AN OVERVIEW OF INSURANCE BAD FAITH LAW AND LITIGATION

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I. INTRODUCTION

In the last decade there has been a marked increase in disputes and tension between insurers and their policyholders.[1] The heightened adversarial relationship between insurance carriers and their insureds is evidenced by juries' willingness to return financially overwhelming verdicts. In 1993, for example, California juries returned $425,600,000 and $89,320,000 verdicts against insurers in bad faith cases.[2] In another 1993 case, a Texas jury assessed compensatory damages of $2,170,000 and punitive damages of $100,000,000 against an insurer that denied a $20,000 underinsured motorist claim.[3] While not all large verdicts survive appeal,[4] there can be no doubt that insurance bad faith litigation has become a high stakes field.[5]

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[1] Thomas A. Gordon & Donald J. Hirsch, *Essential Considerations When Reserving Rights or Denying Coverage, in* THE RIGHTS AND DUTIES OF PRIMARY AND EXCESS INSURANCE CARRIERS 50 (Defense Research Inst. 1993).

[2] In Amoco Chemical Co. v. Certain Underwriters at Lloyd's of London, No. BC030755 (Los Angeles County, Cal. Super. Ct. 1993), two Amoco subsidiaries recovered $425,600,000 from a consortium of European insurers that refused to defend and indemnify them in a series of lawsuits. In Fox v. Health Net, No. 219692 (Riverside County, Cal. Super. Ct. Dec. 23, 1993), a health insurer deemed a bone marrow transplant "experimental" and refused to authorize the procedure. The insured ultimately died of cancer, and a jury awarded her survivors $12,320,000 in compensatory and $77,000,000 in punitive damages. *See 1993's Largest Verdicts*, NAT'L L. J., Jan. 17, 1994, at S6.

[3] *Id.* The case was Hedrick v. Sentry Insurance Co., No. 96-128100-90 (Tarrant County, Tex. Dist. Ct. 1993). *Id.*

[4] *See, e.g.*, McLaughlin v. National Union Fire Ins. Co., 26 Cal. Rptr. 2d 520, 523 (Ct. App. 1993) (reversing $48,974,165 judgment).

[5] *See, e.g.*, Eichenseer v. Reserve Life Ins. Co., 934 F.2d 1377, 1377 (5th Cir. 1991) (compensatory damages of $1,000 supported $500,000 punitive damage award); Principal Fin. Group v. Thomas, 585 So. 2d 816, 817-18 (Ala. 1991), *cert. denied*, 112 S. Ct. 649 (1991) ($750,000 punitive damage award for bad faith denial of $1,000 claim).

In early 1994, yet another California jury perpetuated that state's bad faith gold rush. In D. W. Stephan Enterprises v. Gold City Insurance Agency (Los Angeles County, Cal. Super. Ct. Feb. 25, 1994), the Insurance Company of North America (INA) was hit with a $7,150,000 bad faith verdict, including $6,500,000 in punitive

The need for a tort remedy for insurers' predatory or unscrupulous claims practices is well-recognized.[6] But plaintiffs' attorneys today strive to manipulate insurers into extracontractual and punitive exposure.[7] Increasingly, plaintiffs groundlessly allege insurance companies' bad faith in attempts to win the judicial lottery.[8] As explained by Judge Kozinski of the Ninth Circuit in *Oki America, Inc. v. Microtech International, Inc.*:[9] "This tortification of contract law—the tendency of contract disputes to metastasize into torts—gives rise to a new form of entrepreneurship: investment in tort causes of action."[10] There now exists a nightmarish extracontractual insurance culture.

While discreet areas of insurance bad faith law and litigation have attracted considerable scholarly attention, broader examinations have been avoided. This article represents a modest effort to examine insurance bad faith law and litigation, and attempts to do so in a manner useful to practitioners and scholars alike. Bad faith in both the third-party and first-party contexts is addressed, as are the affirmative defenses available to insurers. Last, this article discusses the newest trend in bad faith law and litigation: insureds' comparative fault, and comparative and reverse bad faith.

II. BACKGROUND

Courts recognize that all contracts include an implied covenant of good faith and fair dealing.[11] Insurance policies, like other contracts, contain this implied covenant.[12] The implied covenant

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damages. INA had paid only part of its insured's $225,000 fire loss, claiming that the subject property was only insured for $20,000. The plaintiff alleged that the property was insured for $200,000. *See Verdicts and Settlements*, NAT'L L.J., Apr. 11, 1994, at A9. Returning on March 30, 1994, a Nevada jury awarded a construction company punitive damages of $30,000,000 in connection with Industrial Indemnity Company's alleged bad faith. Helms Const. Co. v. Industrial Indem. Co., No. CV-N-90-566-HDM (D. Nev. Mar. 30, 1994). *See Verdicts and Settlements*, NAT'L L.J., Apr. 18, 1994, at A9.

6 *See* Green v. State Farm Fire & Cas. Co., 667 F.2d 22, 25 (9th Cir. 1982); Standard Life Ins. Co. of Indiana v. Veal, 354 So. 2d 239, 248 (Miss. 1977).

7 *See* Steven S. Ashley, *The Ethics of Setting Up Insurance Companies*, 6 BAD FAITH L. REP. 45, 45 (1990).

8 C. Lee Cusenbary, Jr., *The Tort of Bad Faith: Leaving Insurers Defenseless*, 34 S. TEX. L. REV. 299, 326 (1993).

9 872 F.2d 312 (9th Cir. 1989).

10 *Id.* at 315.

11 Pemberton v. Farmers Ins. Exch., 858 P.2d 380, 382 (Nev. 1993); Austin Co. v. Royal Ins. Co., 842 S.W.2d 608, 610 (Tenn. Ct. App. 1992); State Farm Mut. Auto. Ins. Co. v. Weiford, 831 P.2d 1264, 1266 (Alaska 1992).

