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SURVEY OF PENNSYLVANIA “BAD FAITH” LAW

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“Third-party” Bad Faith

The Pennsylvania Courts have long recognized that liability insurers have a fiduciary duty to act in good faith in their settlement or defense of third-party claims against their insureds and may be liable for excess verdicts beyond their policy limits in the event that duty is breached.

The right to pursue an excess verdict bad faith case was first recognized in Cowden v. Aetna Cas. Ins. Co., 133 A. 233 (Pa. 1955) and the general principles relating to such “third-party” bad faith claims were recently addressed in the case of Birth Center v. St. Paul Companies, 727 A.2d 1144 (Pa.Super. 1999), affirmed, 787 A.2d 376 (Pa. 2001). Essentially, an insurer’s fiduciary obligations in handling claims against its insureds require that the carrier give its insured’s interests the same consideration which it gives to its own, treating any claim against its insured as if it alone were liable and assessing the impact upon its insured of its decision to settle, or to instead litigate the claim. The insurer’s decision to settle or defend must be honest, intelligent and objectively reasonable and, where there is little possibility of a verdict within limits, the insurer must take into reasonable consideration all relevant factors including anticipated verdict ranges, strengths and weaknesses of the evidence, history of verdicts in the area, and the relative appearance and likely appeal of parties and witnesses.

In the “third-party” bad faith context, an insurer does not demonstrate good faith merely by showing that it acted with sincerity. Nor is it automatically liable for an excess verdict merely because the outcome is adverse. Nor does it have an absolute duty to settle simply because it is possible that a verdict might exceed its policy limits. However, an insurer’s contractual right to settle or defend is not a right to risk the insured’s financial well-being unless there is a real and substantial chance of a finding of non-liability and an insurer will be liable for an excess verdict if it unreasonably refuses an offer of settlement. An insurer’s decision to litigate rather than settle must be based upon a reasonable assessment of the

circumstances and a real and substantial chance of a verdict in favor of the insured. The critical standard (and, admittedly, a movable one,) is that of reasonableness.

There is some authority indicating that an insurer's failure to inform its insured of settlement offers may be evidence of bad faith. Haugh v. Allstate Ins. Co., 322 F.3d 227 (3d Cir. 2003). However, it has also been said that the failure to do so does not constitute bad faith *per se*, and that an insured advancing a Cowden bad faith claim must prove that the insurer's conduct proximately caused the insured's damages. Schubert v. American Independent Ins. Co., 2003 U.S. Dist. LEXIS 10769 (E.D.Pa. 2003), (holding that an insured plaintiff's hypothetical contentions to the effect that the insurance company would have changed its decision not to settle the case had she been aware of the settlement discussions were not persuasive, adding that it is highly unlikely that an insured could ever convince an insurer to settle a case within policy limits).

Although our courts have recognized a cause of action for bad faith on the part of a first-party insurer in settling claims and a cause of action for bad faith against a liability carrier for bad faith failure to settle claims where an excess verdict has resulted, it was held in one recent Pennsylvania federal court decision that no cause of action exists for a liability insurer's alleged delay in settling a third party claim where the claim is ultimately settled by the insurer within policy limits and no excess verdict results. Daniel P. Fuss Builders-Contractors, Inc. v. Assurance Co.of America, 2006 U. S. Dist. LEXIS 56742 (E.D.Pa. 2006).

In that case, it was claimed that the liability insurer and its appointed defense counsel improperly engaged in delaying tactics for a period of approximately four years before settling a claim as to which the insured had repeatedly admitted liability to the insurer, and that this delay caused injury to the insured because the protracted litigation damaged its long-standing business relations with the plaintiff and because the claimant withheld full payment to the insured for its work on the underlying construction project pending the outcome of the third-party case. Although the District Court observed that the complaint painted a "disturbing picture

of improper conduct” on the part of the insurer, it concluded that there was no recognized cause of action against an insurer for delaying settlement of a third party claim under existing Pennsylvania law, declined to create such a claim and granted the insurer’s motion to dismiss the case.

Where multiple claims are involved, it appears to be generally accepted that an insurer is free to settle any one or more of them as it sees fit without exposing itself to excess liability, even if the settlements exhaust the policy limits leaving some of the claims unsettled, provided the settlements are reasonable and entered into in good faith. Scharnitzki v. Bienenfeld, 534 A.2d 825 (Pa.Super. 1987). Policy language which terminates an insurer’s defense obligations upon the exhaustion of its liability limits through payment of settlements or judgments will be enforced provided the policy limits are exhausted in good faith, though insurers are not permitted to “dump and run” by simply depositing their limits with the court or entering into dubious settlements to quickly exhaust their coverage. Maguire v. Ohio Casualty Ins. Co., 602 A.2d 893 (Pa.Super. 1992), appeal denied, 615 A.2d 1312 (Pa. 1992); Commercial Union Ins. Co. v. Pittsburgh Corning, 789 F.2d 214 (3d Cir. 1986). It should also be noted that at least one Pennsylvania trial court has held that it would create an irreconcilable conflict of interests for defense counsel retained by an insurer to petition for interpleader of policy limits on behalf of the insurer which retained him, since such a petition would only serve to benefit the insurer at the possible expense of his true client, the insured. Bohinski v. Trademark, Inc., 17 D.&C.4th 408 (C.P. Allegheny Co. 1993).

As discussed below, insurer exposure in cases of third-party bad faith is not limited to the payment of verdicts in excess of policy limits, but may also extend to payment of all known or reasonably foreseeable compensatory damages, as in any breach of contract case, resulting from the failure to settle.

“First-party” Bad Faith

The Pennsylvania Courts have held that there is no common law right of action on the part of an insured against his or her insurer based upon its alleged bad faith handling of a first-party claim. D’Ambrosio v. Pennsylvania National Mutual Cas. Ins. Co., 431 A.2d 966 (Pa. 1981).

Possibly in response to that decision, the Pennsylvania Legislature enacted the current bad faith statute, appearing at 42 Pa.C.S.A. §8371, effective July 1, 1990, which provides as follows:

§ 8371. Actions on insurance policies

In an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured, the court may take all of the following actions:

- (1) Award interest on the amount of the claim from the date the claim was made by the insured in an amount equal to the prime rate of interest plus 3%.
- (2) Award punitive damages against the insurer.
- (3) Assess court costs and attorney fees against the insurer.

The statute provides no definition of “bad faith”, no mention of the governing statute of limitations, and no guidance with respect to the evidentiary standards or applicable procedures with respect to such claims.

This, coupled with the fact that there has been little Supreme Court authority interpreting the statute more than sixteen years after its effective date warrants a word of caution. When, or if, the Supreme Court of Pennsylvania issues an opinion on the subject, everything we know may be wrong, or more likely, at least some of it will be wrong. Whether the

Supreme Court's general silence on the subject stems from tacit approval of the decisions of lower courts, or something else entirely is anyone's guess. For now, we must rely chiefly upon the numerous and sometimes conflicting opinions of the Superior Court, the Pennsylvania trial courts and the federal courts sitting in the Commonwealth and their predictions as to how our highest court will ultimately interpret the statute.

What is "Bad Faith"?

The courts have generally defined the term "bad faith" as referring to a "frivolous and unfounded" refusal to pay policy proceeds, involving "conduct which imports a dishonest purpose" and involves the breach of the insurer's known duty of good faith and fair dealing through "some motive of self-interest or ill will." To establish bad faith, the courts have held that a plaintiff must show by "clear and convincing evidence" that the defendant insurer (1) lacked a reasonable basis for its denial of coverage or benefits, and (2) that the insurer either knew, or recklessly disregarded its lack of a reasonable basis in denying the claim. Brown v. Progressive Ins. Co., 860 A.2d 493 (Pa.Super. 2004); Terletsky v. Prudential Prop. and Cas. Ins. Co., 649 A.2d 680 (Pa.Super. 1994); Hayes v. Harleysville Mutual Ins. Co., 841 A.2d 121 (Pa.Super. 2003); Keefe v. Prudential Prop. and Cas. Ins. Co., 203 F.3d 218 (3d Cir. 2000). The primary consideration is the degree to which the insurer knew, or recklessly disregarded the lack of a reasonable basis for its position. Williams v. Hartford Cas. Ins. Co., 83 F.Supp.2d 567 (E.D.Pa. 2000).

It has also been said that bad faith on the part of an insurer is "any frivolous or unfounded refusal to pay proceeds of a policy", and while it is not necessary that the insurer's conduct be fraudulent, bad faith conduct "imports a dishonest purpose and means a breach of a known duty ... through some motive of self-interest or ill will." Romano v. Nationwide Mut. Fire Ins. Co., 646 A.2d 1228 (Pa.Super. 1994), quoting Black's Law Dictionary 139 (6th ed. 1990).

Bad faith may also exist outside of the context of an insurer's denial of coverage or refusal to pay policy benefits. It has been held that bad faith

“encompasses a wide variety of objectionable conduct” and that an insurer may also be guilty of bad faith in connection with such things as failing to conduct a good faith investigation of claims, failing to communicate with the insured, misrepresenting policy terms or limits, arbitrarily refusing to accept evidence, and making unreasonable “lowball” settlement offers to an insured. Brown, supra; Hollock v. Erie Ins. Exchange, 842 A.2d 409 (Pa.Super. 2004), *appeal granted*, 893 A.2d 66 (Pa. 2005), *appeal dismissed*, 903 A.2d 1185 (Pa. 2006); Condio v. Erie Ins. Exchange, 899 A.2d 1136 (Pa.Super. 2006).

