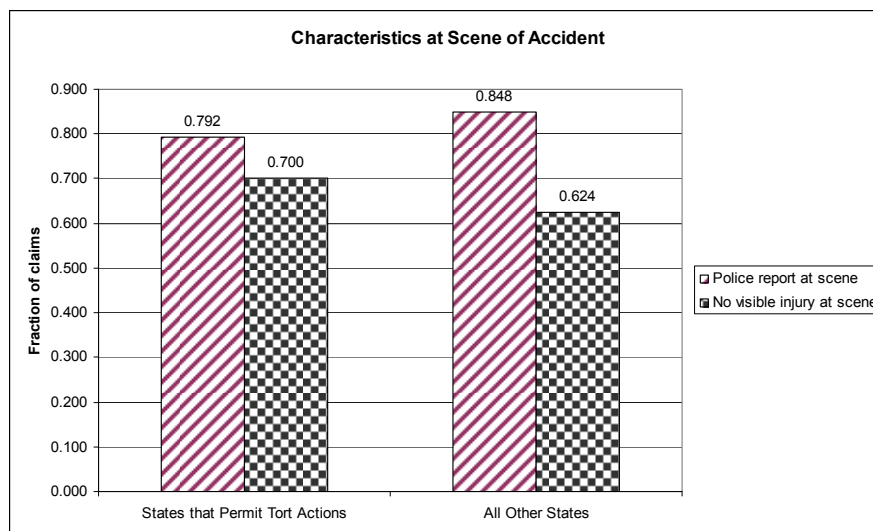
25. IMEs are more common in no-fault states. When no-fault states are examined separately, the difference in bad-faith regimes has this same effect, but there is no significant difference in IME use across the non-no-fault states with different bad-faith regimes.

26. See Cummins and Tennyson (1992) and Abrahamsee and Carroll (1999) for evidence of the extent of the fraud problem in automobile insurance. Tennyson and Salsas-Forn (2002), Crocker and Tennyson (2002) and Loughran (2004) analyze claims handling by insurers.

based bad-faith actions as compared to states that do not. Specifically, if paid claims are more likely to exhibit fraud suspicion indicators in states that allow tort-based bad faith, we might infer that insurers are less likely to deny suspicious claims in these states.

One fraud suspicion indicator is the *lack of a police report* for the accident that produced the claim. The thinking behind this is that in the normal course of an accident, the police will be called and a report will be filed. If there is no police report, it is more likely that the accident (and hence the injury) is fictitious. Another suspicion indicator is the *lack of a visible injury* at the scene of the accident. Although it is possible that the policyholder could realize his or her injuries only with some delay, if there was no injury apparent at the scene of the accident, it is more likely that the injury is fictitious or exaggerated. Exhibit 2 compares these characteristics of claims across states with different bad-faith laws.

Exhibit 2: Accident Characteristics in States with Different Bad-Faith Laws



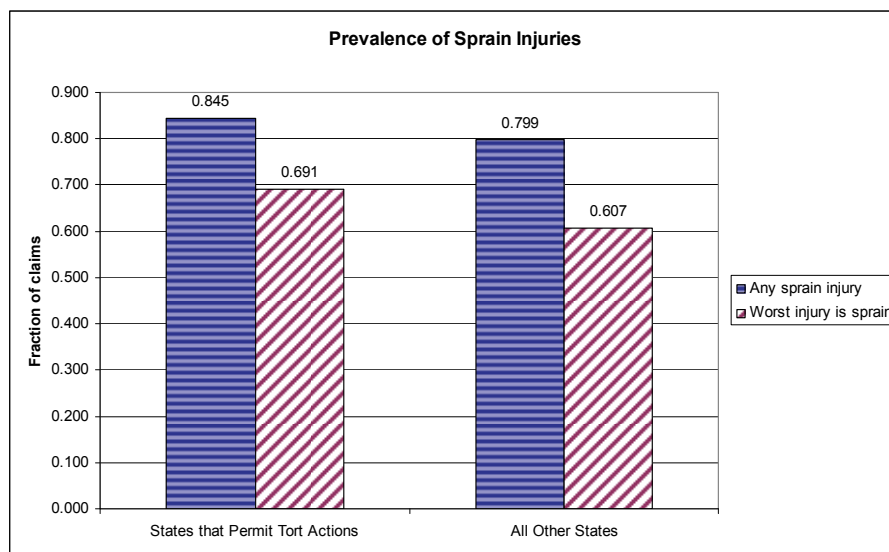
Note: The differences across the states in the fraction of claims that have a police report and the fraction of claims that involve no visible injury are statistically significant.