12 *See* Kansas Bankers Sur. Co. v. Lynass, 920 F.2d 546, 548 (8th Cir. 1990) ("A duty to act in good faith is part of every insurance contract."); Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 27 (N.Y. 1993).

of good faith and fair dealing may be expressed as a promise implied "in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement."[13] Modern insurance bad faith claims have their genesis in contract.[14]

In a landmark 1930 decision, *Hilker v. Western Automobile Insurance Co.*,[15] the Wisconsin Supreme Court merged the concepts of negligence and bad faith with breach of the covenant. The *Hilker* court reasoned:

> [T]he good-faith performance of the obligation, which the insurance company assumed when it took itself the complete and exclusive control of all matters that determine the liability of the insured, requires that it be held to that degree of care and diligence which a man of ordinary care and prudence would exercise in the management of his own business, were he investigating and adjusting [insurance] claims.[16]

Beginning in the 1950's, courts more commonly acknowledged a tort cause of action for breach of the duty of good faith and fair dealing in addition to the underlying contract claim.[17] In 1958, the Supreme Court of California further unified the implied

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[13] Communale v. Traders & Gen. Ins. Co., 328 P.2d 198, 200 (Cal. 1958); *see also* Wagenseller v. Scottsdale Mem. Hosp., 710 P.2d 1025, 1038 (Ariz. 1985) ("The covenant [of good faith and fair dealing] requires that neither party do anything that will injure the right of the other to receive the benefit of their agreement.").

[14] Taylor v. State Farm Mut. Auto. Ins. Co., 854 P.2d 1134, 1142 (Ariz. 1993). First-party bad faith claims remain rooted in contract. An insurer's duty of good faith does not extend to every party arguably entitled to payment from insurance proceeds; as a rule, there must be a contractual relationship between the insurer and the bad faith claimant. Nevada Ins. Guar. Ass'n v. Sierra Auto Ctr., 844 P.2d 126, 128-29 (Nev. 1992) (no bad faith claim absent contractual relationship); *see also* Roach v. Atlas Life Ins. Co., 769 P.2d 158, 161 (Okla. 1989) (must be a contractual or statutory basis for claim). *But see* Psarianos v. Standard Marine, Ltd., 12 F.3d 461, 465 (5th Cir. 1994) (where the claimant is not the insured or a third-party beneficiary, "a direct and close relationship" with the insurer will suffice). The plaintiff in Fobes v. Blue Cross and Blue Shield of Arizona, Inc., 861 P.2d 692 (Ariz. Ct. App. 1993), alleged the defendant's bad faith connected to the denial of benefits to her husband under his health insurance policy. The plaintiff and decedent had separate policies. Inasmuch as the plaintiff was not named as an insured on her husband's policy and was not a third-party beneficiary, the *Fobes* court affirmed the trial court's dismissal of her bad faith claim. *See id.* at 694-98. Similar results were reached in Steptoe v. Auto-Owners Insurance Co., 437 S.E.2d 626, 628-29 (Ga. Ct. App. 1993), Gunny v. Allstate Insurance Co., 830 P.2d 1335, 1336 (Nev. 1992), and Eastham v. Nationwide Mutual Insurance Co., 586 N.E.2d 1131, 1133 (Ohio Ct. App. 1990).

[15] 231 N.W. 257 (Wis. 1930), *aff'd on reh'g*, 235 N.W. 413 (Wis. 1931).

[16] *Hilker*, 231 N.W. at 261.

[17] Richard B. Graves III, Comment, *Bad Faith Denial of Insurance Claims: Whose Faith, Whose Punishment? An Examination of Punitive Damages and Vicarious Liability*, 65 TULANE L. REV. 395, 397 (1990).

duty and tort remedies for its breach in *Comunale v. Traders & General Insurance Co.*[18]

In *Crisci v. Security Insurance Co. of New Haven, Conn.*,[19] a 1967 decision, the California Supreme Court held that an insurer's breach of its duty of good faith and fair dealing by declining to settle a claim within policy limits was an independent tort.[20] It is clear now that insurers owe their insureds a duty of good faith existing independent of their policies.[21] If this duty is breached, an insured's cause of action sounds in tort.[22]

It is not surprising that courts troubled by insurers' claims practices formulated a tort duty of good faith and fair dealing. Insureds purchase their policies for peace of mind and security, rather than for financial gain.[23] Insurance policies are thus more personal than commercial. An insurer and its insured, unlike parties to other contracts, may be thought to share a special relationship.[24] This special relationship arises out of the parties' perceived unequal bargaining power and the nature of insurance policies, which potentially allow unscrupulous insurers to exploit their insureds' misfortunes when resolving or settling claims.[25] As explained by the Ninth Circuit Court of Appeals in *Holmgren v. State Farm Mutual Automobile Insurance Co.*:[26]

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18 328 P.2d 198 (Cal. 1958).

19 426 P.2d 173 (Cal. 1967).

20 *Id.* at 177.

21 Self-insured corporations and independent claims adjusting companies may also owe claimants duties of good faith and fair dealing. *See, e.g.*, Natividad v. Alexis, Inc., 833 S.W.2d 545, 547-48 (Tex. Ct. App. 1992); Scott Wetzel Serv., Inc. v. Johnson, 821 P.2d 804, 805 (Colo. 1991) (workers' compensation claim). Insurance adjusters may be held personally liable for unfair claims practices or acts amounting to bad faith. *See* O'Fallon v. Farmers Ins. Exch., 859 P.2d 1008, 1014-15 (Mont. 1993).

22 Stephens v. Safeco Ins. Co. of Am., 852 P.2d 565, 567 (Mont. 1993); Safeco Ins. Co. of Am. v. Butler, 823 P.2d 499, 503 (Wash. 1992); *cf.* Taylor v. State Farm Mut. Auto. Ins. Co., 854 P.2d 1134, 1142 (Ariz. 1993) ("[T]he precise legal context of a bad faith claim may depend on the context of the discussion . . . . [B]ad faith has components of both tort and contract . . . .").

23 Love v. Fire Ins. Exch., 271 Cal. Rptr. 246, 252 (Ct. App. 1990) ("An insured does not enter an insurance contract seeking profit, but instead seeks security and peace of mind through protection against calamity."); Ainsworth v. Combined Ins. Co. of Am., 763 P.2d 673, 676 (Nev. 1988) ("A consumer buys insurance for security, protection, and peace of mind."), *reh'g denied*, 774 P.2d 1003 (Nev. 1989), *cert. denied*, 110 S. Ct. 376 (1989).

24 *See* Viles v. Security Nat'l Ins. Co., 788 S.W.2d 566, 567 (Tex. 1990).

25 *See* Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987). Insurance policies are routinely characterized as adhesion contracts. *See, e.g.*, Intermountain Gas Co. v. Industrial Indem. Co., 868 P.2d 510, 513 (Idaho Ct. App. 1994); Clemco Indus. v. Commercial Union Ins. Co., 665 F. Supp. 816, 818 (N.D. Cal. 1987), *aff'd*, 848 F.2d 1242 (9th Cir. 1988).

26 976 F.2d 573 (9th Cir. 1992).

