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REFERENDUM 67 WOULD ALLOW PUNITIVE DAMAGES IN INSURANCE LAWSUITS

BRIEFLY

In November, Washington voters will decide whether to approve or reject R-67, a referendum on legislation that would allow policy holders to sue their insurance companies for treble damages whenever a claim has been denied.

Last Spring, the legislature passed and Governor Chris Gregoire signed ESSB 5726, the Insurance Fair Conduct Act. Opponents of the measure, however, gathered a sufficient number of signatures to force a referendum on the measure, which appears on the November ballot as Referendum 67. If approved by voters, R-67 would allow policyholders to sue for treble damages if they feel their insurance company has not handled their claims fairly.

Under the provisions of Referendum 67, when a court finds an insurer has unreasonably denied a claim the plaintiff could be awarded damages of up to three times the amount of the initial claim. In addition, the company would be required to pay reasonable attorney's fees and court costs. Before filing suit, claimants would be required to give 20 days notice to the insurance company and the Insurance Commissioner.

This bill applies to claims related to homeowner's insurance, auto insurance, long-term care insurance, property insurance, malpractice insurance and small business insurance but does not extend to health plans offered by health carriers.

Opponents argue that allowing treble damages will provide incentives for trial lawyers to file frivolous lawsuits and force insurance companies to pay claims when there is suspicion of fraud, which will lead to higher insurance premiums for consumers. They allege the law was written to benefit trial lawyers who will be more willing to take cases with the prospect of treble damages.

Proponents claim Referendum 67 will keep insurance companies honest and force them to handle claims carefully and responsibly. They argue that lawsuits should not increase as insurers are cajoled into handling claims fairly from the start to avoid lawsuits altogether. They also counter that lawyers have nothing to gain from frivolous lawsuits as they are also subject to the Consumer Protection Act.

BACKGROUND

In Washington state insurance claims are governed by general principles of contract law, tort law, state statute and regulations instituted by the Insurance Commissioner. Insurers must attempt to observe standards of reasonableness when assessing claims and must act in good faith.

The Office of the Insurance Commissioner has developed five rules that govern general conduct by insurers in the following areas: specific unfair claims practices; misrepresentation of policy provisions; failure to acknowledge pertinent communications; standards for prompt investigation; and standards for prompt, fair, equitable settlements.

Insurance customers who believe that their insurance company has wrongfully denied a claim can seek redress through three channels. First, they can file suit to enforce the contract. If the suit is successful, in addition to forcing the company

to pay the claim, the court can also award attorney's fees and court costs. Second, they may file a complaint with the Office of the Insurance Commissioner. If the Commissioner finds that the insurer has acted in bad faith, he may assess fines or penalties, or even revoke the company's right to do business in Washington. Third, if the denied claim amounts to a deceptive business practice, the insured may file a complaint with the Attorney General under the Consumer Protection Act (RCW 19.86).

INSURANCE

Insurance is a mechanism to eliminate or at least mitigate risk. Under an insurance contract, the customer pays a premium to the insurer in exchange for a promise that insurer will make a payment back to the customer in the event of some "accident." Insurers' revenues come from the premiums they collect and interest on the reserves they hold against future claims. Insurers' costs include the claims they pay and administrative expenses. The market for insurance is highly competitive. Although insurance profits vary over time due to the underwriting cycle, the prices that customers pay in premiums are ultimately tied to the claims that insurers pay out.

Insurance customers want both lower premium costs and less stringent claims requirements. These two desiderata are in conflict, however, as, in the long run, revenues must cover costs for insurers to stay in the business.

In the vast majority of cases it is clear what is and is not covered by an insurance policy. Occasionally, however, claims fall into a grey area where coverage by the contract is open to argument. R-67 will have the largest impact on these cases.

Insurers will only allow a disputed claim to go to trial if they believe their probability of winning justifies the expense of litigation. Likewise, a customer who's claim is denied will only pursue the claim in court if the expected gain (the amount of the claim multiplied by the probability of winning) exceeds the expected cost (legal fees multiplied by the probability of losing). R-67 will affect these calculations.

From the perspective of the insured person, under R-67 the potential payoff from litigating a claim will increase due to the possibility of treble damages. This would lead to an increase in the number of claims taken to court. From the perspective of the insurer, the trebling increases the cost of losing a claim in court. This will make insurers more likely to settle questionable claims. The end result will be greater payouts by insurers, which will then be passed on to consumers in the form of higher premiums.

THE MILLIMAN STUDY

Consumers Against Higher Insurance Rates, which opposes R-67, hired the actuarial consultancy Milliman Inc. to estimate the effects R-67 would have on insurance rates. The Milliman study looks at five states that have previously changed their first-party bad faith laws, focusing on automobile collision coverage because the data was the most easily available. The study compared countrywide trends in insurance costs with the costs in those five states for the years surrounding the change in law.

Milliman found when these states altered bad faith laws insurance premiums increased 3.5 to 7 percent more than the national average. While they

acknowledge that none of the states looked at in the study had a shift in law exactly like R-67; the authors are comfortable using the data and basic assumptions of rational decision making to predict the cost to Washington. Assuming the national average for insurance premium increases is 5 percent the study predicts Washington's premiums could increase up to 12 percent, costing Washington consumers \$650 million annually.

DISCUSSION

R-67 contains two key provisions. The first mandates that an insurance customer who wins a court judgment that her insurer has unreasonably denied a claim receive reasonable attorneys fees and court costs. Since current law allows judges in such cases to award attorneys fees and court costs, it is not clear that this mandate matters much. The second key provision allows the court to award treble damages in such cases. This provision matters a great deal.

When toting up the plusses and minuses of Washington State as a place to do business, the state's liability system has generally counted as a plus. The two national rankings of state liability systems place Washington 14th (Pacific Research Institute) and 25th (Institute for Legal Reform) respectively (WashACE 2007). This is due, in part, to the fact that punitive damages are generally unavailable in the state. Referendum 67 would erode this advantage.

R-67 will make insurance companies more likely to settle questionable claims and it will increase the magnitude of judgments against insurers in those cases they do take to trial and lose. These additional costs will be passed on to customers in the form of higher insurance premiums. Voters must decide whether the benefit of less stringent claims review by insurers is worth the higher premiums that insurance customers will be forced to pay.

REFERENCES

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