



CLARKE V. CALIFORNIA INSURANCE CO., ET AL.



General Information

This is a contract and tort action pending in the California state court of original jurisdiction. It was filed almost two years ago. Both parties are residents of California. Discovery is nearly complete, but no trial date has been set. In a pretrial conference yesterday, the judge indicated her strong preference that the case be settled before trial. The case will be tried (if at all) before a jury. If it goes to trial, a verdict could be expected in around eighteen months.

Plaintiff Elizabeth Clarke was a payroll clerk and bookkeeper with the Golden State School District. The school district offered group long-term disability insurance as a fringe benefit for its employees. The policy provided monthly disability benefits up to age sixty-five for employees rendered totally disabled due to accident or sickness.

The plaintiff contends that she has suffered from severe ulcerative colitis for four and a half years, resulting in her total disability. After paying disability benefits for two years, the defendant's insurance company determined that the plaintiff's illness did not render her totally disabled under the terms of the policy and terminated its payments. In making the decision to terminate, the defendant also relied on the policy's two-year limit on benefits for a disability that is mental or emotional in nature.

The insurance company contends that Clarke can return to work in an accounting, payroll, bookkeeping, or similar clerical position, though not under the stressful circumstances that existed during the school year four years ago when she was first hospitalized for the disease. During that year the school committee was forced to close an elementary school and a junior high school and to lay off more than 150 teachers. A major cutback was also made in the clerical staff of the school district. Although Clarke's job was not eliminated, she was forced to work many additional hours to computerize the new payrolls.

This case presents a close liability issue. Clarke undoubtedly suffers from ulcerative colitis. This disease can be severely debilitating, often resulting in anemia, internal bleeding, and great loss of weight. Prevailing opinion (only minimally supported by research) is that ulcerative colitis is most likely caused by an enzyme deficiency, but it can clearly be aggravated by both physical and mental stress. In many cases the disease can be treated by drugs, but in the worst cases an ileostomy, or complete surgical removal of the colon, is necessary.



Four and a half years ago, the plaintiff was hospitalized twice in four months for this disease (first for six days and then for ten). Clarke returned to work for four weeks after the first hospitalization, but left again five weeks later and did not return thereafter. Surgery was not recommended, but she was put on a drug-treatment program following the first hospitalization. She responded well to the treatment, and medication was discontinued after two years. She has not been hospitalized for more than four years, with the exception of a brief period for a tubal ligation; she feared that pregnancy might be too traumatic in light of her colon condition.

She has had no relapse of her illness since she was taken off medication, and the only current symptoms of her condition are three soft bowel movements each day. However, her doctor did put Clarke back on medication just over two years ago, after she was notified by the defendant of its termination of her disability payments. The doctor was concerned about mental stress caused by this turn of events and termed the medication "preventive." Clarke makes regular doctor's office visits once every three months.

In the past two years, she has been active in the local chapter of the National Organization for Women. Although she has no official position in the organization, she has contributed some time to organizing a small pro-ERA fundraiser. In addition, Clarke has accompanied her husband to Europe twice in the past three years. She has not had any income outside of her monthly disability check, however.

A deposition of the plaintiff's attending physician, a general practitioner, reveals that he will testify that Clarke cannot handle the strain of a job. Although the causes of ulcerative colitis are the subject of medical debate, the doctor believes that the strain would undoubtedly aggravate the condition regardless of its origins. Moreover, he says, Clarke is a person who takes her work extremely seriously and will feel pressured to perform well even in a job that is less demanding than her last one.

Under the policy the insurance company has a right to demand that those receiving benefits for a permanent disability are examined every five years, or more frequently if there is evidence of changed circumstances, by a physician of its choice and at its expense. The insurance company has had a gastrointestinal specialist examine the plaintiff. He concurs in the diagnosis of ulcerative colitis but suggests that a return to work might be good for Clarke. He notes that there is no consensus on the proper treatment for the illness and recommends to his patients that they attempt to lead as normal a life as possible. He also recommended that Clarke seek psychological counseling on the theory that her fear of work is a psychological problem rather than a rational response to her physical ailment.

Clarke has just turned twenty-nine years old. The monthly benefits called for in the policy are \$634.00 per month. If she were to receive these benefits until her sixty-fifth birthday, the total paid out by the insurance company would be just under \$274,000. If \$84,600 is invested at a 9% rate of interest (an reasonable choice given current economic conditions), it will generate an income equivalent to the policy's monthly payments until Clarke is sixty-five without ever diminishing the principal. Alternatively, if \$81,200 is invested at 9% interest and \$634.00 a

month is withdrawn from the account, the balance will reach zero with the last payment allegedly due to Clarke under the policy.