> When coverage and liability are established . . . a game of the strong against the weak *can* begin. A . . . valid and legitimate [claim] can be settled for far less than its actual value if the need for funds by the victim is great enough and the insurance company is obstinate enough to use its knowledge of that fact to force acceptance of a lesser sum.[27]

The tort duty of good faith and fair dealing fills the void created by the parties' disparity of bargaining power and the insurer's exclusive control over claim processing.[28]

Significantly, tort theory affords aggrieved insureds a mechanism to recover damages well beyond those otherwise available. Were an insurer's duty of good faith purely contractual, an insured's recovery generally would be limited to those damages necessary to restore him to the position he would have occupied had the promise been performed, *i.e.*, the "benefit of the bargain." Such limited damages would do nothing to deter predatory or unscrupulous insurers, inasmuch as their liability would always be tied to policy limits.[29] In tort, however, insureds may recover a breadth of compensatory damages, all intended to restore them to the place they would have enjoyed before their injury. Crucially important is the insurer's liability for any judgment exceeding its policy limits.[30] Consequential or extracontractual damages may further include awards for emotional distress, lost income and related eco-

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27 *Id.* at 578 (emphasis in original).

28 State Farm Fire & Cas. Co. v. Simmons, 857 S.W.2d 126, 132 (Tex. Ct. App. 1993).

29 *See* Bibeault v. Hanover Ins. Co., 417 A.2d 313, 318 (R.I. 1980) (explaining need for a tort remedy to replace unsatisfactory contract remedies).

30 An insurer occasionally argues that because its insured is financially incapable of satisfying an excess judgment, the insured has not been harmed by the insurer's bad faith. Thus, the insurer should not be burdened with extracontractual liability. This principle is known as the "prepayment rule." *See* Smith v. Transit Cas. Co., 281 F. Supp. 661, 667 (E.D. Tex. 1968). The prepayment rule, which reduces to the playground maxim "no harm, no foul," is now outdated and disfavored. The prepayment rule's major flaw is the simple fact that if an insurer has the good fortune to trample on an insolvent insured, there are no consequences for the insurer's bad faith conduct. Most (if not all) courts therefore follow the "judgment rule." Under the judgment rule, the mere entry of an excess judgment against the insured is sufficient to hold the offending insurer wholly liable. The reasoning is basic: judgment proof insureds are injured by excess judgments because their credit is potentially impaired, title to their exempt estates may be clouded, their ability to borrow may be eroded, and they may be forced into bankruptcy. Crabb v. National Indem. Co., 205 N.W.2d 633, 638 (S.D. 1973); *see also* McNally v. Nationwide Ins. Co., 815 F.2d 254, 263 (3d Cir. 1987). The judgment rule prevents an insurer from taking advantage of its insured's financial status. If and when the judgment rule is not followed, it is because the parties stipulate to judgment, causing a court to fear collusion or fraud. *See, e.g.*, Romstadt v. Allstate Ins. Co., 844 F. Supp. 361, 365-67 (N.D. Ohio 1994).

nomic losses. The recognition of a tort duty also exposed insurers to punitive damages, traditionally unavailable for a contract breach.

III. THIRD-PARTY BAD FAITH

Bad faith claims, like types of insurance, fall into two general categories: third-party and first-party. Only liability insurance is truly third-party insurance.[31] Liability insurance is described as third-party insurance because the interests protected by the policy are ultimately those of strangers to the contract who are injured by the insured's conduct.[32] The earliest insurance bad faith cases arose in the third-party context. Today, a tort cause of action for third-party bad faith is widely recognized.[33]

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[31] ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 43 (1987).

[32] A third-party claimant has no conventional rights under a liability insurance policy until the insured's liability is established by way of judgment or written agreement with the insurer. Planet Ins. Co. v. Wong, 877 P.2d 198, 201 (Wash. Ct. App. 1994); State Farm County Mut. Ins. Co. v. Ollis, 768 S.W.2d 722, 723 (Tex. 1989); Scharnitzki v. Bienenfeld, 534 A.2d 825, 828 (Pa. Super. Ct. 1987); *see also* Allstate Ins. Co. v. Watson, 876 S.W.2d 145, 149-50 (Tex. 1994) (deceptive trade practices act does not give third-party claimant standing to sue insurer); Cunningham v. Standard Guar. Ins. Co., 630 So. 2d 179, 181 (Fla. 1994) (ordinarily, third party must obtain excess judgment against insured before pursuing liability carrier). An insurer does not owe a third-party claimant a duty of good faith and fair dealing. Dunn v. National Sec. Fire & Cas. Co., 631 So. 2d 1103, 1107 (Fla. Dist. Ct. App. 1993); Dvorak v. American Family Mut. Ins. Co., 508 N.W.2d 329, 331 (N.D. 1993). This is true even if the claimant is also insured by the carrier. Caserotti v. State Farm Ins. Co., 791 S.W.2d 561, 566 (Tex. Ct. App. 1990). Unless the insured assigns her bad faith claim to the third party, and assuming no "direct action" statute, the third-party plaintiff cannot bring a direct action against the insurer for the excess judgment. In some states, the third party typically garnishes the insurer.

[33] Those states apparently recognizing third-party insurance bad faith as a tort and supporting cases from which the proposition flows include: *Alabama*: Turner Ins. Agency v. Continental Cas. Ins. Co., 541 So. 2d 471, 472 (Ala. 1989); *Alaska*: Alaska Pac. Assur. Co. v. Collins, 794 P.2d 936, 947 (Alaska 1990); *Arizona*: Rawlings v. Apodaca, 726 P.2d 565, 571-72 (Ariz. 1986); *Arkansas*: Employees Equitable Life Ins. Co. v. Williams, 665 S.W.2d 873, 874 (Ark. 1984); *California*: Crisci v. Security Ins. Co., 58 Cal. Rptr. 13, 16-17 (Cal. 1967); *Colorado*: Flickinger v. Ninth Dist. Prod. Credit Ass'n, 824 P.2d 19, 24 (Colo. Ct. App. 1991); *Connecticut*: Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co., 375 A.2d 428, 429-30 (Conn. Super. Ct. 1977); *Delaware*: McNally v. Nationwide Ins. Co., 815 F.2d 254, 259 (3d Cir. 1987); *Florida*: Boston Old Colony Ins. Co. v. Gutierrez, 386 So. 2d 783, 785 (Fla. 1980); *Georgia*: Southern Gen. Ins. Co. v. Holt, 416 S.E.2d 274, 276 (Ga. 1992); *Idaho*: White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1016 (Idaho 1986); *Illinois*: Salvator v. Admiral Merchants Motor Freight, 509 N.E.2d 1349, 1357-58 (Ill. App. Ct. 1987), *appeal denied*, 515 N.E.2d 126 (Ill. 1987); *Indiana*: Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 518-19 (Ind. 1993); *Iowa*: North Iowa State Bank v. Allied Mut. Ins. Co., 471 N.W.2d 824, 828-29 (Iowa 1991); *Kentucky*: Curry v. Fireman's Fund Ins. Co., 784 S.W.2d 176, 178 (Ky. 1989); *Louisiana*: Cousins v. State Farm Mut. Auto. Ins. Co., 294 So. 2d 272, 275 (La. Ct. App. 1974), *writ refused*, 296 So. 2d 837 (La. 1974); *Maryland*: Johnson v.