Several cases have also offered as examples of bad faith “evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.” Somers v. Somers, 613 A.2d 1211 (Pa.Super. 1992); Williams v. Nationwide Mut. Ins. Co., 750 A.2d 881 (Pa.Super. 2000).

It has also been held in at least some cases that proof of harm to the plaintiff is an essential element of a bad faith claim. Ravindran v. Harleysville Ins. Co., 65 D.&C.4th 338 (C.P. Phila. 2002), *affirmed without op.*, 839 A.2d 1170 (Pa.Super. 2003), *appeal denied*, 882 A.2d 479 (Pa. 2005); Builders Square, Inc. v. National Union Fire Ins. Co. of Pittsburgh, 1996 U. S. Dist. LEXIS 19444 (E.D.Pa. 1996), (holding that the Legislature did not intend to create a private cause of action for bad faith “in a vacuum” and that no cause of action exists absent some harm to the plaintiff.)

While some of the foregoing definitions of bad faith might suggest that negligence on the part of an insurer might serve to establish such a claim, it is important to note that “mere negligence or bad judgment” on the part of an insurer’s representatives does not constitute bad faith under the statute. Condio, supra; Bonenberger v. Nationwide Mut. Ins. Co., 791 A.2d 378 (Pa.Super. 2002).

It has also been said that an insurer defending such a claim need not show that the process by which it reached its conclusion was “flawless”, or that the results of its investigation were so certain as to eliminate any possible conclusion to the contrary. Northwestern Mutual Life Ins. Co. v.

Stein, 2005 U.S. Dist. LEXIS 590 (E.D.Pa. 2005).

The “clear and convincing evidence” standard which applies to bad faith claims requires that a plaintiff produce evidence that is so clear, direct, weighty and convincing as to enable a clear conviction, without hesitation, that the insurer is guilty of bad faith - the existence of bad faith cannot be merely insinuated. Terletsky, supra; Polselli v. Nationwide Mut. Fire Ins. Co., 23 F.3d 747 (3d Cir. 1993); Hartman v. Motorists’ Mut. Ins. Co., 2006 U.S. Dist. LEXIS 1719 (W.D.Pa. 2006).

It has been held that an insurer’s good faith duty is an ongoing obligation which lasts throughout the entire management of a claim. Once an insurer has identified a reasonable foundation for its denial of a claim, it is not relieved of its duty of good faith. Thus, if evidence arises which discredits the basis for the insurer’s denial, good faith may require that it reconsider its position and act accordingly. Condio v. Erie Insurance Exchange, 899 A.2d 1136 (Pa.Super. 2006). If an insurer had a reasonable basis for its position at the time of its initial denial, it has also been said that there is nothing wrong with an insurer conducting further investigation leading to further refinement of its coverage position. American Home Assurance Co. v. Merck & Co., 2006 U.S. Dist. LEXIS 78493 (S.D.N.Y. 2006), (Pennsylvania law).

Moreover, it has been held in a number of cases that an insurer’s reliance upon what is ultimately determined to be an unreasonable ground for its position does not support an action for bad faith where it is later discovered that there existed a reasonable alternate basis to support the insurer’s position. Williams v. Hartford Cas. Ins. Co., 83 F.Supp.2d 567 (E.D.Pa. 2000); The Philadelphia Parking Authority v. Federal Ins. Co., 385 F.Supp.2d 280 (S.D.N.Y. 2005). This holding is consistent with Pennsylvania case law indicating that an insurer need not raise all potential coverage defenses simultaneously and will not be estopped from asserting additional defenses at a later date unless the insured can prove that it suffered prejudice as a result. See, e.g., Weintraub v. The St. Paul Fire and Marine Ins. Co., 609 F.Supp. 273 (E.D.Pa. 1985).

It should be noted, however, that one federal court has recently taken a inconsistent position on this issue, holding that where an insurer denied coverage on one incorrect basis, it cannot later defeat a bad faith claim by adopting a reasonable basis after the fact - the court's inquiry is instead limited to whether the insurer was guilty of bad faith at the time of its coverage denial. Trunzo v. Allstate Ins. Co., 2006 U. S. Dist. LEXIS 68566 (W.D.Pa. 2006).

Bad faith cannot be found where an insurer's conduct is in accord with a reasonable, but incorrect interpretation of its insurance policy, or the law. Bostick v. ITT Hartford Group, 56 F.Supp.2d 580 (E.D.Pa. 1999). Nor is it bad faith for an insurer to make a low, but reasonable offer, or to reach a "reasonable legal conclusion based on an area of the law that is uncertain or in flux." Brown, *supra*; Condio, *supra*.

An insurer does not act in bad faith merely by investigating or litigating legitimate issues of coverage. Hyde Athletic Industries v. Continental Casualty Co., 969 F.Supp. 289 (E.D.Pa. 1997); J. C. Penney Life Ins. Co. v. Pilosi, 393 F.3d 356 (3d Cir. 2004). An insurer has the right to conduct a thorough investigation and any reasonable delay resulting from such an investigation cannot give rise to a claim of bad faith. Saylor v. State Farm, 47 D.&C.4th 129 (C.P. Dela. Co. 2000). An insurer is not guilty of bad faith merely because it has taken a stand with a reasonable basis or aggressively investigates and protects its interests in the normal course of litigation. Brown, *supra*; Condio, *supra*.

The fact that an insurer previously paid similar claims for reasons of expediency or by mistake, or simply decided to take a tougher stand on a particular claim when it had entered into quick settlements under similar circumstances in the past does not amount to bad faith if there was a reasonable basis for the insurer's position. American Home, *supra*; Burrell v. United Health Care Ins. Co., 2001 U.S. Dist. LEXIS 10856 (E.D.Pa. 2001). As noted in Burrell, "The bad faith statute addresses only whether insurers acted recklessly or with ill will in a particular case, not whether its business practices are reasonable in general," (quoting Hyde, *supra*).

In a case involving an insurer's denial of the duty to defend, it was held that there could be no claim of bad faith premised upon the insurer's failure to investigate because the insurer's defense obligations were properly based solely upon its comparison of the insurance policy to the complaint allegations under Pennsylvania law. Hyde, supra.

Nor can a bad faith claim be premised solely upon an insurer's settlement offer in an amount less than its reserves, since the amount of established reserves has no direct bearing upon the amount which should be offered, or the amount which the plaintiff should be paid. Segall v. Liberty Mutual Ins. Co., 2000 U.S. Dist. LEXIS 16382 (E.D.Pa. 2000).

Nor can bad faith be shown through evidence that the insurer offered to settle such a claim - it is a common practice in the insurance industry to attempt to resolve disputed claims by compromise, rather than subjecting each claim to litigation. An offer of compromise is neither evidence of bad faith, nor an acknowledgment of coverage. Hartman, supra.

Although an insurer's delay in paying policy benefits may be relevant in determining bad faith, the amount of time passing between a demand and settlement is not indicative of bad faith by itself. Courts should instead look to the degree to which the insurer knew that it had no reasonable basis to deny payment - if the delay is attributable to a need for additional information, the conduct of the plaintiff or his attorney, or mere negligence on the part of the insurer, there is no bad faith. Kosierowski v. Allstate Ins. Co., 51 F.Supp.2d 583 (E.D.Pa. 1999).

Where there are portions of a claim which are undisputed, an insurer may be guilty of bad faith based upon its failure to pay that undisputed part of the claim while continuing to investigate, or to litigate the remainder. It has been held, however, that the insured must ask for payment of the undisputed portion and that there is no bad faith unless that part of the claim was, in fact, undisputed. Keefe v. Prudential Prop. and Cas. Ins. Co., 203 F.3d 218 (3d Cir. 2000); Williams v. Nationwide Mut. Ins. Co., 750 A.2d 881 (Pa.Super. 2000); Zappile v. AMEX Ins. Co., 2006 Phila.Ct.Com.Pl. LEXIS 357 (C.P. Phila. 2006).

The fact that an insurer accepted coverage and issued payment of first-party medical benefits to its insured does not subject the insurer to a bad faith claim in connection with its subsequent refusal to pay UM benefits arising from the same accident, or preclude the insurer from reasonably contesting its obligation to issue such benefits. A refusal to pay UM benefits after acknowledging causation on the first-party benefits claim is not *per se* an arbitrary decision since the two claims are subject to differing standards. Pantelis v. Erie Ins. Exchange, 890 A.2d 1063 (Pa.Super. 2006).

Absent evidence of fraud, intentional deception or misleading conduct, an insurer has no duty to advise its insured regarding any and all policy benefits available. Miller v. Keystone Ins. Co., 636 A.2d 1109 (Pa. 1994). However, if the insurer undertakes to advise its insured and knows that the insured is relying upon its advice and counsel regarding a claim for benefits, it has been held that the insurer has a duty to advise its insured as to the amounts and types of coverages that may be available. Dercoli v. Pennsylvania National Mut. Cas. Ins. Co., 554 A.2d 906 (Pa. 1989).

