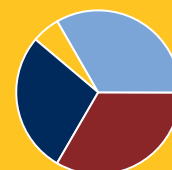


Third-Party Bad Faith in Florida's Automobile Insurance System



Insurance
Research
Council



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Executive Summary

Bad-faith lawsuits targeting automobile insurers in Florida impose a heavy burden on the state's auto insurance system and auto insurance consumers. The possibility of winning large bad-faith settlements and court judgments creates powerful incentives for potential claimants and their attorneys to file auto liability insurance claims that otherwise would not be filed. The Insurance Research Council (IRC) estimates that deterioration in the liability claim environment attributable to Florida's third-party bad-faith law resulted in approximately \$813 million in excess bodily injury (BI) liability claim costs in 2013. This estimate includes costs resulting from the changed liability claim environment attributable to third-party bad-faith lawsuits. It does not include any direct costs associated with the litigation and settlement of actual third-party bad-faith lawsuits.

Key Findings

- Previously published research has shown that allowing claimants to file lawsuits against insurers claiming bad-faith treatment in the claim settlement process has a substantial and long-lasting impact on the claim environment, resulting in higher claim frequency and higher claim settlement amounts.
- The cost of BI liability auto insurance claims in Florida has increased rapidly in recent years. The average BI liability claim payment per insured vehicle in the state increased 68 percent from 1995 to 2013. In contrast, average claim payments per insured vehicle in three other major no-fault states (New Jersey, New York, and Pennsylvania) that do not authorize third-party bad-faith lawsuits against insurers were essentially unchanged or increased very little over the same period of time.
- Many more BI liability insurance claims are being filed in Florida than would likely be the case if the state did not authorize third-party bad-faith lawsuits. The BI liability claim frequency rate (the number of claims paid per 100 insured vehicles) rose 21 percent in Florida from 1995 to 2013. Over the same period, BI claim frequency in New Jersey, New York, and Pennsylvania, on average, fell by 34 percent. For the nation as a whole, BI claim frequency fell 38 percent from 1995 to 2013.

- By 2013, BI liability claim frequency in Florida, a no-fault state, was greater than in most tort-system states. A key objective with no-fault insurance is to limit access to BI liability coverage reimbursement and provide easy access to first-party no-fault reimbursement. As a result, BI claim frequency rates in no-fault states are generally quite low. But this is no longer the case in Florida.
- IRC estimates that Florida's third-party bad-faith rule was responsible for \$79 in additional claim costs for every insured vehicle in the state in 2013. For a household with two vehicles, the additional cost was approximately \$160. The additional costs statewide, for all insured vehicles, totaled approximately \$814 million in 2013 alone.

The Bad-Faith Legal Environment in Florida

This report presents new evidence of the impact of third-party bad-faith lawsuits in Florida's auto insurance system. A third-party bad-faith lawsuit arises when a person who has filed a liability insurance claim alleging injury caused by another driver claims that the other driver's insurance company has refused to settle the person's liability claim in good faith. The action is called a "third-party" lawsuit because the person alleging bad-faith treatment by the insurance company is not a direct party to the insurance contract involved.

Most states do not allow third-party bad-faith lawsuits against auto insurance companies. Instead, they rely exclusively or primarily on administrative mechanisms to enforce claim settlement rules and impose fines and penalties when the rules are violated. In states that do allow third-party bad-faith lawsuits, the authority to file such lawsuits developed under common law, as a result of one or more significant court decisions, or was explicitly granted to claimants through acts of the state legislature. In a few states, including Florida, both common law and statute have contributed to the development of the state's legal basis for allowing third-party bad-faith lawsuits.¹

Florida's laws governing bad-faith lawsuits have been a subject of intense debate for many years. Proponents of the current law allowing claimants to sue insurance companies for bad-faith treatment in the claim settlement process argue that the law provides necessary protections for consumers and holds insurance companies accountable for their treatment of claimants. Critics contend that the laws encourage abuse as attorneys representing third-party claimants intentionally make unreasonable, vague, or impossible demands of policyholders and their insurance companies.² The reality, critics contend, is that claimant attorneys are able and encouraged to create the basis for claiming that an insurance company has acted in bad faith.