In addition to her claim for breach of contract and reinstatement of benefits, the plaintiff seeks punitive damages of \$1,000,000, claiming that the defendant's decision to terminate was malicious and oppressive — that is, that the insurance company had no reasonable basis to refuse to pay benefits and knew so at the time of its decision. The defendant denies any malice or bad faith. Discovery by that plaintiff has revealed interoffice correspondence by employees of the insurance company that bears on this issue. The most damning letters discovered are attached.

Settlement Negotiations

Each side's attorney is experienced in cases of this type and is well respected in the local legal community. Even before the judge's warning yesterday, counsel had met and engaged in unusually candid and forthright discussions to explore the possibility of settlement. The situation is as follows: both counsel agree that the case hinges on the liability issue. The plaintiff is counting on a combination of sympathy and spillover outrage from the punitive damages evidence to sway the jury in her favor. The defendant will emphasize that Clarke is only twenty-nine and manifests no outward signs of disability and will try to raise doubts that she will be totally unable to work for the entire thirty-six years until she reaches age sixty-five.

Both counsel also acknowledge that going through a trial will be a stressful experience for Clarke. She would naturally like to avoid that, and for that reason, the defendant's counsel continues to expect the plaintiff will ultimately want to settle before trial. But the plaintiff's counsel points out that if Clarke did break down on the stand and suffer a relapse, the defendant would be in the soup.

Insurance companies are obligated under the Uniform Fair Claims Practices Act, adopted in some form in all fifty states, to evaluate and pay insurance claims in good faith, and they are liable for punitive damages if they do not. Also, unlike regular compensatory damages, punitive damage awards are not limited to the maximum amount of the insured's policy. California courts have been the most aggressive in the nation in applying this statute on behalf of aggrieved plaintiffs. The plaintiff's counsel is convinced that the internal letters raise a real possibility of a big punitive damages award in this case and points out the undesirability from an insurance company's perspective of publicity suggesting that they try to avoid paying valid claims. The defendant's counsel has not explicitly conceded these points but also has not said anything to rebut them. The defendant's counsel has made clear, however, the company's strong interest in maintaining a reputation for cracking down on false claims.

The plaintiff's attorney has signed a contingency agreement with Clarke providing for 25% of any settlement before trial, or 33% of any award at trial. The defendant has hired local trial counsel on an hourly basis. The defendant's total costs so far have been about \$10,000. (This figure includes both legal fees and other costs. In cases such as this, other costs total



approximately 25% of legal fees, so that the \$10,000 represents legal fees to date and other costs of approximately \$8,000 and \$2,000, respectively.) The defendant's total trial costs are estimated to reach approximately another \$15,000, plus \$2,000 for expert testimony. Total costs to defendant of an appeal, if the plaintiff were to win a large punitive damages award, might reach \$20,000.



CLARKE TIME LINE

July 2–8, Year 5	Clarke hospitalized. Drug treatment begins.
August 14, Year 5	Clarke returns to work.
September 25, Year 5	Clarke leaves work with renewed illness.
October 2–12, Year 5	Clarke is again hospitalized.
October 12, Year 5	Clarke returns home but does not return to work.
November 7, Year 5	Clarke files claim for total disability.
March 1, Year 4	First payment received on California Insurance Company disability policy.
September 11, Year 4	Clarke's medication is discontinued.
March 2, Year 2	Clarke receives a letter from the defendant stating that payments are being discontinued as of this date.
March 21, Year 2	Clarke resumes some medication on her doctor's advice.
April 6, Year 2	Clarke files complaint.
March 1, Year 0	Today.



CALIFORNIA INSURANCE COMPANY

76666 Mohican Way
Los Angeles, CA

Post Office Box 76666
Telephone 213-555-1212

November 1, Year 3

Herbert Walters
Claims Reviewer
Local Group Office - Bay Area

RE: Claim No. LTD604-3

Dear Mr. Walters:

In accordance with my telephone call to you yesterday, I have reviewed this file and I am, quite frankly, disturbed by it. The insured's disability has been in "a state of remission" since we started paying benefits. She only goes to her doctor for periodic visits once every three months, and she hasn't sought to return to work or to look for another job that is not so "stressful." I don't think there is anything wrong with the woman at all. Possibly there never was. I think she is just trying to con us out of a lot of money.