It was recently recognized by the Superior Court that claims on the part of insureds for UM/UIM benefits are hybrid claims which actually involve elements of both first-party and third-party claims, that insurers' handling of such claims are at "arm's length" and are "inherently adversarial in nature" and that an insured must prove his entitlement to such benefits - an insurer is not required to sacrifice its interests by blindly paying UIM benefits on demand, with no questions asked, in order to avoid a bad faith action, but is instead entitled to protect its interests provided it has a reasonable basis for its position. Condio v. Erie Insurance Exchange, 899 A.2d 1136 (Pa.Super. 2006). At the same time, the court held that no legal authority exists for the proposition that an insurer has a "heightened duty of good faith" to its insured in the context of a first-party claim, as opposed to a third-party claim.

Bad Faith As Independent Cause of Action

There has been some inconsistency in the case law as to whether a bad faith claim can proceed even if it is determined that the insurer is entitled to

prevail on the insured's claim under the contract, however, the cases can seemingly be reconciled based upon the nature of the bad faith claim and the basis upon which the insurer prevails on the merits of the underlying claim under the policy.

If the insurer prevails on the insured's contract claim due to a technical defense, such as its insured's failure to file suit within the policy's contractual suit limitations period, it has been held that a bad faith claim is an independent cause of action and can still proceed. March v. Paradise Mut. Ins. Co., 646 A.2d 1254 (Pa.Super. 1994), *appeal denied*, 540 Pa. 613 (1995).

However, where it is claimed only that an insurer was guilty of bad faith in its denial of coverage and it is later determined that the insurer's position was correct, the courts have not hesitated to dismiss bad faith claims as a matter of law. T.A. v. Allen, 868 A.2d 594 (Pa.Super. 2005), (holding that bad faith claims premised upon insurer's failure to defend or settle claim could not be maintained where court had determined that insurer had no duty to defend); H.L. Libby Corp. v. Fireman's Fund Ins. Co., 2006 U. S. Dist. LEXIS 50433 (W.D.Pa. 2006), (it is axiomatic that, where no duty to defend existed, a bad faith claim regarding the insurer's denial of coverage must fail); USX Corp. v. Liberty Mutual Ins. Co., 444 F.3d 192 (3d Cir. 2006), (a bad faith claim cannot survive a determination that the insurer had no duty to defend); Hyde Athletic Indus., Inc. v. Continental Cas. Co., 969 F.Supp. 289 (E.D.Pa. 1997); The Frog, Switch & Mfg. Co. v. Travelers Ins. Co., 193 F.3d 742 (3d Cir. 1999).

Bad Faith During Litigation

The Superior Court has rejected the contention made by some insurers that the bad faith statute applies only to insurer conduct in denying claims prior to litigation, holding that a bad faith action can be based upon an insurer's acts prior to, during or following litigation, including litigation of the bad faith claim itself. O'Donnell v. Allstate Ins. Co., 734 A.2d 901 (Pa.Super. 1999); Hollock v. Erie Ins. Exchange, 842 A.2d 409 (Pa.Super. 2004), *appeal granted*, 893 A.2d 66 (Pa. 2005), *appeal dismissed*, 903 A.2d 1185 (Pa. 2006).

In O'Donnell, the Superior Court recognized that bad faith suits are not restricted to the denial of claims and held that the statute was intended to remedy all instances of bad faith conduct by an insurer, refusing to hold that an insurer's duty to act in good faith ends upon the initiation of suit by the insured. Nevertheless, the court held that the evidence presented of the insurer's conduct during the course of the litigation did not constitute bad faith and was properly withheld from the jury's consideration. In that regard, the plaintiff complained that Allstate acted in bad faith when it served frivolous discovery requests which were duplicative of information which the insurer had already obtained through its pre-suit investigation of the claim and that the carrier already had all of the information which it needed to accept or deny the claim. The plaintiff also complained that the insurer was guilty of bad faith in taking her deposition and then refusing to pay the claim. Quoting the trial court's opinion, the Superior Court held that "propounding discovery on the insured in preparation for trial and failing to settle a claim after a discovery deposition is conducted do not constitute acts of bad faith."

In that regard, the court cited with approval the federal court decision in Slater v. Liberty Mut. Ins. Co., 1999 U.S. Dist. LEXIS 3753 (E.D.Pa. 1999), in which an insurer was accused of withholding material documents, raising unsupported objections to discovery requests, delayed in producing discoverable material and failed to adhere to the discovery deadline. The District Court in Slater predicted that the Pennsylvania courts would not permit recovery under §8371 "for discovery abuses by an insurer or its lawyer in defending a claim" and held that the statute was designed to provide "a remedy for bad faith conduct by an insurer in its capacity as an insurer and not as a legal adversary." The Superior Court in O'Donnell also agreed with the District Court's statement that its decision did not preclude a finding of liability for an insurer's "bad faith conduct arising in the insurer-insured relationship which happens to occur during the pendency of an action, or for initiating an action against an insured in a bad faith effort to evade a duty owed under the policy."

Absent evidence demonstrating that the insurer was motivated by a dishonest purpose or ill motive, or otherwise breached its contractual duty to conduct a proper investigation, the Superior Court in O'Donnell refused to

equate the defendant's propounding of interrogatories and its taking of her deposition with the type of bad faith investigative practices actionable under §8371. Thus, it was held that there was insufficient evidence to reach the jury on the claim (the case having been decided before it was held that this issue is one for the court to decide).

In Hollock, the Superior Court upheld a bad faith verdict premised in part upon the trial court's determination that the insurer "did not act reasonably in investigating, evaluating and paying" the insured's claim for UIM benefits and in part upon the insurer's the conduct following its payment of UIM benefits and during the course of the bad faith action which followed, in which the trial judge found that the insurer's representatives gave testimony "in an intentional attempt to conceal, hide or otherwise cover-up the conduct of Erie employees in the handling the Hollock claim," and that the insurer's witnesses engaged in "a blatant attempt to undermine the truth finding process."

Notably, after granting a discretionary appeal and hearing argument in Hollock, a majority of the Supreme Court declined to review the case, dismissing the appeal as having been "improvidently granted" on August 22, 2006. Chief Justice Cappy nevertheless took the unusual step of writing a lengthy dissenting statement (in which he was joined by Justice Castille) noting that the case presented important issues with regard to the language and intent of the statute and whether a court can consider an insurer's conduct during the course of the litigation of a bad faith claim as relevant to a finding of bad faith on the underlying claim and that, by failing to confront the issues, the Court was simply delaying the task and allowing the lower courts to follow what he considered an incorrect interpretation of the law.

In his dissent, Justice Cappy took issue with the conclusion of the Superior Court in extending an insurer's duty of good faith throughout litigation on the bad faith claim and in considering its award of punitive damages, stating that, "In my opinion, once an action has been initiated by the insured against the insurer under the bad faith statute, the relationship has been severed and the duty of good faith and fair dealing no longer remains." He also suggested that a bad faith claim cannot properly be

premised upon conduct on the part of the insurer in litigating the underlying claim, stating that only the conduct of the insurer in the processing of the insurance claim is relevant to the resolution of the bad faith action, and should the insurer act inappropriately in the litigation process, that conduct can be addressed through other means.

While Chief Justice Cappy's dissenting statement suggests that there is at least some question as to the extent to which an insurer's litigation conduct can give rise to a bad faith claim, it lacks precedential value and unless or until the Supreme Court actually speaks on the subject, the Superior Court's rulings in O'Donnell and Hollock remain the law of the land.

Because §8371 was designed to provide "a remedy for bad faith conduct by an insurer in its capacity as an insurer and not as a legal adversary," it has not only been held that a claim cannot be premised upon mere discovery violations by insurers absent evidence of an intent to avoid policy obligations, but also that a bad faith claim cannot be based simply upon an insurer's filing of pleadings or motions. Sanders v. State Farm, 47 D.&C.4th 129 (C.P. Dela. Co. 2000), *appeal denied*, 777 A.2d 516 (Pa.Super. 2001).

However, summary judgment motions by insurers were denied where it was claimed that an insurer pursued a baseless counterclaim, Krisa v. The Equitable Life Assur. Soc., 109 F.Supp.2d 316 (M.D.Pa. 2002), and where it was claimed that the insurer made misrepresentations to the court and filed abusive motions. General Refractories v. Fireman's Fund Ins. Co., 2002 U.S. Dist. LEXIS 25324 (E.D.Pa. 2002).

Pre-Policy Conduct

Although the Superior Court in O'Donnell held that an insurer's conduct during litigation could be the basis of a bad faith claim, the court later rejected the notion that an insurer can be sued for bad faith under the statute based upon conduct "preceding the execution of insurance coverage" in The Brickman Group, Ltd. v. CGU Ins. Co., 865 A.2d 918 (Pa.Super. 2004). In that case, the plaintiff maintained that the insurer acted in bad faith in connection

with its reliance upon policy language relating to premium increases, policy cancellations and policy non-renewal. The court held that such a claim did not fall within the scope of §8371, which was intended to protect an insured from bad faith denials of coverage.

Bad faith claims premised upon an insurer's allegedly improper underwriting practices and its alleged misrepresentations in selling insurance policies have also been dismissed as falling outside the scope of the statute, Nationwide Mutual Ins. Co. v. Brown, 2005 U.S. Dist. LEXIS 25417 (W.D.Pa. 2005), as have claims based upon an insurer's alleged scheme to collect annual insurance premiums while providing less than a full year of coverage. Wise v. American General Life Ins. Co., 2005 U.S. Dist. LEXIS 4540 (E.D.Pa. 2005).