Federal Kemper Ins. Co., 536 A.2d 1211, 1213 (Md. Ct. Spec. App. 1988), *cert. denied*, 542 A.2d 844 (Md. 1988); *Massachusetts*: Peckham v. Continental Cas. Ins. Co., 895 F.2d 830, 834-35 (1st Cir. 1990); *Michigan*: Commercial Union Ins. Co. v. Liberty Mut. Ins. Co., 393 N.W.2d 161, 164-66 (Mich. 1986); *Minnesota*: Short v. Dairyland Ins. Co., 334 N.W.2d 384, 387-88 (Minn. 1983); *Mississippi*: Burley v. Homeowners Warranty Corp., 773 F. Supp. 844, 859-60 (S.D. Miss. 1990), *aff'd*, 936 F.2d 569 (5th Cir. 1991); *Missouri*: Heartland Stores, Inc. v. Royal Ins. Co., 815 S.W.2d 39, 40-41 (Mo. Ct. App. 1991); *Montana*: Gibson v. Western Fire Ins. Co., 682 P.2d 725, 730 (Mont. 1984); *Nebraska*: Braesch v. Union Ins. Co., 464 N.W.2d 769, 772 (Neb. 1991); *New Hampshire*: Gelinas v. Metropolitan Prop. & Liab. Ins. Co., 551 A.2d 962, 966 (N.H. 1988); *New Jersey*: Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford, 72 N.J. 63, 68-79, 367 A.2d 864, 866-72 (1976); *New Mexico*: Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co., 690 P.2d 1022, 1024-25 (N.M. 1984); *New York*: Roldan v. Allstate Ins. Co., 544 N.Y.S.2d 359, 361 (App. Div. 1989); *North Carolina*: Wilson v. State Farm Mut. Auto. Ins. Co., 394 S.E.2d 807, 811 (N.C. Ct. App. 1990), *aff'd in part, rev'd in part*, 404 S.E.2d 852 (N.C. 1991); *North Dakota*: Smith v. American Family Mut. Ins. Co., 294 N.W.2d 751, 755-60 (N.D. 1980); *Ohio*: Motorists Mut. Ins. Co. v. Said, 590 N.E.2d 1228, 1232 (Ohio 1992); *Oklahoma*: Townsend v. State Farm Mut. Auto. Ins. Co., 860 P.2d 236, 237-38 (Okla. 1993); *Oregon*: Maine Bonding & Cas. Co. v. Centennial Ins. Co., 693 P.2d 1296, 1299 (Or. 1985); *Rhode Island*: Calenda v. Allstate Ins. Co., 518 A.2d 624, 628-29 (R.I. 1986); *South Carolina*: Nichols v. State Farm Mut. Auto. Ins. Co., 306 S.E.2d 616, 618-19 (S.C. 1983); *South Dakota*: Kansas Bankers Sur. Co. v. Lynass, 920 F.2d 546, 548 (8th Cir. 1990); *Tennessee*: State Auto. Ins. Co. v. Rowland, 427 S.W.2d 30, 33 (Tenn. 1968); *Texas*: Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987); *Utah*: Ammerman v. Farmers Ins. Exch., 430 P.2d 576, 578-79 (Utah 1967); *Vermont*: Brunet v. American Ins. Co., 660 F. Supp. 843, 845-46 (D. Vt. 1987); *Virginia*: Aetna Cas. & Sur. Co. v. Price, 146 S.E.2d 220, 228 (Va. 1966); *Washington*: Tank v. State Farm Fire & Cas. Co., 715 P.2d 1133, 1136-37 (Wash. 1986); *West Virginia*: Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990); *Wisconsin*: Professional Office Bldgs., Inc. v. Royal Indem. Co., 427 N.W.2d 427, 432-33 (Wis. Ct. App. 1988), *review denied*, 436 N.W.2d 30 (Wis. 1988); *Wyoming*: Darlow v. Farmers Ins. Exch., 822 P.2d 820, 825 (Wyo. 1991). Puerto Rico apparently recognized third-party bad faith in 1993, although the standard is unclear. *See* Event Producers, Inc. v. Tyser & Co., 854 F. Supp. 35, 38-39 (D.P.R. 1993).

While third-party bad faith is widely recognized as an independent tort, its acceptance has not been universal. In Kansas, an insurer's failure to defend or settle a third-party claim amounts to a breach of contract, and is not an independent tort. Glenn v. Fleming, 799 P.2d 79, 90 (Kan. 1990). Kansas courts merely use tort expressions to describe the substance of a contract duty. *Id.* Hawaii and the District of Columbia do not recognize bad faith in either the third-party or first-party context. Genovia v. Jackson Nat'l Life Ins. Co., 795 F. Supp. 1036, 1045-46 (D. Haw. 1992); Washington v. Government Employees Ins. Co., 769 F. Supp. 383, 386-87 (D.D.C. 1991). Maine does not recognize either third-party or first-party bad faith, instead allowing expanded general and consequential damages for an insurer's breach of its contractual obligations. *See* Marquis v. Farm Family Mut. Ins. Co., 628 A.2d 644, 652 (Me. 1993). Maine also employs an unfair claims practices statute. *Id.* Nevada has yet to adopt third-party bad faith; however, based on Nevada courts' holdings in other contexts, it seems likely that it will when presented the opportunity. *See* Pemberton v. Farmers Ins. Exch., 858 P.2d 380, 382-83 (Nev. 1993) (recognizing first-party bad faith); Nevada Ins. Guar. Ass'n v. Sierra Auto Ctr., 844 P.2d 126, 127-29 (Nev. 1992) (no third-party bad faith because no privity of contract). Pennsylvania has no common law bad faith; Pennsylvania's cause of action is statutorily created. *See* Eastern Stainless Corp. v. American Protection Ins. Co., 829 F. Supp. 797, 801-803 (D. Md. 1993) (interpreting 42 PA. CONS. STAT. ANN. § 8371 (1994)).