¹ General Re Corporation, *Bad Faith Laws for Property/Casualty Claims* (Stamford, Conn.: General Re Corporation, 2013).

² The Florida Senate, Committee on Judiciary, *Insurance Bad Faith* (Tallahassee, Fla: Florida Senate, 2011), pp. 3-4.

According to critics, the techniques employed by claimant attorneys include these:

- Sending demand letters to obscure company addresses, with the objective of creating significant delays in processing the demand
- Providing incomplete and inadequate information in demand letters requiring clarification and resulting in considerable additional delay
- Making numerous “multi-conditional” demands, in addition to demanding the payment of policy limits, that may be impossible for an insurance company to meet in the short period of time demanded by the attorney³

With a bad-faith lawsuit, the policy limit that would normally apply to the underlying claim is no longer a limiting factor in the amount potentially available to the claimant. Damages paid to a claimant and his or her attorney in a bad-faith lawsuit are not considered claim payments and, therefore, are not subject to the policy limits for the underlying auto liability insurance policy.

³ Victor E. Schwartz, *Restoring the Good Faith in Florida's "Bad Faith" Insurance Litigation* (Washington, D.C.: Shook, Hardy & Bacon LLP, 2014), pp. 11-13.

Documenting the Effects of the Law

The impact of bad-faith litigation on auto insurance systems has been studied extensively by economists and legal analysts. In a 2001 study, researchers at the RAND Institute for Civil Justice examined the impact of the California Supreme Court's 1979 Royal Globe decision, which established a third-party claimant's right to file a lawsuit claiming bad-faith treatment by a liability insurance company. The researchers found a sharp increase in BI liability claim frequency in California following the Royal Globe decision, and a subsequent and equally sharp decrease in claim frequency after the Royal Globe decision was overturned in 1988.⁴ In another study, researchers at the University of Michigan and Cornell University examined the impact across all states of rules imposing tort liability on first-party auto insurers for claims of bad-faith treatment in claim settlements. The researchers found that insurer tort liability for bad-faith claims was associated with significantly higher claim settlement amounts than when tort liability was not present, and that the impact of bad-faith litigation was long-lasting, with no diminishment in effects over time.⁵

It should be noted that the focus of the studies described above was the underlying claiming behavior and claim outcomes in the auto insurance systems being studied. Neither study included actual settlement and litigation costs associated with bad-faith lawsuits in the scope of study. For this analysis, IRC took a similar approach by examining BI liability claiming behavior and claim outcomes in Florida and other states. IRC examined the average BI liability claim payment per insured vehicle (also known as "loss costs") in Florida and in three comparison states: New Jersey, New York, and Pennsylvania. These states were chosen because, like Florida, they are large no-fault states with major urban areas. Unlike Florida, however, New Jersey, New York, and Pennsylvania do not authorize third-party bad-faith lawsuits against auto insurance companies.⁶ Instead, each state relies primarily on administrative procedures to investigate complaints alleging unfair treatment in the claim settlement process and to levy fines and penalties where violations are confirmed. For additional perspective, IRC included BI liability claims experience countrywide in the comparison.

⁴ Angela Hawken, Stephen J. Carroll, and Allan F. Abrahamse, *The Effects of Third-Party, Bad-Faith Doctrine on Automobile Insurance Costs and Compensation* (Santa Monica, Calif.: RAND Institute for Civil Justice, 2001), p. xv.