MVFRL Preemption

Because the Pennsylvania Motor Vehicle Financial Responsibility Law (MVFRL) contains its own statutory remedies with respect to unreasonable denials or delay on the part of insurers in issuing payment of "first-party benefits" under auto insurance policies (including payment of interest on overdue benefits at the rate of 12%, awards of counsel fees and, in some cases, treble damages) an issue has arisen as to whether the general remedies afforded an insured under the bad faith statute are preempted by those provided in such cases arising under the MVFRL.

The Supreme Court has not yet weighed in on this issue, and the cases are divided, however, a number of courts have held that statutory bad faith claims cannot be maintained and are preempted by the more specific provisions of the MVFRL at least in some cases, so this is an issue which should certainly be asserted in defending bad faith claims arising from an insurer's alleged mishandling of any first-party benefits claim.

The Superior Court addressed this issue in Barnum v. State Farm Mut. Auto. Ins. Co., 635 A.2d 155 (Pa.Super. 1993), *reversed on other grounds*, 652 A.2d 1319 (Pa. 1994) and held that an insured who filed an action for payment

of first-party medical benefits and statutory bad faith against its insurer, which had declined to pay for medical expenses based upon a Peer Review Organization (PRO) determination that they were unnecessary, was unable to maintain a bad faith claim. The court reasoned that the remedies provided by the MVFRL, which had specific application to claims for first-party benefits, were at variance with those provided by the more general bad faith statute, that the two could not be reconciled, and under the rules of statutory construction, the more specific motor vehicle insurance statute prevailed. The court viewed the remedies provided under the MVFRL as an exception to the remedies afforded under the more general bad faith statute and held that the plaintiff was, therefore, relegated to those remedies afforded by the MVFRL. As noted above, however, that decision was later reversed by the Supreme Court on other grounds, leaving us back where we started.

Since then, Pennsylvania's trial courts and federal courts have continued to consider this issue with inconsistent results.

The Court of Appeals followed Barnum in Gemini Physical Therapy & Rehab., Inc. v. State Farm Mut. Auto. Ins. Co., 40 F.3d 63 (3d Cir. 1994), holding that the remedies provided under the MVFRL provided the exclusive remedy for bad faith denials of first-party benefit claims arising from auto accidents, however, the federal courts have since questioned the validity of that decision in light of the reversal of Barnum by the Supreme Court. However, this has not stopped some courts from following the Gemini and Barnum decisions, or variations on the same theme.

In one such recent decision, Cronin v. State Farm Mut. Auto. Ins. Co., 2006 U.S. Dist. LEXIS 82139 (M.D.Pa. 2006), the District Court noted that, even if the holding in Gemini "has been somewhat called into question" because the Third Circuit had explicitly relied upon Barnum and that decision was later reversed by the Supreme Court of Pennsylvania, the court "would still find that the bad faith statute is preempted by section 1797 of the MVFRL," since the two statutes provide different and irreconcilable remedies and the more specific auto insurance statute should prevail. The court held that the plaintiff could not maintain a claim of statutory bad faith based upon an insurer's denial of medical and wage loss benefits.

A similar approach was taken in Harris v. Lumberman's Mut. Cas. Co., 409 F.Supp.2d 618 (E.D.Pa. 2006), though the court took a narrower view of the preemption issue, holding that the MVFRL only partially preempted the plaintiff's bad faith claims. Specifically, it was held that a claim of bad faith with respect to an insurer's denial of first-party medical benefits was preempted since the applicable provisions of the MVFRL conflicted with those of the bad faith statute. At the same time, the court held that the MVFRL did not preempt the insured's bad faith claim stemming from the insurer's denial of wage loss benefits. In that regard, the court held that the remedies provided for denial of medical benefits under §1797 of the MVFRL (including 12% interest, costs, attorneys' fees and treble damages if the denial of benefits is "wanton") could not be reconciled with those available under the bad faith statute. However, it was of the view that the more limited remedies allowed under §1716 of the MVFRL for an insurer's failure to pay lost wage benefits (overdue benefits, interest and attorneys' fees if the insurer acted in an "unreasonable manner", with no provision for an insurer's wanton or bad faith conduct) could be reconciled with the bad faith statute since the MVFRL provided remedies for "unreasonable" denials, but did not provide remedies for bad faith, which requires an element of knowledge or intent.

Right To Jury

The text of §8371 provides that, if the "court" finds that an insurer has acted in bad faith, the "court" may award interest and punitive damages and assess court costs and fees against the insurer. There is no mention in the statute of a right to trial by jury.

Accordingly, interpreting the term "court" as a reference to a judge or tribunal, the Supreme Court of Pennsylvania has held that there is no right to demand a trial by jury in connection with statutory bad faith claims. Mishoe v. Erie Ins. Co., 824 A.2d 1153 (Pa. 2003). In the Pennsylvania state courts, the trial judge will, therefore, determine whether an insurer is guilty of bad faith and the relief to be afforded. Where statutory bad faith claims are coupled with breach of contract claims, it has been held that a jury is to decide the latter and that the bad faith claims are to be decided by the court.

Petrecca v. Allstate Ins. Co., 797 A.2d 322 (Pa.Super. 2002)

On the other hand, the federal courts sitting in Pennsylvania have nonetheless held that there is a right to trial by jury in such cases under the 7th Amendment to the U.S. Constitution. Klinger v. State Farm Mut. Automobile Ins. Co., 115 F.3d 230 (3d Cir. 1997); W.V. Realty v. Northern Ins. Co. of New York, 334 F.3d 306 (3d Cir. 2003).

This division of authority should definitely be taken into account in deciding whether to remove a bad faith suit from state to federal court on diversity of citizenship grounds.

Jurisdiction of Arbitrators

The Superior Court of Pennsylvania has held that UM/UIM arbitration panels do not have the authority to decide bad faith claims. Nealy v. State Farm Mut. Auto. Ins. Co., 695 A.2d 790 (Pa.Super. 1997).

Standing To Sue

It appears to be generally accepted that only an insured has legal standing to maintain a bad faith action, though it should be noted that this would presumably extend to any party qualifying as an insured (including additional insureds,) as opposed to only named insureds.

The Pennsylvania Courts have long held that a third-party tort claimant is not a third-party beneficiary of a liability insurance policy, has no standing to maintain a direct action against an alleged tortfeasor's insurer and that liability insurers owe no duty of good faith to such parties. Strutz v. State Farm Mut. Ins. Co., 609 A.2d 569 (Pa.Super. 1992). The same is true with respect to an insured's indemnitees. Tremco, Inc. v. PMA Ins. Co., 832 A.2d 1120 (Pa.Super. 2003).

Accordingly, it has also been held that third-party tort plaintiffs lack standing to maintain a bad faith action against a tortfeasor's liability insurer or to seek a recovery in excess of policy limits in the absence of an express written assignment of that right from the insured. Marks v. Nationwide Ins. Co., 2000 Pa.Super. LEXIS 3052 (2000); Brown v. Candelora, 708 A.2d 104 (Pa.Super. 1998); T.A. v. Allen, 868 A.2d 594 (Pa.Super. 2005). While policy provisions prohibiting the transfer or assignment of rights under insurance policies are generally enforced in Pennsylvania, that is not true in cases where an insurer has disclaimed coverage. In that situation, it has been held that such policy provisions will not serve to prevent the assignment of an insured's rights if the insurer has breached its own contractual obligations. Alfiero v. Berks Mutual Leasing Co., 560 A.2d 169 (Pa.Super. 1985). A denial of liability coverage by an insurer triggers the insured's right to protect its own interests by entering into settlement negotiations and assigning its rights to a third-party claimant in order to shield itself from further liability. Barr v. General Accident Group Ins. Co., 520 A.2d 485 (Pa.Super. 1987), appeal denied, 536 A.2d 1327 (Pa. 1987); Continental Cas. Co. v. Diversified Industries, 884 F.Supp. 937 (E.D.Pa. 1995).

Application To Out-Of -State Policies or Insureds

The statute contains no language addressing issues such as whether it applies only to Pennsylvania insureds, whether it applies to out of state insureds to whom policies are issued by Pennsylvania insurers, or whether it applies to any insured whose claim is processed by an insurer within Pennsylvania. Unfortunately, there is no Pennsylvania appellate precedent addressing any of these questions.

To the extent that any case law exists, it has come from federal trial courts sitting in Pennsylvania and neighboring states and those cases would indicate that the bad faith statute is intended to apply only to claims on the part of Pennsylvania residents or insureds.

For example, in Celebre v. Windsor-Mount Joy Mut. Ins. Co. 1994 U.S. Dist. LEXIS 409 (E.D.Pa. 1994), it was held that §8371 did not apply to the claims of New Jersey residents under a policy issued in that state simply because the claim was denied by an insurer's Pennsylvania office.

Similarly, it was held that §8371 was inapplicable to the claims of a New Jersey insured under a disability policy issued in that state against a Canadian insurer with a Massachusetts claims office in Mizrahi v. Great-West Life Assur. Co., 1999 U.S. Dist. LEXIS 9098 (E.D.Pa. 1999).

In Paul Revere Ins. Co v. Patniak, 2004 U.S. Dist. LEXIS 7669 (D.N.J. 2004), it was held that the bad faith statute was enacted for the purpose of protecting Pennsylvania residents from overreaching insurers and thus did not apply to the claims of a New Jersey resident, despite the fact that he purchased the disability insurance policy in Pennsylvania when residing here, his medical practice was located in Pennsylvania and he suffered his disabling heart attack in Pennsylvania.