Henceforth the home office will assume responsibility for this claim. I intend to close this file as soon as I can. We are getting too many of these long-term disability claims, and I think that a lot of them are bogus, especially this one. The only thing this woman is disabled from is work itself.

Don't take any action on this claim without my knowledge, and forward all supplementary documents to me. I will authorize any subsequent monthly payments from this office. I don't want to start payments under the nonoccupational clause.

I'll need your assistance in the handling of this claim. I'll be communicating with you shortly. I hereby authorize payment of full benefits for this next month (December) over your signature.

Yours truly,

Stuart Tindall
Senior Claims Analyst

ST:jlt



CALIFORNIA INSURANCE COMPANY

76666 Mohican Way
Los Angeles, CA

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December 20, Year 3

Herbert Walters
Local Group Office - Bay Area

RE: Claim No. LTD604-3

Dear Herb:

Thank you for the closing and projected figures. And yes, you can be of further assistance. There are only two months left before we reevaluate this claim under the nonoccupational provision of the group policy. The insured's physician has reported that the insured is totally and permanently disabled from any and all gainful employment. We had better get a doctor's report on our side in this file. I want you to arrange for a medical exam by a local gastrointestinal specialist. This would look good to a local jury.

Be sure the doctor examines for "severe" ulcerative colitis. Also have him discuss the extent of her daily activities, the specific duties of her occupation, how many hours she worked each week, and the demands of her job. We need the doctor's opinion about whether her job as some kind of clerk was really "stressful" and also whether he thinks she can go back to work or at least perform some type of gainful employment. We want to show that she is capable of doing more than sitting around watching soap operas.

Continue paying benefits for now. At the worst, we will just pay benefits for the balance of the two-year occupational disability period. I am convinced this woman is nothing but a freeloader. As far as I am concerned, colitis is like getting a headache when you don't feel like doing any work. But whatever the merits of her claim, it will help us in future settlements if we take a hard line and get a very low settlement here.

Yours,

Stuart Tindall

STG:jlt

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Confidential Information for the Plaintiff's Attorney

You believe you have a winner here. Although the liability issue is close, it will go to a jury and you are counting on their sympathy to resolve any doubts in your client's favor. Moreover, whatever the judge instructs about the law, in practice there is a good chance that the documentary evidence on the punitive damages issue will persuade the jury in your favor on the liability issue.

The only real problem is that your client is exceptionally apprehensive about being on the witness stand. If you believe your own case, the trial has to hurt her health. The defendant's lawyer will no doubt cross-examine her extensively. Consequently, you might be willing to settle this case for less than it would otherwise be worth.

Although your client is not currently suffering from money difficulties even without the payments, she and her husband intend to adopt a child after he is given a partnership in his law firm, probably in four or five years. She is worried about the additional costs of rearing a child. She might be willing to accept a settlement payment deferred for four or five years if the price is high enough.

You believe that the defendant will also want to settle if it is smart. The internal letters create the possibility of a big jury award on punitive damages. And whatever the jury decides, the letters are bad publicity for a company trying to sell insurance.

In your negotiation before the judge you offered to settle for \$175,000. This seemed fair for several reasons: you estimated Clarke's chances of winning on the liability issue at 70%. This would mean a compensatory damage award of \$191,800 (70% of \$274,000). However, your client's fear of testifying is a strong reason to avoid a trial, and you feel that if it were not for the punitive damage claim you, would settle for \$150,000.

Although a jury may be reluctant to find malice here, your best estimate is that there is a 10% chance that your client would recover punitive damages. Realistically, even if you won punitives, you would be unlikely to get the full \$1 million you have claimed. A reasonable estimate would be \$250,000. Ten percent of \$250,000 is \$25,000. Hence your offer of \$175,000.



Now that the judge has forced you and the defendant's counsel to get serious about settlement, you would like to be better prepared for negotiation. Although you are pretty confident in the estimates you have mentioned earlier of the probability of success on various points, you are less certain of how to use those estimates to determine a reasonable settlement figure. Before negotiating, you would like to review your references on litigation valuation and try to work out more systematically what litigation is worth to your client economically, and likewise what it would be worth to the defendant. Then you will have a stronger foundation from which to factor in other monetary and nonmonetary interests the clients may have.

