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PERSPECTIVE

Can you sue insurance companies for emotional-distress damages?

By Richard J. Doren and Michael Holecek

The COVID-19 pandemic may give rise to a variety of novel insurance coverage disputes, and some of those disputes may include claims by policyholders for emotional distress due to a bad-faith claim denial. In California, however, the right to emotional-distress damages in the context of an insurance bad-faith claim is hotly contested. Two older decisions from the California Court of Appeal created a split in the law — with one court ruling that a plaintiff may recover only the emotional-distress damages caused by financial loss (e.g., anxiety over unpaid medical bills), and another court holding that once a plaintiff proves *some* financial loss, he can recover all of his emotional-distress damages, even if not caused by the financial loss. Recent decisions have referenced these two rules in passing without grappling with the conflict. This article explains why California courts will likely limit emotional-distress damages to injuries that are directly tied to economic loss. The damages principles in this article generally apply to claims for bad-faith breaches of any type of insurance contract.

Actions against insurers for "bad faith" conduct are unique because they straddle the line between tort and contract law. In *Gourley v. State Farm Mut. Auto. Ins. Co.*, the California Supreme Court explained that, although the breach of an insurance contract is normally an issue of contract law, a plaintiff can bring a tort action when the insurer breaches the contract in bad faith. But not all tort damages are available in a bad-faith action. In *Gourley*, the court held that "the bad faith action is *not* a suit for personal injury, but rather relates to financial damage." Thus, a plaintiff suing for bad faith can recover emotional-distress damages, but only when they are tied to financial injury.

In 1997, the California Court of Appeal seemingly expanded the scope of emotional-distress damages available in a bad-faith lawsuit. In *Clayton v. U.S. Automobile Assn.*, the insurer argued that the plaintiff was limited to emotional-distress damages directly caused by financial loss. The trial court rejected that rule, and the jury awarded $29,000 in economic damages and $400,000 in emotional-distress damages, without any evidence linking the two. The Court of Appeal affirmed, holding that a plaintiff need not show a link between his purported emotional distress and financial loss. Rather, once a plaintiff proves *any* financial loss, he may recover for all of his emotional distress caused by the insurer. The Court of Appeal did not cite *Gourley*.

Twelve years later, in *Major v. Western Home Insurance Co.*, the Court of Appeal rejected the rule in *Clayton* and held that a plaintiff suing for bad-faith breach of contract cannot recover noneconomic damages unless they were caused by actual financial loss. The court retraced the history of the bad-faith cause of action in California law and explained that "it is the financial loss or risk of financial loss which defines the cause of action" and therefore mental distress is compensable only "as an aggravation of the financial damages," citing *Gourley*. The court went on to explain that "[i]n the customary 'bad faith' case, the essence of a plaintiff's emotional distress is the anxiety arising from the financial deprivation *traceable directly* to nonpayment of the claim." Accordingly, a plaintiff cannot recover emotional-distress damages unless he proves that they were caused by financial loss — such as the bad-faith nonpayment of a claim.

Several recent decisions have restated the rules in *Major* and *Clayton*, but without addressing the conflict. In 2019, for example, the California Court of Appeal stated in *Deters v. Castro-Carranza* (unpublished) that "emotional distress damages must be tied to actual, not merely potential, economic loss," citing *Major*s. Also in 2019, in *Yackytooahnipah v. Liberty Mut. Fire Ins. Co.*, a federal district court stated that, under California law, "an insured cannot recover damages for emotional distress where the insured suffers no actual economic loss," but the court did not explain whether economic loss is merely a prerequisite for obtaining all emotional-distress damages or whether economic loss must be the cause of the alleged emotional distress. A year earlier, in 2018, the California Court of Appeal in *Watts v. Safeco Ins. Co. of Illinois* seemingly restated the *Clayton* rule — that an insured must establish only a "predicate financial loss" before recovering emotional-distress damages — but did not cite *Clayton* or address its conflict with *Major*.

Two older decisions from the California Court of Appeal created a split in the law — with one court ruling that a plaintiff may recover only the emotional-distress damages caused by financial loss (e.g., anxiety over unpaid medical bills), and another court holding that once a plaintiff proves *some* financial loss, he can recover all of his emotional-distress damages, even if not caused by the financial loss.

The current public-health crisis, which is generating significant anxiety and may also lead to a variety of insurance coverage disputes, could force California courts to grapple with the permissible scope of emotional-distress damages in bad-faith insurance actions. The rule in *Major*, that emotional-distress damages are compensable only when directly caused by financial loss, appears to hold the more solid footing in California law. As the California Supreme Court has long cautioned, the bad-faith action is not a generalized personal-injury action that permits a plaintiff to recover all noneconomic caused by his insurer. Rather, it is "financial loss which defines the cause of action." The conclusion most consistent with *Gourley* is that plaintiffs suing for bad-faith breach of an insurance contract must show a direct causal link between economic loss and the emotional-distress damages that they seek to recover. ■

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