We observe that police reports from the scene of the accident are less prevalent among claims in states that allow tort actions. In these states, 79.2% of claims have a police report from the scene of the accident, while 84.8% of claims in states that do not allow tort actions have an on-scene police report. In addition, we observe that claims involving no visible injury at the scene of the accident are more prevalent in

states that allow tort-based bad faith (70%) than in states that do not (62.4%). Tests show that these differences are statistically significant. Thus, suspicion indicators from the scene of the accident are more prevalent among paid claims in states that allow tort-based bad faith. This is consistent with the idea that insurers might be less likely to challenge disputable claims in states with these laws.

A second set of fraud suspicion indicators has to do with the nature of the injury. Soft-tissue injuries such as sprains and strains are difficult to medically verify and, therefore, fall into the category of claims that might not lend themselves to discovery through investigations (Dionne and St-Michele, 1991). As a result, they are notorious for being prone to falsification and exaggeration, and a claim involving *only or primarily a sprain injury* is a fraud suspicion indicator for insurers. Exhibit 3 compares the prevalence of sprain claims among states with different bad-faith laws.

Exhibit 3: Characteristics of Injuries in States with Different Bad-Faith Laws

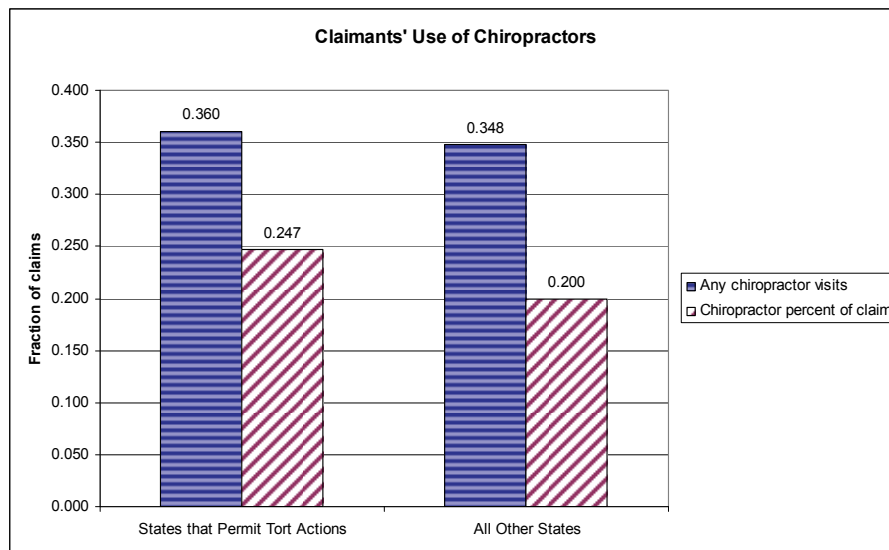


Note: The differences across states in the fraction of claims involving a sprain and in the fraction of claims for which a sprain is the worst injury are statistically significant.

The exhibit reveals that paid claims in states that allow tort-based bad faith are more likely to involve a sprain injury (84.5% in states that allow tort-based bad faith, compared to 79.9% in states that do not), and more likely to involve a sprain as the most severe injury received by the policyholder (by 69.1% to 60.7%). Both of these differences are statistically significant.

Appropriate treatment of sprain injuries is also difficult to determine, providing an additional avenue for a policyholder to falsify the treatment or to exaggerate the amount of treatment. Because of this, *large numbers of visits to a chiropractor* for treatment of accident injuries is another fraud suspicion indicator in the eyes of insurance claims professionals.