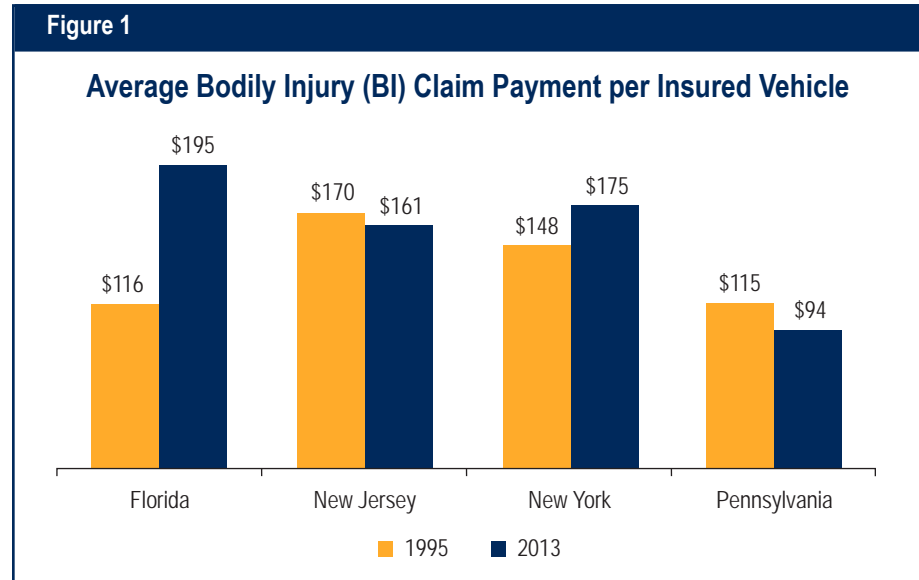
⁵ Danial P. Asmat and Sharon Tennyson, "Does the Threat of Insurer Liability for 'Bad Faith' Affect Insurance Settlements?" *Journal of Risk and Insurance*, vol. 81, no. 1, 2014, p. 2.

⁶ *Bad Faith Laws for Property/Casualty Claims*.

Utilizing data reported through the Fast Track Monitoring System, IRC calculated and compared changes in average liability claim costs per insured vehicle in Florida, in the comparison states, and countrywide, since 1995. The year 1995 has been identified as when Florida's experiment with third-party bad-faith litigation started to develop.⁷ IRC compared changes in BI liability claim payments per insured vehicle in Florida with changes in loss costs in the comparison states and countrywide. Specific changes in BI claim frequency and average costs per paid claim also were examined. With these comparisons, IRC was able to isolate the impact of Florida's third-party bad-faith laws on key insurance system outcomes. While other factors may contribute to the differences identified in the analysis, Florida's laws authorizing third-party bad-faith lawsuits are very likely a primary factor in producing starkly different claim outcomes.

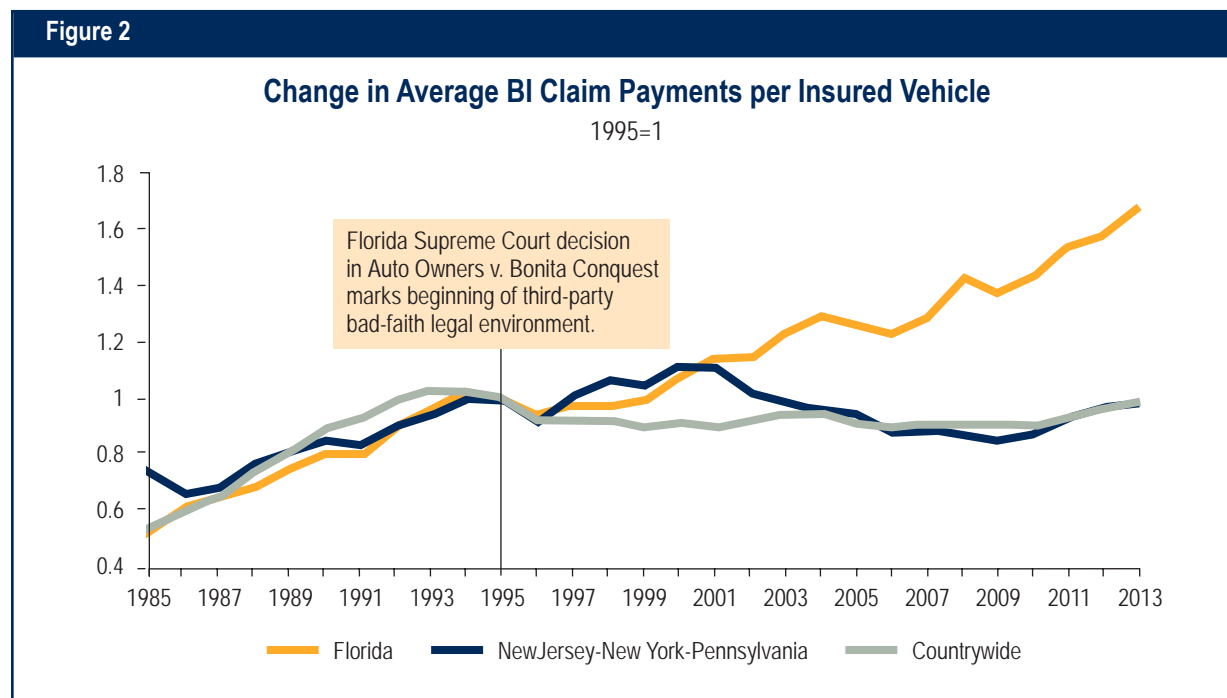
⁷ William G. Hamm, Jeannie Kim, and Rebecca Reed-Arthurs, *The Impact of Bad Faith Lawsuits on Consumers in Florida and Nationwide* (Emeryville, Calif.: Berkeley Research Group, 2010), p. 16.