On the other hand, in Kilmer v. Connecticut Indemnity Co. , 189 F.Supp.2d 237(M.D.Pa. 2002), it was held that the bad faith statute did apply in connection with the claims of Pennsylvania residents under a policy delivered in this state, even though the insured property was located in New York.

Who Can Be Sued

While again, Pennsylvania state court precedent appears to be lacking, it has generally been recognized that ***only insurers*** are subject to liability under the terms of the bad faith statute and courts have held that §8371 does not apply to outside adjusters, TPA's, insurance agents, examining physicians, self-insured entities, or insurance company employees. See, e.g., Powell v. Crawford & Co., 2003 U.S. Dist. LEXIS 20207 (E.D.Pa. 2003); Kearns v. Minnesota Mut. Ins. Co., 75 F.Supp.2d 413 (E.D.Pa. 2003); Dresdner v. State Farm Mut. Auto. Ins. Co., 1995 U.S. Dist. LEXIS 11213 (E.D.Pa. 1995); Comcast

Spectacor v. Chubb & Son, Inc., 2006 U.S. Dist. LEXIS 55226 (E.D.Pa. 2006); Lockhart v. Federal Ins. Co., 1998 U.S. Dist. LEXIS 4046 (E.D.Pa. 1998); Chu v. Disability Reinsurance Mgt. Services, Inc., 2006 U.S. Dist. LEXIS 61244 (W.D.Pa. 2006).

Although one might assume that the identity of the insurer involved could be readily determined by examining the policy declarations, there has been some controversy on this subject particularly in cases where different names appear on the policy or in other documents such as claim related correspondence.

For example, in Brown v. Progressive Ins. Co., 860 A.2d 493 (Pa.Super. 2004), *appeal denied*, 582 Pa. 714 (2005), suit was actually filed against two related but legally distinct companies, Progressive Insurance Company and Mountain Laurel Insurance Company. Obviously, only one of them actually underwrote and was a party to the insurance policy involved (Mountain Laurel), whose name appeared on the declarations page, the policy form and the UM/UIM coverage sign-down form. At the same time, the name “Progressive” was displayed more prominently and in a bolder font on the policy booklet, the name “Progressive Casualty Insurance Company” appeared along with the name “Mountain Laurel” on the policy booklet, and the name “Progressive Companies” appeared in more prominent type on the declarations page, opposite that of Mountain Laurel. Those factors, coupled with a lack of further information in the declarations or policy booklet sufficient to identify the insurer in the view of the court, led the court to conclude that both were proper parties to the bad faith claim.

The court in Brown distinguished an earlier federal court decision to the contrary in Lockhart, *supra*, in which it had been held that a bad faith claim will not lie against an “insurer-affiliated entity which does not act as a de facto insurer, but instead merely performs administrative tasks.” The District Court indicated that a party who is not legally obligated to pay a claim and which does not make the decision to deny a claim cannot be liable for bad faith. In Lockhart, the plaintiff had named both Federal Insurance Company and Chubb & Son, Inc., its corporate parent. The Superior Court in Brown distinguished Lockhart on the basis that the policy in that case clearly

identified the insurer as Federal, even though the Chubb name also appeared on some documents.

While the result in Brown seems absurd, the court did at least approach the issue with some degree of logic, first looking to the definition of the term “insurer” in the Insurance Department Act of 1921 as “any person who is doing, has done, purports to do, or is licensed to do an insurance business, and is or has been subject to the authority of, or to liquidation, rehabilitation, reorganization, or conservation by any insurance commissioner,” though the court concluded that this was true of both Mountain Laurel and Progressive.

The Brown court then cited with approval the District Court’s opinion in Lockhart for the proposition that the question of who is the insurer is necessarily one of fact to be determined by the documents and by considering the actions of the company involved, looking at (1) the extent to which the company was identified as the insurer in the policy documents; and (2) the extent to which the company acted as an insurer, the second being significantly more important because it focuses upon the actions of the parties rather than the vagaries of corporate structure and ownership.

As more recently recognized by the Western District in Chu, *supra*, both the Brown and the Lockhart decisions left open the possibility that an insurer which is not listed as a party to the contract itself may be liable for bad faith under theories such as agency, alter ego or “de facto insurer”.

Thus, an insurer cannot necessarily rely safely upon its knowledge of the facts relating to what entity actually underwrote a particular policy of insurance, particularly if the policy documents are even remotely ambiguous, conflicting or confusing.

Although this sort of thing might be viewed as mere nit-picking by some, it is generally not viewed in that manner by insurers and it could conceivably have a very significant bearing in the event that punitive damages are awarded and the court considers evidence of the defendants’ assets in arriving at a figure sufficient to inflict an appropriate level of economic pain.

Vicarious Liability

It has been held in some cases that an insurer is not vicariously liable for the bad faith conduct of outside defense counsel, outside investigators and other independent contractors. Sanders v. State Farm, 47 D.&C.4th 129 (C.P. Delaware Co. 2000), *affirmed without opinion*, 777 A.2d 516 (Pa.Super. 2001); Ravindran v. Harleysville Mut. Ins. Co., 65 D.&C.4th 338 (C.P. Phila. 2002), *affirmed without opinion*, 839 A.2d 1170 (Pa.Super. 2003).

The Third Circuit, however, appears to have taken a contrary view in Klinger v. State Farm, 115 F.3d 230 (3d Cir. 1997), in which it held that an insurer was chargeable with the actions and inactions of its attorney, who allegedly had a hand in the mishandling of the plaintiff's claim, stating that an insurer could otherwise "hire counsel, bury its head in the sand, pay when ordered to do so, retain the use of the insured's money in the meantime, and escape without adverse consequences."

Although actions on the part of an insurer's attorneys were certainly at issue in O'Donnell, Hollock and several other cases involving claims of insurer bad faith premised upon conduct occurring in the course of litigation, it does not appear from the opinions that this issue of vicarious liability was raised or directly considered in those cases.

Workers Compensation Act Preemption

The Pennsylvania Courts have held that the workers compensation statute and its penalty provisions provide a claimant's exclusive remedy in connection with claims for workers compensation benefits and that a claimant cannot maintain a bad faith action against his employer or its workers compensation insurer in connection with their handling of such claims. Alston v. St Paul Ins. Cos., 612 A.2d 421 (Pa. 1992); Winterberg v. Transportation Ins. Co., 72 F.3d 318 (3d Cir. 1995); Fry v. Atlantic States Ins. Co., 700 A.2d 974 (Pa.Super. 1997).

Two-Year Statute of Limitations

The statute is silent on the subject of the applicable statute of limitations on bad faith claims and the Supreme Court has yet to address the question of whether such claims are subject to Pennsylvania's two-year tort statute of limitations, the four-year contractual limitations period, or the six-year "catch-all" limitations period.

After years of conflicting state and federal trial level decisions, a majority of them choosing the 2-year tort limitations period, that issue was finally addressed by the Superior Court of Pennsylvania in Ash v. Continental Ins. Co., 861 A.2d 979 (Pa.Super. 2004), *appeal granted*, 584 Pa.671, 880 A.2d 1235 (2005), in which it was held that the 2-year statute of limitations applies, describing §8371 as a "statutorily created tort action."

Although the Supreme Court allowed a discretionary appeal in December, 2005, it has not yet rendered a decision on this question. Accordingly, unless or until the Supreme Court renders a decision to the contrary, the Superior Court's decision in Ash will be considered binding precedent in the Pennsylvania state courts and a 2-year statute of limitations will apply. Fusco v. Harleysville Ins. Co., 2005 Pa. Dist. & Cnty. Dec. LEXIS 390 (C.P. Bucks Co. 2005).

The same 2-year statute of limitations is now controlling precedent in the federal courts as well, the Court of Appeals having predicted that our Supreme Court would so hold in Haugh v. Allstate Ins. Co., 322 F.3d 227 (3d Cir. 2003).

As for the question of when the statute of limitations begins to run, it has been held that the statute of limitations on a bad faith claim premised upon a liability insurer's improper refusal to defend commences when the insurer initially provides clear notice of its coverage denial, rather than at the conclusion of the underlying litigation, rejecting the insured's contention that an insurer which initially declined coverage outside the limitations period and thereafter continued to act in a manner consistent with that denial by refusing to defend, refusing to settle, permitting a judgment to be entered against the

insured, etc. was guilty of a “continuing tort” which would permit the plaintiff to sue for those ongoing actions falling within the statute. Adamski v. Allstate Ins. Co., 738 A.2d 1033 (Pa.Super. 1999), (drawing an analogy to contract cases holding that a statute of limitations commences at the time of the initial breach, whether or not the breach continues, and holding that a plaintiff **“may not separate initial and continuing refusals to provide coverage into distinct acts of bad faith”**). The plaintiff in Adamski conceded and the court appeared to agree that the statute of limitations applicable to a bad faith claim based upon an insurer’s failure to pay policy benefits would accrue at the time of the denial.

More recently, in Jones v. Harleysville Mut. Ins. Co., 900 A.2d 855 (Pa.Super. 2006), it was held that the applicable statute of limitations on a bad faith claim premised upon an insurer’s denial of coverage in connection with a first-party property loss commenced “from the date of the first claim denial,” rejecting the insured’s argument that the limitations period was extended by the insurer’s actions in reopening its file and seeking further information after learning of its insured’s acquittal on criminal charges before issuing a second denial letter after the limitations period had already expired.