First you need to work out the sequence of key decisions and uncertain events that stand between the plaintiff today and a final resolution of the case. The first and current decision, which is to be addressed in your upcoming negotiation and which will remain an option right up until the close of the trial, will be whether to settle the case or proceed to trial. We can represent this as follows:

Settle

Proceed to Trial

The simplest model would then consider the trial outcome as a probability event with three main possible outcomes: win big (punitives), win (no punitives), or lose. This would look like:

Settle			\$S
	$a\%$	Win	$\$(0.67)a$
Proceed to Trial	$b\%$	Win, no punitives	$\$(0.67)b$
	$c\%$	Lose	$\$(0.67)c$

a , b , and c would represent your best estimates of the odds of each of these three outcomes. As you have noted earlier, you think your overall chances of winning are 70%, and the chance of getting punitive damages is around 10%. That suggests that $a = 10\%$, $b = 60\%$, and $c = 30\%$.

In this diagram A , B , and C represent the possible verdict amounts. A would include actual compensatory damages plus punitive damages. You have estimated the latter at \$250,000. B would include only compensatory damages. $C = 0$. For each of these verdicts, the plaintiff would actually receive only two-thirds of the amount, with the other third going to you as attorney's fees.

See if you can proceed from here to determine what B should be, what the expected value of litigation would then be, and what value for S would then be economically equivalent to



litigating. When you are done, compare your results with the analysis that follows.

ANALYSIS

To figure out what compensatory damages would be, we need to recognize that there are two components to them: (a) the value of future monthly payments through the plaintiff's sixty-fifth birthday, and (b) the value of past due payments that she should have received but has not. We need to figure each of these amounts as of the time when the verdicts will be reached, which is estimated to be in eighteen months.

(a) Future payments. In eighteen months the plaintiff will be 30.5 years old. If the policy had been honored, she would at that time be entitled $(34.5)(12) = 414$ further monthly payments of \$634 each. At $(9\%)/(12) = 0.75\%$ interest per month, the value in then current dollars of that future stream of payments would be \$80,700.

(b) Past due payments. At the time of verdict, the plaintiff will not have received a monthly payment for forty-two months. We would like to know the what the value of forty-two payments of \$634/month with a prevailing interest rate of 0.75%/month would be at the end of the forty-two months. After entering $I = 0.75$, $n = 42$, and $PMT = 634$ in our calculator, we ask for FV instead of the usual PV. The result is \$31,163.

Thus total compensatory damages should be $\$111,863 = B$, and therefore $A = \$111,863 + \$250,000 = \$361,863$. Reducing these amounts by attorney's fees, our chart now looks like this:

Settle			\$S
	10%	Win	\$241,242
Proceed to Trial	60%	Win, no punitives	\$74,575
	30%	Lose	\$0

To figure the expected value of litigation, we need to weight each of these outcomes by their estimated probability:

10%	of	\$241,242	= \$ 24,124
65%	of	\$74,575	= \$ 44,745
<u>30%</u>	of	<u>\$0</u>	<u>= \$ 0</u>
100%			\$ 68,869

We also have to reduce this \$68,869 figure to present value, because it won't be received for eighteen months. The present value of \$68,869 received in eighteen months with a prevailing interest rate of 0.75% per month is \$60,202.

Wow! That is a lot less than you thought. You'll want to consider these figures in more depth and perhaps look more closely at how events at trial, particularly the witnesses, may affect your



probability estimates. But taking this figure as is for the moment, you now have to figure out what settlement offer is appropriate.

You should begin with a simple economic calculation. One-quarter of any settlement offer you accept will go to you as attorney's fees. So a settlement offer needs to be at least $(4)(\$60,202)/(3) = \$80,269$ for the plaintiff to get as much money as she would litigating, given our estimates of what would happen in litigation.

From what we know, the plaintiff would probably accept less than this, however, for any of several reasons: (a) She would like to avoid the trauma of trial. (b) She is risk averse and would prefer less cash for certain than gambling for a larger expected value. (c) Her husband agrees. How much less is a subject for further discussions with her. Perhaps other quantitative techniques useful for quantifying intangible preferences could be used to assist in that discussion.

Well, this is a good beginning. Before settling on a negotiation strategy, however, you will also want to think about how litigation looks to the defendant and perhaps also do more analysis on your own situation. What, for example, would be the impact of witnesses, or an appeal by the defendant of a large punitive damages award? Some suggestive trees for consideration are shown below:

Defendant's Simple Tree

Settle				\$S
	\$e	x%	Lose	$$(0.67)X$
Proceed to Trial		y%	Lose, no punitives	$$(0.67)Y$
		z%	Win	$$(0.67)Z$