A. *The Duty to Defend.*

Liability insurers owe their insureds a duty of defense and a duty of indemnity.[34] An insurer's breach of either duty can lead to a bad faith claim. A liability insurer's duty to defend is much broader than its duty to indemnify.[35] Insurers owe their insureds a defense if the allegations of the subject lawsuit are even potentially within the scope of the policy.[36] Generally, whether a defense is owed may be determined by reviewing the petition or complaint.[37] If just one of several pleaded theories potentially triggers coverage the insurer must defend the entire suit, even if the policy specifi-

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[34] Liability policies promise that the insurer will defend any suit against an insured alleging damage within the scope of the policy "even if such suit is groundless, false or fraudulent." With respect to indemnity, a standard liability insurance policy provides that the insurer will pay all sums that the insured becomes legally obligated to pay as damages for injury to a third party caused by an "accident" or "occurrence," up to policy limits.

[35] *See* Reynolds v. Select Props., Ltd., 634 So. 2d 1180, 1185-86 (La. 1994); City of Maple Lake v. American States Ins. Co., 509 N.W.2d 399, 403 (Minn. Ct. App. 1993); Horace Mann Ins. Co. v. Barbara B., 846 P.2d 792, 795 (Cal. 1993); Universal Underwriters Ins. Co. v. Stokes Chevrolet, Inc., 990 F.2d 598, 605 (11th Cir. 1993) (Alabama law); Brenner v. Lawyers Title Ins. Corp., 397 S.E.2d 100, 102 (Va. 1992); Commerce & Indus. Ins. Co. v. Bank of Hawaii, 832 P.2d 733, 735 (Haw. 1992), *reconsideration denied*, 834 P.2d 1315 (1992); Elliott v. Donahue, 485 N.W.2d 403, 407 (Wis. 1992); Hecla Mining Co. v. New Hampshire Ins. Co., 811 P.2d 1083, 1089 (Colo. 1991); State Mut. Ins. Co. v. Bragg, 589 A.2d 35, 36 (Me. 1991).

[36] ARTRA Group, Inc. v. American Motorists Ins. Co., 642 A.2d 896, 903 (Md. Ct. Spec. App. 1994); Britamco Underwriters, Inc. v. Grzeskiewicz, 639 A.2d 1208, 1210 (Pa. Super. Ct. 1994); Save Mart Supermarkets v. Underwriters at Lloyd's London, 843 F. Supp. 597, 602 (N.D. Cal. 1994) (California law); Harleysville Mut. Ins. Co. v. Sussex County, 831 F. Supp. 1111, 1130 (D. Del. 1993) (applying New Jersey law); Enserch Corp. v. Shand Morahan & Co., Inc., 952 F.2d 1485, 1492 (5th Cir. 1992) (Texas law); James Graham Brown Found., Inc. v. St. Paul Fire & Marine Ins. Co., 814 S.W.2d 273, 279 (Ky. 1991); Mutual Serv. Cas. Ins. Co. v. Luetmer, 474 N.W.2d 365, 368 (Minn. Ct. App. 1991); Kootenai County v. Western Cas. & Sur. Co., 750 P.2d 87, 89 (Idaho 1988); *see, e.g.*, Granite State Ins. Co. v. Bottoms, 415 S.E.2d 131, 134 (Va. 1992).

[37] *See* Green Mountain Ins. Co. v. Foreman, 641 A.2d 230, 232 (N.H. 1994); Hames Contracting, Inc. v. Georgia Ins. Co., 440 S.E.2d 738, 739 (Ga. Ct. App. 1994); Hart Constr. Co. v. American Family Mut. Ins. Co., 514 N.W.2d 384, 389 (N.D. 1994); Lopez v. New Mexico Pub. Sch. Ins. Auth., 870 P.2d 745, 747 (N.M. 1994); Monter v. CNA Ins. Cos., 608 N.Y.S.2d 692, 693 (App. Div. 1994); Travelers Indem. Co. v. Holloway, 17 F.3d 113, 115 (5th Cir. 1994) (Texas law); Ajdarodini v. State Auto Mut. Ins. Co., 628 So. 2d 312, 313 (Ala. 1993); Apcon Corp. v. Dana Trucking, Inc., 623 N.E.2d 806, 809 (Ill. App. Ct. 1993), *appeal denied*, 631 N.E.2d 705 (Ill. 1994); Ducote v. Cliffs Drilling Co., 624 So. 2d 960, 961 (La. Ct. App. 1993); First Wyoming Bank, N.A. v. Continental Ins. Co., 860 P.2d 1094, 1097 (Wyo. 1993); Jefferson-Pilot Fire & Cas. Co. v. Sunbelt Beer Distrib., Inc., 839 F. Supp. 376, 378 (D.S.C. 1993); Lime Tree Village Community Club Ass'n, Inc. v. State Farm Gen. Ins. Co., 980 F.2d 1402, 1405 (11th Cir. 1993) (applying Florida law); Professional Office Bldgs., Inc. v. Royal Indem. Co., 427 N.W.2d 427, 430 (Wis. Ct. App. 1988), *review denied*, 436 N.W.2d 30 (Wis. 1988).

cally excludes other alleged bases for recovery.[38] In some jurisdictions, the insurer must look beyond the pleadings to determine whether it owes its insured a defense.[39]

An insurance company's wrongful refusal to defend its insured is a breach of contract.[40] When an insurer breaches its contract (*i.e.*, the policy) by refusing to defend a covered claim, the policyholder must be put in the position he would have occupied had there been no breach.[41] This is fundamental contract law. Damages for a simple contract breach of the duty to defend include: (1) the defense costs incurred in the underlying action, among them attorneys' fees; (2) the amount of the judgment entered against the insured, up to the limits of coverage, plus interest; and (3) any other costs naturally resulting from the breach.[42] If costs and judgment amounts can be allocated between covered causes of action and those that the insurer had no duty to defend, they will be; if not, the insurer is entirely liable.[43] Absent bad faith, an insurer's liability for any judgment or settlement in the underlying action is capped by its policy limits.[44]

But what of the insurer-insured relationship existing independent of the policy? An insurer that assumes its insured's defense against a third-party claim is often considered to share a

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38 Curtis Universal, Inc. v. Sheboygan Emergency Medical Serv., Inc., 844 F. Supp. 492, 496 (E.D. Wis. 1994) (Wisconsin law); Ledford v. Gutoski, 887 P.2d 80, 83 (Or. 1994); Fidelity & Cas. Co. of N.Y. v. Mobay Chem. Corp., 625 N.E.2d 151, 155 (Ill. App. Ct. 1993), *appeal denied*, 624 N.E.2d 806 (Ill. 1993); Voorhees v. Preferred Mut. Ins. Co., 607 A.2d 1255, 1259 (N.J. 1992); Gregory v. Tennessee Gas Pipeline Co., 948 F.2d 203, 205 (5th Cir. 1991) (Louisiana law); Overthrust Constructors, Inc. v. Home Ins. Co., 676 F. Supp. 1086, 1091 (D. Utah 1987) (applying Utah law).