Similar conclusions have been reached by federal courts interpreting the bad faith statute. In Sikirica v. Nationwide Ins. Co., 416 F.3d 214 (3d Cir. 2005), it was likewise held that the statute of limitations on a bad faith claim stemming from an insurer’s refusal to defend ran from the date when the insurer first disclaimed, rejecting the same continuing tort argument put forward by the plaintiff in Adamski and citing two earlier District Court decisions to the same effect.

Citing both Adamski and Sikirica, the Eastern District recently reached the same result in Blithstein v. Hartford Fire Ins. Co., 2006 U.S. Dist. LEXIS 17960 (E.D.Pa. 2006), holding that the statute of limitations on a bad faith claim based upon an improper denial of UM benefits accrues “when an insurer provides clear notice of its denial of coverage.”

Unfair Insurance Practices Act

Although it has been recognized that the Unfair Insurance Practices Act, 40 P.S. §1171.1, *et seq.*, (Appendix A) and the Insurance Department's accompanying regulations, 31 Pa. Code §146.1, *et seq.*, (Appendix B) do not give rise to a private right of action against insurers, it has also been held that violations of those standards may be evidence, or a potential indicator of bad faith conduct in connection with a §8371 claim. Hayes v. Harleysville Mutual Ins. Co., 841 A.2d 121 (Pa.Super. 2003).

At the same time, it has been held that a violation of the UIPA does not constitute bad faith *per se*, but should instead be considered a reference from which a court may determine whether an insurer has acted in bad faith in a given case. Parasco v. Pacific Indemnity Co., 920 F.Supp. 647 (E.D.Pa. 1996).

Consistent with case law determining the meaning of bad faith in general, it has been held that mere negligence by an insurer in violating the UIPA would not constitute bad faith. Williams v. Hartford Cas. Ins. Co., 83 F.Supp.2d 567 (E.D.Pa. 2000).

Consumer Protection Law

Insurance related disputes have also generated claims premised upon alleged violations of Pennsylvania's Unfair Trade Practices and Consumer Protection Law, 73 P.S. §201-1, *et seq.*, creating a private right of action with respect to "unfair or deceptive acts or practices". Although some courts have recognized that the statute might potentially support a claim against an insurer, research has disclosed no examples of cases in which such a suit has successfully been maintained.

One significant limitation upon the statute is that it provides a private right of action only to persons who purchase or lease goods or services "primarily for personal, family or household purposes," 73 P.S. §201-9.2, which would serve to prevent its application to commercial insurance policies entirely, or to insureds who did not actually purchase a policy.

Another limitation is that the statute applies only to acts of “misfeasance” (the improper performance of an obligation), whereas acts of “nonfeasance” (such as an insurer’s denial of coverage or failure to pay benefits,) are not actionable under the statute.

It has also been held that, to prevail under the Consumer Protection Law, a plaintiff must advance specific allegations of fraud. Horowitz v. Federal Kemper Life Ins. Co., 57 F.3d 300 (3d Cir. 1995); Gordon v. Pennsylvania Blue Shield, 548 A.2d 600 (Pa.Super. 1988); Tenos v. State Farm Ins. Co., 716 A.2d 626 (Pa.Super. 1998).

Discovery Related Issues

Because the mental impressions, opinions and thought processes of the insurer’s employees and/or attorneys are likely to be considered directly at issue in bad faith litigation, the discovery process often intrudes into areas which are generally considered confidential, if not sacred, and can often become quite contentious.

An insurer can safely anticipate that its entire file on the underlying claim and, in some cases, that of its attorneys will be made available to its adversary if sued for bad faith and should guide itself accordingly.

As a general matter, it has been recognized that the entire, non-privileged contents of an insurer’s claim file will be subject to discovery in bad faith litigation, despite insurer objections that such discovery would require the production of non-discoverable “work product” tending to reveal mental impressions, conclusions or opinions respecting the value or merit of a claim or defense, or respecting strategy or tactics, matters otherwise generally shielded from discovery under the state and federal rules.

For example, in the Pittsburgh case of Mueller v. Nationwide Mut. Ins. Co., 31 D.&C.4th 23 (C.P. Allegheny Co. 1996), an insurer was asked to produce its entire claim file, but withheld those parts consisting of communications with counsel and documents prepared by company employees

regarding the merits of the insured's first party claim and the company's strategy, pointing to the attorney-client privilege and the work product doctrine. The court held that the insurer was obliged to produce its entire claim file with the exception of the attorney communications, holding that the materials were directly relevant to the bad faith claims since the defendant's motives and rationale were at issue. The court also noted that the work product doctrine applies only to protect mental impressions and opinions concerning the claim for which the materials were prepared (i.e., the underlying contract claim,) a point which was also made by the Court of Common Pleas of York County when rendering a similar decision in Yohe v. Nationwide Mut. Life Ins. Co., 7 D.&C.4th 300 (C.P. York Co. 1990). That is, a plaintiff should not be entitled to discovery of such information or materials relating to the bad faith claim itself.

Federal courts sitting in Pennsylvania have reached similar results, as in Marshall v. Nationwide Mut. Ins. Co., 1994 U.S. Dist. LEXIS 7834 (E.D.Pa. 1994), in which it was held that an insurer must produce its entire claims file and claims log, the court explaining that bad faith claims "can only be proved by showing exactly how the company processed the claim, how thoroughly it was considered and why the company took the action it did." Because the strategy, opinions and mental impressions of the insurer's representatives were directly at issue, they were subject to discovery.

Communications to and from attorneys and documents reflecting summarizing such conversations may be subject to attorney-client privilege (applicable only to communications *from* the client), the work product doctrine (applicable to materials prepared and communications by or from the attorney and the insurer) , or both. It has been said that mere allegations of bad faith do not create an exception to the doctrine of attorney-client privilege. Mueller v. Nationwide Mut. Ins. Co. , 31 D.&C.4th 23 (C.P. Allegheny Co. 1996); Provident Life & Acc. Ins. Co. v. Nissenbaum, 1998 U.S. Dist. LEXIS 18576 (E.D.Pa. 1998).

However, it has also been held that such communications and materials are subject to discovery where an insurer has affirmatively raised "advice of counsel" as a defense to allegations of bad faith. See, e.g., Mueller, *supra*

(holding that insurers could not raise privilege for attorney communications unless they stated that they would not contend that advice of counsel was a factor in the manner in which they handled the insured's claims); McAndrew v. Donegal Mut. Ins. Co., 56 D.&C.4th 1 (C.P. Lackawanna Co. 2002), (holding that an insurer could not maintain that it denied a claim, in part, on the advice of counsel, while simultaneously blocking the insured's access to documents which might demonstrate the validity, or expose the frivolity of that defense); Connecticut Indem. Co. v. Markham, 1993 U.S. Dist. LEXIS 10853 (E.D.Pa. 1993), (holding that once an insurer put forth the affirmative defense of reliance upon advice of counsel, all information and materials relative to that advice became discoverable).

In one federal trial level case, it was held that all communications exchanged between an insurer and its attorneys containing legal opinions, mental impressions, and discussions of strategy were discoverable in a bad faith case, even where the insurer did not raise an "advice of counsel" defense, since the attorney's advice is necessarily "interwoven into the substantive issues of fact and law" in a bad faith action. Alternatively, the court reasoned that the insurer made the advice of its attorney relevant merely by pleading that it had acted in compliance with Pennsylvania law when handling the claim. Jones v. Nationwide Ins. Co., 1999 U.S. Dist. LEXIS 2991 (M.D.Pa. 2000). That case does not appear to be representative of the views taken by most courts on either point.

To the extent that discovery is sought with respect to what would ordinarily qualify as privileged communications or work product relating not to the underlying dispute, but to the bad faith claim itself, there is authority indicating that such discovery will not be allowed. McAndrew v. Donegal Mut. Ins. Co., 56 D.&C.4th 1 (C.P. Lackawanna Co. 2002). However, the same court held that the plaintiff was entitled to discovery of claim file materials post-dating the litigation to the extent that they were relevant to the merits of the underlying claim, reasoning that the insurer had a continuing duty to investigate the insured's first party claim even after suit was filed. Presumably, such post-complaint discovery would also be permitted to the extent that bad faith claims are asserted in connection with an insurer's conduct in litigation, as discussed previously.

Whether an insurer's reserves on a claim are discoverable depends upon the nature of the bad faith alleged. Reserves may be relevant to a bad faith claim premised upon the insurer's failure to settle, or based upon a dispute regarding the value of a claim. Executive Risk Indemnity, Inc. v. Cigna Corp., 2006 Phila.Ct.Com.Pl. LEXIS 328 (C.P. Phila. 2006); North River Ins. Co. v. Greater New York Mut. Ins. Co., 872 F.Supp. 1411 (E.D.Pa. 1995); Maiden Creek T.V. Appliance, Inc. v. General Cas. Ins. Co., 2005 U.S. Dist. LEXIS 14693 (E.D.Pa. 2005). However, it has been held that reserve information is not relevant where the bad faith claim is concerned with the issue of whether an insurer was guilty of bad faith in connection with a denial of coverage. As explained in Executive Risk, the amount established as reserves by an insurer as required by statute and responsible insurance practice does not establish that the insurer expected the claim to be covered by its policy and is independent of the insurer's litigation strategy. See also, Safeguard Lighting Systems, Inc. v. North American Specialty Ins. Co., 2004 U.S. Dist. LEXIS 26136 (E.D.Pa. 2004); Fidelity and Deposit Co. of Md. v. McCulloch, 168 F.R.D. 516 (E.D.Pa. 1996).