Findings



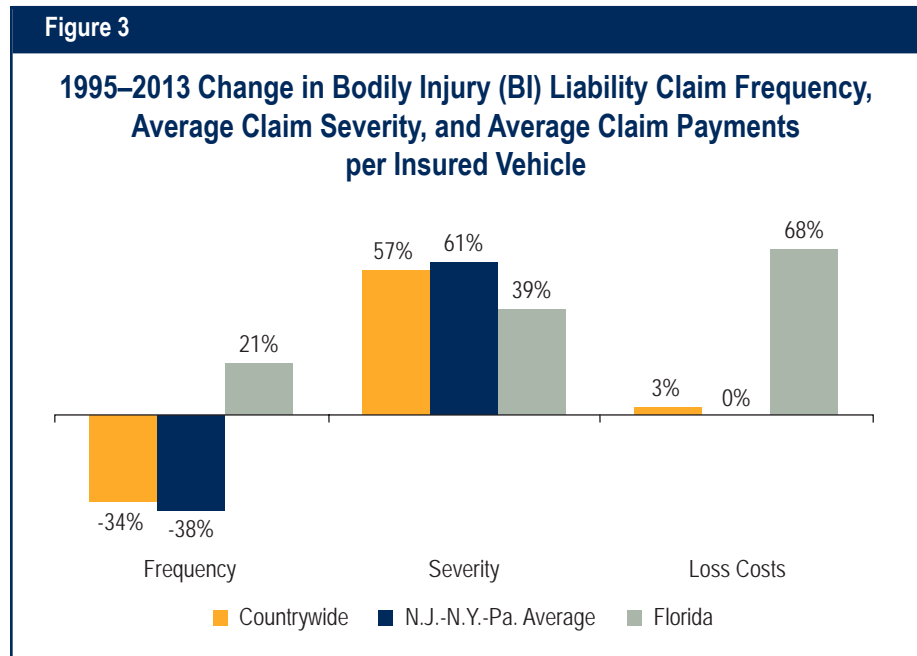
Key Findings

- The average BI claim payment per insured vehicle in Florida grew 68 percent from 1995 to 2013. The annualized percentage increase over the 19-year period was 2.9 percent.
- In other large no-fault states, none of which authorize third-party bad-faith lawsuits, average claim payments per insured vehicle either declined or grew significantly less than in Florida. The annualized percentage increase in New York was 0.9 percent—about one-third the growth rate in Florida. In New Jersey and Pennsylvania, average claim payments per insured vehicle fell 5 percent and 18 percent, respectively.
- Average claim payments per insured vehicle in Florida were 36 percent higher in 2013 than in similar large no-fault states that do not provide statutory authorization for third-party bad-faith lawsuits. In 2013, auto insurers in Florida paid \$195, on average, in BI liability claim payments for every insured vehicle in the state. In comparison, average claim payments per insured vehicle in New Jersey, New York, and Pennsylvania, which do not provide statutory authorization for third-party bad-faith lawsuits, averaged \$143.