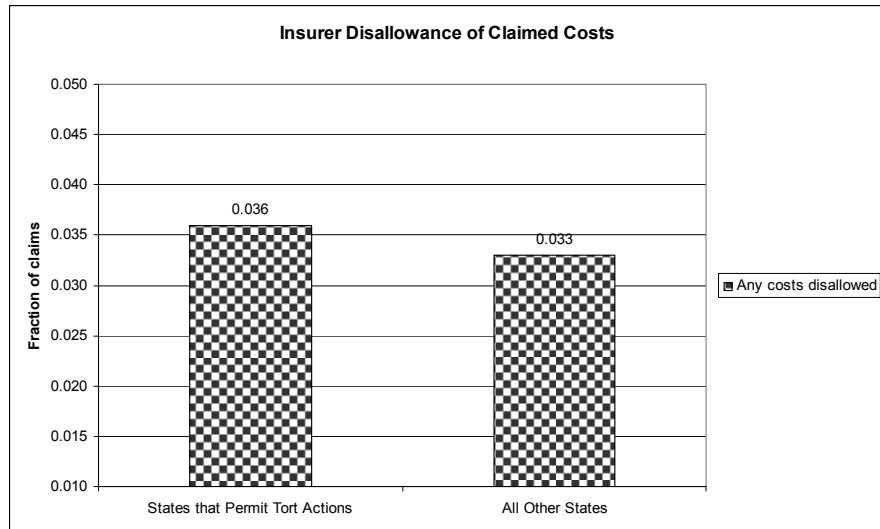
Exhibit 4: Use of Chiropractors in States with Different Bad-Faith Laws



Note: The difference across states in the fraction of claims involving any chiropractor treatment is not statistically significant; however, the difference across states in the proportion of the total claim amount arising from chiropractor treatments is statistically significant.

Exhibit 4 shows that the fraction of claims with any chiropractor treatments is about the same among states with different bad-faith laws (36% in states that allow tort-based bad faith and 34.8% in states that do not), and the difference between the two sets of states is not statistically significant. However, the proportion of the total claimed amount that arises from chiropractor care is significantly larger in states that allow tort actions (24.7%) compared to states that do not (20%), and this difference is statistically significant. These differences in treatment patterns are suggestive of differences in insurers' handling of claims that involve suspicious treatment patterns.

Exhibit 5: Disallowance of Claim Costs in States with Different Bad-Faith Laws



Note: The difference across states in the fraction of claims for which any costs were disallowed is not statistically significant, meaning that the difference might be due to random chance.

In light of the greater prevalence of fraud-suspicion indicators among claims in states that allow tort-based bad-faith actions, we examine the likelihood that some portion of the claim costs are disallowed by the insurer. Exhibit 5 compares the proportion of paid claims for which any charges were disallowed by the insurer, in states that allow tort-based bad faith and states that do not.

There is no statistically significant difference in the rate of disallowances among the two sets of states. This lack of difference, even as fraud-suspicion indicators are more prevalent in states with tort-based bad faith, suggests that insurers might be more reluctant to challenge claims when faced with tort liability.

Overall, Exhibits 1 through 5 provide a pattern of evidence: Paid UM claims in states that allow tort actions for insurer bad faith are significantly more likely to contain characteristics associated with claims fraud; but insurers in these states are not more aggressive in investigating claims or in disallowing part of the claimed costs.

Conclusion

This paper has examined first-party insurance bad-faith remedies under common law and the recent legislative expansion of such remedies. Theory predicts that allowing policyholders to recover damages over and above the value of the insurance benefit owed will provide insurers with added incentives to engage in fair claims settlement, and that this might enhance the efficiency of contracting in insurance markets. However, theory also predicts that uncertain bad-faith standards for insurers and excessive damage awards for policyholders will undermine the benefits of the bad-faith remedy, distorting insurers' claims-settlement practices and policyholders' claim-filing incentives in ways that will lead to more borderline (or even fraudulent) claims and unwarranted increases in insurance costs.

The paper presents empirical evidence that automobile UM claims in states that permit tort liability for first-party insurance bad faith are characterized by less intensive insurer investigations and more characteristics that are often associated with fraud. These patterns are consistent with the hypothesis that insurers might be inhibited in challenging disputable claims due to concerns about bad-faith liability. This could be one source of the higher claim costs in states that permit tort-based standards for insurer bad faith identified by previous research (Brown, Pryor and Puelz, 2004). If this is the case, policymakers should carefully consider whether the benefits of expanded bad-faith liability outweigh the costs of added uncertainty to insurers and the increased costs of insurance to consumers (Abraham, 2004). Further empirical research into insurance claims-settlement behaviors under different legal standards for bad faith would help to shed light on this question.

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