Insurer claims manuals and educational materials are also frequently sought in such cases and case law would indicate that such items, or at least potentially relevant portions, are subject to discovery as well. In that regard, the Superior Court held that an insurer's claims practices manual was relevant, admissible and properly considered by a trial judge when determining the existence of bad faith in Bonenberger v. Nationwide Mut. Ins. Co., 791 A.2d 378 (Pa.Super. 2002), stating that "a company manual, which dictates a certain philosophy in claims handling, may be relevant and useful in evaluating a bad faith claim." Such a claims manual was also apparently produced through discovery and utilized against an insurer with great effect in the case of Galko v. Harleysville Pennland Ins. Co., 71 D.&C.4th 236 (C.P. Lackawanna Co. 2005) in which the court noted in support of its finding of bad faith that "the protocol provided in the claims manual was blatantly ignored."

The federal courts have likewise considered such materials properly subject to discovery in bad faith litigation. It was held that an insurer's claim manual was subject to discovery in Parker v. Nationwide Ins. Co., 2001 U.S. Dist. LEXIS 15910 (E.D.Pa. 2001), subject only to a letter of commitment from

the plaintiff's attorney that he would not distribute it to others and would use it only for the purpose of the case. The District Court issued a similar decision in Sickora v. The Northwestern Mut. Life Ins. Co., 2001 U.S. Dist. LEXIS 16394 (E.D.Pa. 2001), but held that the plaintiff's request for all manuals and training materials was overbroad and that the insurer only had to produce those documents which were pertinent to the issue at hand, involving the company's interpretation of certain policy language. The materials produced were also made the subject of a confidentiality order, the court concluding that public dissemination of the documents would potentially injure the insurer competitively and facilitate fraud. An order limiting discovery of an insurer's claim manuals and educational materials was likewise limited in scope to only those items pertaining to the policy clause at issue in the case in Cincinnati Ins. Co. v. Clark, 1992 U.S. Dist. LEXIS 2054 (E.D.Pa. 1992).

Discovery with respect to an insurer's handling of "other claims", its prior coverage positions, or its past involvement in other bad faith litigation or insurance department complaints, has generally not been allowed for a variety of reasons, some cases holding that such information is irrelevant, some holding that the discovery is unduly burdensome even if remotely relevant, some characterizing such discovery requests as "fishing expeditions", and others concluding that such discovery requests are designed more to punish the defendant than to obtain any useful information. W.V. Realty v. Northern Ins. Co. of New York, 334 F.3d 306 (3d Cir. 2003); Fidelity & Deposit Co. v. McCullough, 168 F.R.D. 516 (E.D.Pa. 1996); Kaufman v. Nationwide Mut. Ins. Co., 1997 U.S. Dist LEXIS 18530 (E.D.Pa. 1997); North River Ins. Co. v. Greater New York Mut. Ins. Co., 872 F.Supp. 1411 (E.D.Pa. 1995); Leksi v. Federal Ins. Co., 129 F.R.D. 99 (D.N.J. 1989); Adams v. Allstate Ins. Co., 189 F.R.D. 331 (E.D.Pa. 1999); Stewart v. State Farm Ins. Cos., 2000 U.S. Dist. LEXIS 4938 (E.D.Pa. 2000). Some courts, however, have held that discovery with respect to other claims is permissible to the extent that the requests are confined to facts and circumstances similar to those at issue in the pending case. See, e.g., Cicccone v. Allstate Ins. Co., 49 D.&C.4th 505 (C.P. Monroe Co. 2000).

Insureds have not been terribly successful in forcing insurers to produce documents such as employee personnel files, compensation records and

performance evaluations, the courts generally considering such materials either to be irrelevant, or unduly invasive. See, e.g., Closterman v. Liberty Mut. Ins. Co., 1995 U.S. Dist. LEXIS 11356 (E.D.Pa. 1995); Kaufman v. Nationwide Mut. Ins. Co., 1997 U.S. Dist. LEXIS 18530 (E.D.Pa. 1997); Cella-Carlucci v. Maryland Cas. Co., 2000 U.S. Dist. LEXIS 3518 (E.D.Pa. 2000); Dombach v. Allstate Ins. Co., 1998 U.S. Dist. LEXIS 15611 (E.D.Pa. 1998).

Damages & Other Relief

The bad faith statute expressly provides at 42 Pa.C.S.A. §8371 that a court which finds that an insurer has acted in bad faith “may” award interest at prime plus 3%, award punitive damages and assess court costs and attorney’s fees against the insurer, suggesting that the relief is discretionary, rather than mandatory in character, a view which appears to be accepted by the courts. Birth Center v. St. Paul Companies, 727 A.2d 1144 (Pa.Super. 1999), affirmed, 787 A.2d 376 (Pa. 2001). While this would appear at first blush to be favorable to defendants, it would be a rare case in which the available relief is not afforded, and the discretionary aspect of such awards would render them subject to a limited standard of appellate review.

Compensatory Damages

The statute makes no mention of compensatory damages and, consistent with that omission, it has been held that a court cannot award compensatory damages, such as compensation for emotional distress, in connection with a statutory bad faith claim. Albertini Restaurants v. Nationwide Mut. Ins. Co., 1993 WL 209583 (E.D.Pa. 1993); Duffy v. Nationwide Mut. Ins. Co., 1993 WL 475501 (E.D.Pa. 1993); Krisa v. The Equitable Life Assur. Soc., 109 F.Supp.2d 316 (M.D.Pa. 2002).

However, it has been held that compensatory damages are recoverable in the contractual third-party bad faith context, where insurers were subject to liability at common law prior to the enactment of the bad faith statute. In Birth Center v. St. Paul Cos., 787 A.2d 376 (Pa. 2001), an insured filed suit

against its liability insurer based upon its wrongful refusal to settle a catastrophic injury claim, asserting both common law claims for breach of contract and fiduciary duty of good faith against the insurer and a statutory bad faith claim. Concluding that the damages in question were awarded on the common law claims, a divided Supreme Court upheld a \$700,000 compensatory damage award in favor of the insured, representing compensation for resulting harm to the insured's reputation, lost revenues and lost business opportunities. In doing so, the Court rejected the insurer's contention that it was not subject to further liability to its insured because it had paid in full the \$4.5 million excess verdict. Instead, it was held that the insurer was subject to liability for all damages which were reasonably foreseeable as a result of the insurer's breach of its contractual obligations and its contractual duty of good faith. The Court also rejected the insurer's argument that §8371 prohibited the award of compensatory damages, concluding that the bad faith statute merely created an additional remedy and did not in any way reference or reject the remedies previously available in the third-party bad faith claim context at common law. The fact that §8371 also authorized courts to award punitive damages, interest and counsel fees did not prohibit them from granting other remedies which they already had the power to award.

Presumably, because damages for emotional distress are not recoverable in connection with a claim for breach of contract as a general matter in Pennsylvania, such damages will not be recoverable in connection with contractually based third-party bad faith claims. Nevertheless, the prospect of additional exposure to emotional distress damages in connection with contractually based bad faith claims cannot be ruled out in light of the Supreme Court's comments in D'Ambrosio v. Pennsylvania National Mut. Cas. Ins. Co., 431 A.2d 966 (Pa. 1981), in which it said that the possibility of allowing recovery of emotional distress damages for breach of contract cannot be ruled out, "where, for example, the breach is of such a kind that serious emotional disturbance was a particularly likely result."

Attorney's Fees

In calculating reasonable fees under §8371, the Superior Court has stated that a court is to consider the factors set forth in Pennsylvania Rule of Civil Procedure 1716 (applicable to Class Actions,) including (1) the time and effort reasonably expended by the attorney in the litigation; (2) quality of services rendered; (3) results achieved and benefits conferred upon the class or upon the public; (4) magnitude, complexity, and uniqueness of the litigation; and (5) whether the receipt of a fee was contingent upon success. The calculation should begin with the actual number of hours spent, multiplied by a reasonable rate, though the court may also consider discretionary “fee enhancement” to reflect the contingent risk of the bad faith claim. Birth Center v. St. Paul Ins. Cos. 727 A.2d 1144 (Pa.Super. 1999), affirmed, 787 A.2d 376 (Pa. 2001).

Significantly, in a marked departure from the usual American approach to the issue, it has been held that an award of attorney's fees under §8371 can include the fees incurred in pursuing the bad faith litigation, as well as those incurred in connection with the underlying claim. *Id.*; Bonenberger v. Nationwide Mut. Ins. Co., 791 A.2d 378 (Pa.Super. 2002).