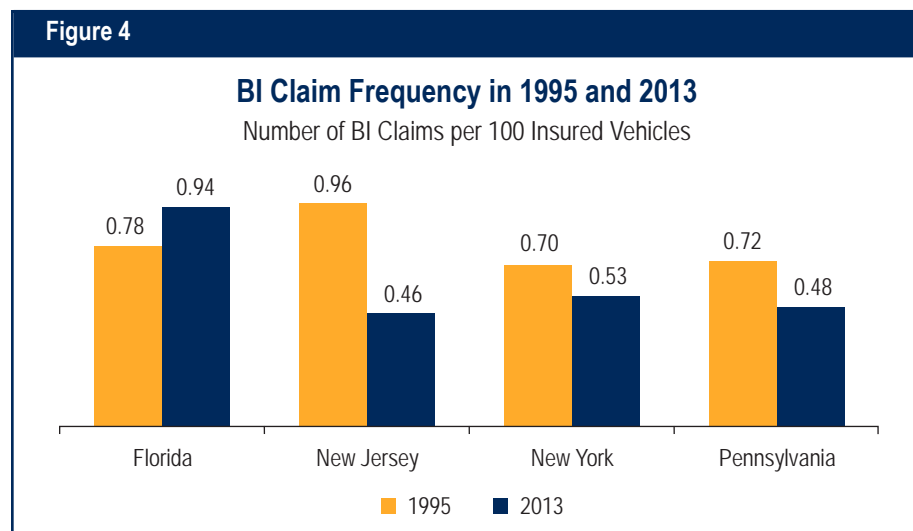
Key Findings

- Figure 2 illustrates the change in average BI claim payments per insured vehicle in Florida, for the three comparison states, and countrywide by indexing 1995 costs to 1. As the figure illustrates, average claim payments per insured vehicle in Florida grew significantly while average costs for New Jersey, New York, and Pennsylvania were virtually the same in 2013 as in 1995. The same was also true for BI claims countrywide, with average claim payments per insured vehicle virtually the same in 2013 as in 1995.
- Prior to 1995, average claim payments per insured vehicle in Florida followed a trend that was very similar to trends in the three comparison states and for BI claims countrywide. However, soon after the beginning of Florida's experiment with third-party bad-faith litigation, BI claim costs in Florida started a much different trend than in other states.



Key Findings

- The 68 percent increase in average BI claim payments per insured vehicle in Florida since 1995 is attributable to substantial increases in both claim frequency (the relative number of claims filed) and claim severity (average costs per claim). Claim frequency in Florida increased 21 percent, from 0.78 claims per 100 insured vehicles in 1995, to 0.94 claims per 100 insured vehicles in 2013. BI claim severity increased 39 percent, from \$14,843 to \$20,637 over the same period.
- The New Jersey, New York, and Pennsylvania comparison group also experienced a significant increase in claim severity—61 percent from 1995 to 2013. At the same time, however, these states experienced significant declines in claim frequency (-38 percent), which offset all of the increase in claim severity. As a result, average claim payments per insured vehicle in the comparison states were essentially the same in 2013 as in 1995. Changes in the frequency and severity of BI claims countrywide were very similar to the changes experienced in the New Jersey, New York, and Pennsylvania comparison group.



Key Findings

- Florida's 2013 BI claim frequency rate of 0.94 claims per 100 insured vehicles was almost double the average claim frequency rate for New Jersey, New York, and Pennsylvania (0.49 claims per 100 insured vehicles). Among all no-fault states, Florida's BI claim frequency rate was the highest in 2013.⁸ Florida's 2013 BI claim frequency rate (0.94) is more than twice the average BI claim frequency rate for other no-fault states (0.40).
- Florida's BI claim frequency rate is also higher than the claim frequency rate of most tort system states. This finding is especially noteworthy in light of Florida's status as a no-fault state. A primary goal in creating no-fault insurance systems was to reduce the frequency of third-party liability claims by making first-party benefits more readily available to claimants. Historically, BI claim frequency rates in no-fault states have been much lower than in states with tort-based systems. That is no longer the case with Florida.
- Florida's high BI claim frequency rate draws into question the effectiveness of the system's tort threshold, which is intended to limit access to BI liability claim reimbursement. It appears very likely, however, that the potential for receiving significant compensation from a bad-faith lawsuit is also a major factor since filing a BI liability claim is a prerequisite to filing a lawsuit claiming bad-faith on the part of an insurance company.