39 Spivey v. Safeco Ins. Co., 865 P.2d 182, 188 (Kan. 1993) ("[A]n insurer must look beyond the effect of the pleadings and must consider any facts brought to its attention or any facts which it could reasonably discover in determining whether it has a duty to defend."); *see also* American Motorists Ins. Co. v. Allied-Sysco Food Servs., Inc., 24 Cal. Rptr. 2d 106, 112 (Ct. App. 1993) (existence of potential liability is determined from all facts learned by the insurer, including those from extrinsic sources); Garvis v. Employers Mut. Cas. Co., 497 N.W.2d 254, 258 (Minn. 1993) (facts outside complaint may obligate insurer to accept tender of defense, or further investigate potential claim); SL Indus., Inc. v. American Motorists Mut. Ins. Co., 607 A.2d 1266, 1272 (N.J. 1992) (facts outside complaint may give rise to duty to defend if known to insurer); Aetna Cas. & Sur. Co. v. Dannenfeldt, 778 F. Supp. 484, 499 (D. Ariz. 1991); Fitzpatrick v. American Honda Motor Co., 575 N.E.2d 90, 93 (N.Y. 1991); Patron's Mut. Ins. Ass'n v. Harmon, 732 P.2d 741, 744 (Kan. 1987).

40 Newhouse v. Citizens Sec. Mut. Ins. Co., 501 N.W.2d 1, 6 (Wis. 1993); Greer v. Northwestern Nat'l Ins. Co., 743 P.2d 1244, 1247 (Wash. 1987).

41 *Greer*, 743 P.2d at 1250.

42 *Id; see also Newhouse*, 501 N.W.2d at 6.

43 William F. Cronin & Colleen A. Christensen, *Litigating the Duty to Defend: The Policyholder's Perspective*, 28 GONZAGA L. REV. 641, 649 (1992-93).

44 *Id.* at 648.

fiduciary relationship with its insured.[45] The insured surrenders control of the defense and places her potential monetary liability in the insurer's hands. With that kind of relationship comes "a standard of care that exists independent of the contract and without reference to the specific terms of the contract."[46] While indemnity might initially seem to be an insured's highest priority, that is not necessarily true. An insured's desire to secure a defense of third party claims is probably as significant a motive for the purchase of liability insurance as is the need for potential indemnity.[47] An insurer that in bad faith declines to defend its insured is therefore appropriately liable in tort for its refusal. Such liability is unlimited by the policy; with bad faith come extracontractual remedies, including excess liability and punitive damages.

Logic would appear to dictate that, in order for an insurer to actually breach its duty to defend, a claim must fall within coverage.[48] While the duty to defend and the duty to indemnify are separate and distinct,[49] they are not unrelated. In their zeal to aid

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45 Stetler v. Fosha, 809 F. Supp. 1409, 1422 (D. Kan. 1992), *aff'd*, 7 F.3d 1045 (10th Cir. 1993); Village of Morrisville Water & Light Dept. v. United States Fidelity & Guar. Co., 775 F. Supp. 718, 734 (D. Vt. 1991); Jones v. Continental Ins. Co., 716 F. Supp. 1456, 1459 n.5 (S.D. Fla. 1989), *vacated on other grounds*, 956 F.2d 1052 (11th Cir. 1992); Illinois Masonic Medical Ctr. v. Turegum Ins. Co., 522 N.E.2d 611, 613 (Ill. App. Ct. 1988); Pareti v. Sentry Indem. Co., 536 So. 2d 417, 423 (La. 1988); Gibson v. Western Fire Ins. Co., 682 P.2d 725, 730 (Mont. 1984); Fireman's Fund Ins. Co. v. Security Ins. Co. of Hartford, 367 A.2d 864, 866, 72 N.J. 63, 68 (1976); *see also* Motorists Mut. Ins. Co. v. Said, 591 N.E.2d 1228, 1235 (Ohio 1992) (insurer's duty is "analogous to that of a fiduciary"). *But see* Corrado Bros., Inc. v. Twin City Fire Ins. Co., 562 A.2d 1188, 1192 (Del. 1989) (insurer-insured relationship is not fiduciary); Crossley v. Allstate Ins. Co., 400 N.W.2d 625, 627 (Mich. Ct. App. 1986); Henry v. Associated Indem. Corp., 266 Cal. Rptr. 578, 586-87 (Ct. App. 1990) (while insurer-insured relationship is akin to a fiduciary relationship, insurer has no duty to disregard its own interests when they conflict with the insured's).

46 Georgetown Realty, Inc. v. Home Ins. Co., 831 P.2d 7, 14 (Or. 1992).

47 *See* Montrose Chem. Corp. v. Superior Court, 861 P.2d 1153, 1157 (Cal. 1993).

48 *See* Carstensen v. Chrisland Corp., 442 S.E.2d 660, 666 (Va. 1994); Allied Mut. Ins. Co. v. State Farm Mut. Auto. Ins. Co., 502 N.W.2d 484, 487 (Neb. 1993); Allstate Ins. Co. v. Russo, 829 F. Supp. 24, 26 (D.R.I. 1993); City of Bozeman v. AIU Ins. Co., 865 P.2d 268, 271-73 (Mont. 1993); Johnson v. Studyvin, 839 F. Supp. 1490, 1496 (D. Kan. 1993) ("The determination of whether there is a duty to defend ultimately depends upon whether coverage exists under an insurance policy."); Standard Fire Ins. Co. v. Peoples Church of Fresno, 985 F.2d 446, 450 (9th Cir. 1993) (applying California law); Becker Metals Corp. v. Transportation Ins. Co., 802 F. Supp. 235, 240 (E.D. Mo. 1992) ("Although the duty to defend is broader than the duty to indemnify, there is no duty to defend . . . if the claim is not within the coverage of the policy."); Garneau v. Curtis & Bedell, Inc., 610 A.2d 132, 134 (Vt. 1992) (no duty to defend where as a matter of law there is no duty to indemnify).