The fact that an insured was represented by counsel on a contingent fee basis does not preclude an award of attorney's fees pursuant to the bad faith statute. This issue was recently addressed in Gallatin Fuels, Inc. v. Westchester Fire Ins. Co., 2006 U.S. Dist. LEXIS 36033 (W.D.Pa. 2006), in which the court explained that the purpose of an attorney's fee award under §8371 is to compensate the plaintiff for having to pay an attorney in order to get that to which he was contractually entitled and that this principle applies regardless of whether the plaintiff paid his attorney throughout the case on an hourly basis, or at the end of the case as part of a contingent fee agreement. Under either scenario, the plaintiff is required to pay fees that would not have been incurred had the insurer acted appropriately. As stated in that case, “Working on contingency is not the equivalent of working pro bono.” Prior holdings to the same effect include PolSELLI v. Nationwide Mut. Fire Ins. Co., 126 F.3d 524 (3d Cir. 1997), (upholding award of fees in a

contingent fee case and suggesting that, in some cases, such fees may be enhanced under Pennsylvania law), and Willow Inn v. Public Service Mut. Ins. Co., 399 F.3d 224 (3d Cir. 2005).

However, it has been held that an award of attorney's fees under the bad faith statute is not to be determined on the basis of a percentage or contingent fee. Jurinko v. The Medical Protective Co., 2006 U.S. Dist. LEXIS 42923 (E.D.Pa. 2006). In rejecting a plaintiff's request for an attorneys' fee award of \$2,372,503.50, amounting to 30% of the plaintiff's total recovery of policy benefits, interest and punitive damages, the District Court in Jurinko held that both the Third Circuit's decision in PolSELLI and the Superior Court's Birth Center decision dictate that fees be determined in accordance with Pennsylvania Rule of Civil Procedure 1716 as discussed previously, calling for a calculation of time spent by a reasonable hourly rate.

Court Costs

A plaintiff's record costs and costs incurred for such things as copying and transcription expenses are recoverable under §8371 by a successful bad faith plaintiff, however, such costs do not include the plaintiff's expert witness fees. Jurinko, *supra*.

Punitive Damages

While there is no question but that §8371 expressly authorizes awards of punitive damages in bad faith cases, the statute provides the courts with no guidance as to the circumstances under which such awards may be rendered.

There is no Pennsylvania Supreme Court precedent on the question of whether punitive damages can be awarded simply upon a finding of bad faith under the statute, or whether further proof of particularly "outrageous", "willful" or "malicious" misconduct is needed. There have been several lower court and federal decisions on either side of the question.

In Coyne v. Allstate Ins. Co., 771 F.Supp. 673 (E.D.Pa. 1991), for example, it was held that the insurer's conduct must be "outrageous" to support an award of punitive damages and that principle appears to have been followed in other cases including the Superior Court's decision in Birth Center v. St. Paul Cos., 727 A.2d 1144 (Pa.Super. 1999), (noting that the trial court had appropriately stated in its charge that the jury could award punitive damages only if it found the insurer's conduct "extreme and outrageous"). On the other hand, it has been held that "reckless" behavior on the part of an insurer in a §8371 case is sufficient to reach a jury on punitive damages in other cases including Thomas v. State Farm Ins. Co., 1999 U.S. Dist. LEXIS 17384 (E.D.Pa. 1999).

The Superior Court of Pennsylvania has now passed directly on that question through its recent *en banc* decision in Hollock v. Erie Ins. Exchange, 842 A.2d 409 (Pa.Super. 2004), *appeal granted*, 893 A.2d 66 (Pa. 2005), *appeal dismissed*, 903 A.2d 1185 (Pa. 2006), holding that a bad faith plaintiff need only prove a violation of §8371 to support an award of punitive damages under the statute. The federal courts are bound to consider the decision, but remain free to disregard it based upon their own predictions as to how the issue would be decided by our Supreme Court.

In Hollock, the defendant insurer argued that the trial court erred in awarding punitive damages, maintaining that it was incumbent upon the plaintiff not only to prove bad faith conduct under the established §8371 standards, but also "aggravating circumstances" such as "acts of malice, vindictiveness, and a wholly wanton disregard for the rights of others." The Superior Court dismissed that contention as specious, holding that case law with respect to common law claims was irrelevant and that the wording of the statute itself, which did not suggest any pre-condition for an award apart from a determination of bad faith, mandated that a finding of bad faith is the only prerequisite to an award of punitive damages. While a finding of bad faith does not compel such an award, the court concluded that it does allow for such an award without further proof.

Another area which is likely to remain a source of uncertainty and contention for the indefinite future involves the extent to which punitive

damage awards may be limited by the requirement that they bear some reasonable relationship to the harm caused, or to the amount of compensatory damages involved. Pioneer Commercial Corp. v. American Financial Mortgage Corp., 797 A.2d 269 (Pa.Super. 2002). Current case law would indicate that there are Constitutional limitations upon the amount of punitive damage awards, but that they are neither particularly clear-cut, or terribly meaningful from an insurer's perspective. What constitutes a reasonable relationship is obviously an issue as to which minds will differ.

The Superior Court's recent decision in Hollock also addressed the standards to be applied in determining the amount of punitive damage awards both under Pennsylvania law and the Due Process Clause of the 14th Amendment to the U.S. Constitution, while upholding an award of \$2.8 million in punitive damages in a case where UIM limits of \$500,000 had originally been at issue and the compensatory damages awarded in the bad faith action amounted to approximately \$278,825 (consisting of interest, fees and costs).

In so doing, the court initially noted that the amount of a punitive damage award must be reasonably related to the state's interest in punishing and deterring the behavior at issue, a standard which requires consideration of three factors including (1) the character of the act; (2) the nature and extent of the harm, and (3) the wealth of the defendant. Concerning the character of the insurer's conduct, the Superior Court cited the trial court's findings that the insurer's employees had been guilty of behavior ranging from deliberate indifference to blatant dishonesty, including such acts as misrepresenting the amount of available coverage, establishing an arbitrary reserve, and discounting wage loss projections without supporting medical or vocational evidence, and the trial court's determination that the carrier's supervisory personnel "sanctioned deceit" in the service of a corporate belief that it is acceptable to lie. On the second prong, the court reasoned that the harm suffered by the insured was substantial in that he was deprived of the only available means of compensation for his disability for a period of years and was subjected to unwarranted and unnecessary surveillance and litigation. Finally, the court concluded that the insurer's "vast" net worth in the area of \$4.8 million during the years in question required a substantial punitive award to deter its bad faith conduct, while the \$2.8 million awarded was also

considered to be consistent with a recognition of the insurer's obligations to other insureds.

From a Constitutional perspective, the Superior Court in Hollock concluded that the award was not arbitrary, excessive or disproportionate under the due process standards which had recently been articulated by the U.S. Supreme Court in State Farm Mut. Ins. Co. v. Campbell, 538 U.S. 408 (2003) and BMW of North America, Inc. v. Gore, 517 U.S. 559 (1996). The Supreme Court in those cases established three guideposts for courts reviewing punitive damage awards, namely, (1) the degree of reprehensibility of the defendant's conduct, (2) the disparity between the actual or potential harm suffered and the amount of the punitive damages award, and (3) the difference between the punitive damages awarded and any civil penalties authorized or imposed in similar cases.

Regrettably, the U.S. Supreme Court in Campbell declined to establish a definite, or "bright-line" ratio between the amount of punitive damages which may be awarded and the amount of compensatory damages involved, but suggested that "few awards exceeding a single-digit ratio will satisfy due process". The Superior Court in Hollock reasoned that the \$2.8 million punitive damage award, representing a 10 to 1 ratio over the compensatory award, just barely exceeded the single-digit ratio mentioned in Campbell, and considering the insurer's wealth, its reprehensible conduct and the "limited" compensatory award of under \$300,000, it concluded that the disparity between the harm and the punitive award was not violative of due process.

A somewhat different approach was taken in the case of The Willow Inn v. Public Service Mut. Ins. Co., 2003 U.S. Dist. LEXIS 9558 (E.D.Pa. 2003), *affirmed*, 399 F.3d 224 (3d Cir. 2005). In that case, the District Court's award of \$150,000 in punitive damages was appealed to the Third Circuit and then remanded to the District Court with instructions to determine whether that award was constitutionally excessive under the dictates of Campbell and Gore. After reviewing those authorities, the District Court upheld its prior award, reasoning that the punitive damages were awarded in an amount approximately equal to the amount of the insured's claim for windstorm damage under the policy and the amount which it was belatedly paid by the

insurer, resulting in a ratio of about one to one, which the court observed would not “raise a suspicious judicial eyebrow” under Gore.

Notably, in deciding whether the punitive damage award was disproportionate, the District Court in Willow Inn focused on the total amount of the underlying insurance claim (which was apparently paid before trial,) and not upon the amount of its compensatory damage award, which amounted to only \$2,000 and that approach to the issue was later affirmed on appeal. This would appear to contrast with the Hollock decision, in which the court focused not upon the amount of policy benefits at issue in the underlying claim, but upon the amount which it awarded in compensatory damages on the bad faith claim, consisting of interest, attorney’s fees and costs. This would suggest that the basis for determining the proper ratio, to the extent one exists, is not even a settled question.

While an insurer’s financial worth will obviously be relevant in connection with an award of punitive damages under the above standards, it should be noted that discovery with respect to a defendant’s financial situation is generally not permitted in Pennsylvania based solely upon the allegations of a plaintiff’s complaint. Instead, it has been held that a party seeking such discovery must first substantiate the claim through the submission of proof sufficient to establish at least a *prima facie* entitlement to punitive damages. Burda v. Cesare, 50 D.&C.3d 354 (C.P. Luzerne Co. 1988); Peter v. Tomsic, 57 D.&C.2d 340 (C.P. Lehigh Co. 1972); King v. Logue, 9 D.&C.3d 137 (C.P. Phila. 1978).

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