⁸ In addition to Florida, the no-fault states are Hawaii, Kansas, Kentucky, Massachusetts, Michigan, Minnesota, New Jersey, New York, North Dakota, Pennsylvania, and Utah. In Massachusetts, many personal injury protection (no-fault) claims are also reported as BI claims because of an unusual feature of Massachusetts law that allows insurance companies paying no-fault claims to subrogate for amounts paid against the insurer of the at-fault party in an accident. For this reason, the reported BI claim frequency rate in Massachusetts is not a true measure of claimant-initiated BI liability claims and is not included in this comparison.

Figure 5

**Estimated BI Liability Claim Costs in 2013
Attributable to Florida's Third-Party Bad-Faith Law**

1. Excess BI liability claim costs per insured vehicle = **\$79**
2. Number of insured vehicles in 2013 = **10.3 million**
3. Estimated Total Claim Costs in 2013
Attributable to Third-Party Bad Faith = **\$814 million**

Key Findings

- The comparison states of New Jersey, New York, and Pennsylvania averaged zero growth in BI liability claim costs between 1995 and 2013. To estimate the impact of Florida's third-party bad-faith law, IRC assumed that average claim payments per insured vehicle in Florida also would have experienced zero growth between 1995 and 2013 if the state had not opened the door to third-party bad-faith lawsuits against auto insurance companies. The \$79 increase in BI liability claim costs in Florida between 1995 and 2013 is, therefore, attributed entirely to the state's bad-faith law and the resulting claim environment in the state. Other factors might also contribute to the different experiences with cost growth in Florida and in the other states. None, however, are believed to be as pervasive or as substantial in impact as the ability to file lawsuits alleging bad-faith treatment by an insurance company.
- IRC estimates that Florida's third-party bad-faith law resulted in a \$79 increase in average claim payments per insured vehicle from 1995 to 2013. According to the National Association of Insurance Commissioners (NAIC), there were 10.5 million earned liability exposures for private passenger auto insurance in Florida in 2010.⁹ Allowing for a decline in recent years in the number of insured exposures in Florida, IRC assumed 10.3 million vehicles were insured in the state in 2013.
- With 10.3 million insured vehicles in the state and \$79 in claim costs for every insured vehicle, IRC estimates that Florida's third-party bad-faith claim environment was responsible for approximately \$814 million (10.3 million × \$79) in claim costs in 2013. The evidence suggests that the bad-faith claim environment in Florida encourages a much higher overall BI claim frequency in the state, despite the presence of the

⁹ National Association of Insurance Commissioners, *Auto Insurance Database Report 2010/2011* (Kansas City, Mo., 2013), p. 47.

no-fault threshold requirement that was intended to limit third-party liability reimbursement to only the most serious auto accident victims. The prospect of receiving substantial settlements in successful third-party bad-faith lawsuits appears to be the driving incentive for filing many BI liability claims, which is always preliminary to claiming bad-faith treatment by a liability insurer.

- These estimated costs do not include the payments, litigation, and court costs directly related to actual bad-faith lawsuits. These additional costs, which may be substantial, do not enter into an insurance company's loss experience and are, therefore, not reflected in the claims experience examined in this analysis. Nor are they included in the loss experience that forms the basis for calculating premium rates and coverage costs for consumers.

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Auto Injury Claims & Trends

Third-Party Bad Faith in Florida's Automobile Insurance System, August 2014, 12 pages.