49 Britamco Underwriters, Inc. v. Weiner, 636 A.2d 649, 651 (Pa. Super. Ct. 1994); Weyerhauser Co. v. Aetna Cas. & Sur. Co., 874 P.2d 142, 148 (Wash. 1994); Nationwide Mut. Ins. Co. v. Tate, 438 S.E.2d 266, 268 (S.C. Ct. App. 1993); Federal Ins. Co. v.

insureds who they believe to be victims of insurer misconduct, however, courts sometimes reason their way around this basic principle. The Supreme Court of Washington demonstrated such protective judicial zeal in *Safeco Insurance Co. of America v. Butler*.[50]

In *Butler*, Safeco's insured, Hap Butler (Butler), shot a motorist who he believed vandalized his mailbox. Butler claimed that he did not intend to hurt anyone and that he intentionally aimed at the victim's vehicle. Anticipating a civil suit, Safeco engaged counsel although it was unclear whether the attorney represented the carrier or was hired to defend Butler.[51] Safeco directed the attorney to take no action with respect to the potential civil suit because it first wanted to determine whether there was coverage. The shooting victim, Eddie Zenker (Zenker), ultimately filed suit. Butler promptly tendered the matter to Safeco which, two months later, filed a declaratory judgment action. Two weeks later, Safeco notified Butler that it would defend he and his wife under a reservation of rights.[52] Safeco eventually denied coverage because Zenker's injuries were not the result of an "accident" within the policy's meaning, and based on the policy's intentional acts exclusion.[53]

Thereafter, the Butlers and Zenker stipulated to damages in the amount of $3,000,000. The trial court entered judgment in the stipulated amount. The Butlers then assigned their rights in any bad faith claim to Zenker. The declaratory judgment action proceeded. The trial court granted Safeco's summary judgment motions on coverage, holding that Zenker's injuries were not covered by the Butlers' policy and Safeco was not estopped from litigating coverage.[54] The trial court denied Safeco's motion for summary judgment on the Butlers' bad faith counterclaim.

On appeal, the Butlers argued that Safeco's bad faith was evidenced by a number of acts or decisions:

> (1) Safeco decided to defend under a reservation of rights over two months prior to notifying the Butlers of its intent to do so; (2) Safeco delayed the Butlers' attorney's investigation; (3) Safeco used that delay to enhance its position on the coverage issue; (4) Safeco did not conduct a timely and thorough investi-

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Century Fed. Sav. & Loan Ass'n, 824 P.2d 302, 309 (N.M. 1992); *see* Reisen v. Aetna Life & Cas. Co., 302 S.E.2d 529, 533 (Va. 1983).

50 823 P.2d 499 (Wash. 1992).

51 *See id.* at 502.

52 *Id.*

53 *Id.*

54 *Id.*

> gation; (5) due to Safeco's delay evidence was lost that would have been useful to the Butlers in the coverage suit; (6) Safeco attempted to use the Butlers' attorney to obtain statements for use in the coverage action; (7) at the regional level, Safeco commingled information from the tort defense and coverage action files; and (8) Safeco exhibited greater concern for its financial risk than for the Butlers' interests.[55]

Safeco countered that none of the alleged wrongful acts were done in bad faith and none prejudiced the Butlers.

The *Butler* court first opted to presume harm to insureds in situations (such as the one before it) in which a *prima facie* bad faith case is established. Imposing a rebuttable presumption of prejudice relieved the insured of the difficult burden of proving his damages. This, the court thought, was consistent with the fiduciary aspects of the insurer-insured relationship.[56] The court next observed that an insurer's duty to defend is one of the main benefits conferred by an insurance policy.[57] An insurer who accepts the duty pursuant to a reservation of rights is no less liable than an insurer who accepts but then later rejects the duty; in either circumstance the duty is equally breached.[58] Were an insurer allowed to protect itself from bad faith claims simply by reserving its rights, the duty of good faith would be rendered meaningless.[59] The *Butler* court thus held that "where an insurer acts in bad faith in handling a claim under a reservation of rights, the insurer is estopped from denying coverage."[60]

Butler is not the only case signalling insurers' potential liability for inappropriately handling uncovered claims, although the others involved first-party claims. In *Viles v. Security National Insurance Co.*,[61] the Texas Supreme Court allowed homeowners to prosecute a bad faith action even though they did not comply with policy requirements. The *Viles* court allowed the action to proceed because the insurer's duty of good faith was independent of the policy and should not be contractually limited.[62] In *First Texas Savings Ass'n v. Reliance Insurance Co.*, [63] the Fifth Circuit Court of Appeals followed *Viles* and reasoned that a Texas unfair insurance practices

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55 *Id.* at 506.
56 *Id.* at 504.
57 *Id.*
58 *Id.* at 504-505.
59 *Id.* at 505.
60 *Id.*
61 788 S.W.2d 566 (Tex. 1990).
62 *See id.* at 566-68.
63 950 F.2d 1171 (5th Cir. 1992).

statute provided a cause of action even though the plaintiff's losses were not covered by the subject bond. As in *Viles*, the *First Texas* court was persuaded that the insurer's statutory duty of good faith was independent of any contractual obligations and was thus unaffected by coverage.[64]

Insurers may assume a duty to defend even where there is no actual coverage. One of the *Lloyd v. State Farm Mutual Automobile Insurance Co.*[65] plaintiffs called his insurer's claims office when he was served with an application of default in a significant personal injury action which he and his wife had neither answered nor tendered to State Farm. Someone at the claims office told the plaintiff that State Farm "would 'take care of it[,]'" which he thought meant the company would assume the defense and address the pending default.[66] He thus did nothing more. Default judgment was entered before State Farm hired defense counsel and began their insureds' defense under a reservation of rights. Four months later State Farm declined to settle the third-party action for $50,000 (policy limits) and denied coverage, leaving its insured exposed to a $10,000,000 default judgment.[67]

The plaintiffs conceded that their policy did not cover the underlying accident, but asserted that the insurer assumed a duty to defend them when the unknown claims representative said State Farm "would take care of it" and State Farm then hired defense counsel.[68] State Farm asserted that it could not be liable for assuming a duty of defense in the absence of a policy covering the accident.[69] The *Lloyd* court sided with the insureds. The court saw no reason to exempt insurers from the established principle "Justice Cardozo once called the universal and 'ancient learning that one who assumes to act, even though gratuitously, may thereby become subject to the duty of acting carefully . . . .'"[70]

Lloyd, while expanding insurers' potential bad faith liability for breaching their duty to defend, is not so disturbing as *Butler, Viles* and *First Texas*. The Supreme Court of Washington essentially created a new form of strict liability in *Butler* by presuming an insured's harm in bad faith cases, even when the cause of action is

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64 *Id.* at 1178-79.