Bad-faith lawsuits targeting automobile insurers in Florida impose a heavy burden on the state's auto insurance system and auto insurance consumers. This report examines the effect that potential bad-faith settlements have on underlying claiming behavior in Florida. Estimates of additional claim costs attributable to the bad-faith legal environment are included.

Attorney Involvement in Auto Injury Claims, July 2014, 50 pages.

This report uses data from the 2012 closed claim study to examine trends in the rate of attorney involvement in auto injury claims over time and across states. It also provides details on the interaction between the presence of attorneys and cost drivers such as medical treatment and claim abuse and looks at how represented claimants fare compared to claimants without attorneys with respect to claim payment and time to settlement.

Auto Injury Insurance Claims: Countrywide Patterns in Treatment, Cost, and Compensation, 2014 Edition, March 2014, 65 pages.

This closed claim study is based on a sample of more than 35,000 auto injury claims paid in 2012. The report compares 2012 data to results from similar studies conducted in 2007 and earlier. The study examines trends in claim patterns, including characteristics of the accidents and those injured, medical treatment, losses and payments, the claim settlement process, attorney involvement, and fraud.

Automobile Insurance Affordability, November 2013, 30 pages.

This report seeks to establish a conceptually logical definition of automobile insurance affordability and examine changes and differences in automobile insurance affordability over time and across states. It also analyzes variables (including competition, regulation, residual market size, richness of the system, uninsured motorists, and the unemployment rate) that may influence the variance in automobile insurance affordability across states and over time. Using these variables, a multivariate model is estimated to determine each factor's impact and significance on affordability.

Interstate Differences in Medical Utilization in Auto Injury Claims, July 2013, 48 pages.

This reports documents significant differences across states in the use of selected diagnostic and treatment services in auto injury insurance claims. The report also illustrates the potential savings available by bringing utilization rates in high-use states down to median state levels.

Uninsured Motorists

Uninsured Motorists, 2014 Edition, August 2014, 83 pages.

This study examines trends in the percentage of uninsured motorists in each state based on uninsured motorists and bodily injury claim frequencies from 2010, 2011 and 2012. Estimates for the number of uninsured motorists and the total amount of paid for uninsured motorists' claims are also included.

The Potential Effects of No Pay, No Play Laws, November 2012, 31 pages.

This study seeks to measure the impact of no pay, no play laws on the percentage of uninsured motorists. It also estimates the costs of noneconomic damages awarded to uninsured motorists in states that have yet to enact such laws. The findings suggest that not only would a properly enforced no pay, no play law result in a moderate decrease in uninsured motorists, it may also reduce auto insurance costs.

Public Attitude Monitor

PAM 2011. Accident Response Fees

PAM 2010. Texting While Driving.

Insurance Fraud

Insurance Fraud: A Public View, 2012 Edition, December 2012, 44 pages.

This report updates previous IRC studies surveying the public about the acceptability and perceived frequency of various types of insurance fraud, with special emphasis on auto insurance fraud. It also examines attitudes toward a variety of tools that insurers and law enforcement use to fight against insurance fraud, including claim handling techniques and consequences for fraudulent behavior, and the public's willingness to perform fraud-fighting efforts.

Property Insurance

Trends in Homeowners Insurance Claims, September 2012, 86 pages.

This report documents homeowners insurance claim frequency, severity, and loss cost trends from 1997 to 2011. Special emphasis is given to the role of catastrophe-related claims. Countrywide and state findings are presented.

Other Issues

The Affordable Care Act and Property-Casualty Insurance, February 2014.

The Affordable Care Act (ACA) dramatically alters healthcare markets and health insurance systems in the United States. Although the property-casualty insurance industry is not directly included or targeted by the act, it is not immune to its effects. This white paper identifies the ways in which the ACA may affect the property-casualty insurance industry.

Expert Views of Auto Insurance Rate Regulation, August 2013, 40 pages.

This report surveys academic experts in risk and insurance on the effectiveness of prior approval and market-oriented rate regulatory policies in automobile insurance. The results show that a vast majority believe the prior-approval regulation of auto insurance rates is unnecessary and does not benefit consumers.

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