65 860 P.2d 1300 (Ariz. Ct. App. 1992).

66 *Id.* at 1301.

67 *Id.* at 1302.

68 *Id.* at 1303.

69 *Id.*

70 *Id.* at 1304 (quoting Glanzer v. Shepard, 233 N.Y. 236, 239, 135 N.E. 275, 276 (1922)).

assigned to a third party and the insured escapes all liability by way of stipulation.[71] The *Viles* and *First Texas* courts simply ignored the contractual aspect of bad faith. The *Lloyd* court at least remained tethered to the basic principle that the duty to defend is imposed by agreement—not by operation of law.[72]

B. The Duty to Indemnify and the Duty to Settle.

The most commonly encountered third-party bad faith scenario is an insurer's failure or refusal to settle a claim within policy limits. This situation is easily understood by way of example: While driving home one day, Andrea collides with a car driven by Bob. Andrea has an automobile liability insurance policy with Enormous Mutual Insurance Co., with a limit of $100,000. Bob sues Andrea for his personal injuries, alleging her negligence and claiming damages of $250,000. Andrea tenders the suit to Enormous, which hires defense counsel and assumes control of the litigation, as is its right and duty under Andrea's policy. After discovery closes but before trial, Bob offers to settle for $100,000. Bob's injuries are legitimate. Andrea's interests and those of her insurer now diverge. From Enormous Mutual's perspective, it has nothing to lose by rejecting Bob's demand because, under the terms of its policy, its potential liability is capped at $100,000 even if Bob recovers his claimed damages of $250,000. On the other hand, if Enormous gambles by trying the case, a jury might return a favorable verdict, saving it as much as $100,000. From Andrea's perspective, however, settlement spares her potential financial ruin. If her insurer's gamble fails and Bob receives a large verdict, Andrea will be liable for any judgment exceeding her $100,000 policy limits. Enormous Mutual is essentially gambling with Andrea's money.[73]

An insurer's refusal to settle a case within policy limits is a breach of its duty to indemnify, not its duty to defend. In fact, since an insurer's duty to indemnify does not truly become an issue until the insured incurs liability for the underlying claim,[74] it may

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[71] *See* Safeco Ins. Co. of Am. v. Butler, 823 P.2d 499, 503-04 (Wash. 1992). This point is particularly well made in Justice Dolliver's dissent in *Butler*. *See id.* at 512-13 (Dolliver, J., dissenting).

[72] Overbaugh v. Strange, 853 P.2d 80, 82 (Kan. Ct. App. 1993), *modified and aff'd*, 867 P.2d 1016 (Kan. 1994); Wheelways Ins. Co. v. Hodges, 872 S.W.2d 776, 786 (Tex. Ct. App. 1994).

[73] *See* JERRY, *supra* note 31, at 595.

[74] *See* Outboard Marine Corp. v. Liberty Mut. Ins. Co., 607 N.E.2d 1204, 1221 (Ill. 1992).

be fairly said that a liability insurer has a separate "duty to settle" claims.[75] In order to breach its duty to indemnify or duty to settle, an insurer must be presented a settlement demand within its policy limits. Where there is no settlement demand, there can be no breach.[76] Similarly, where the demand exceeds policy limits the insurer cannot be held liable for refusing to settle.[77] Moreover, an insurer is not required to settle a claim within policy limits under penalty of absolute liability for any excess judgment rendered against the insured.[78] Insurance companies are not charities. There are certainly many cases in which a vigorous defense is preferable to a proposed settlement. In other situations settlement negotiations may break down through no fault of the insurer. In order for an insurer to be held liable for extracontractual damages, its refusal to settle must be arbitrary or made in bad faith.

An illustrative case is *Ganaway v. Shelter Mutual Insurance Co.* .[79] In *Ganaway,* a 20 year-old passenger in the insured's automobile was rendered a quadriplegic in a November, 1981 accident. There was no doubt that the insured, Scott, was at fault. The plaintiff hired an attorney, who wrote Shelter indicating his desire to negotiate an expedient and amicable resolution of his client's claim.[80] Thereafter, the attorney demanded that Shelter pay its bodily injury limits of $50,000. Shelter declined, offering $45,000 instead. Shelter reasoned that it was entitled to a $5,000 offset for the "med pay" portion of its coverage. For more than a year, the plaintiff's attorneys and the claims representative exchanged numerous letters and telephone calls, with the plaintiff's attorneys outlining in detail why Shelter was not entitled to an offset.[81]

In January, 1984, the plaintiff filed suit against Scott and others. In December, 1986, the plaintiff was awarded a $4,050,000

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75 *See* American Physicians Ins. Exch. v. Garcia, 876 S.W.2d 842, 848 (Tex. 1994); Continental Cas. Co. v. Kinsey, 513 N.W.2d 66, 69 (N.D. 1994); Jordan v. United States Fidelity & Guar. Co., 843 F. Supp. 164, 171 (S.D. Miss. 1993).

76 State Farm Fire & Cas. Co. v. Metcalf, 861 S.W.2d 751, 756 (Mo. Ct. App. 1993); Snodgrass v. State Farm Mut. Auto. Ins. Co., 804 P.2d 1012, 1022 (Kan. Ct. App. 1991).

77 McLaughlin v. National Union Fire Ins. Co., 26 Cal. Rptr. 2d 520, 525 (Ct. App. 1993).

78 *See* Allstate Is. Co. v. Campbell, 639 A.2d 652, 659 (Md. 1994); Southern Am. Ins. Co. v. Hartford Accident & Indem. Co., 498 So. 2d 280, 282 (La. Ct. App. 1986), *writ denied,* 500 So. 2d 425 (La. 1987); Van Vleck v. Ohio Cas. Ins. Co., 471 N.E.2d 925, 927 (Ill. App. Ct. 1984) (quoting LaRotunda v. Royal Globe Ins. Co., 408 N.E.2d 928, 935-36 (Ill. App. Ct. 1980)).

79 795 S.W.2d 554 (Mo. Ct. App. 1990).

80 *See id.* at 558.

81 *Id.* at 558-59.

judgment against Scott. In February, 1987, Shelter remitted the limit of its liability coverage plus interest on the judgment. Later, the plaintiff received the $5,000 medical payment from Shelter.[82] After the plaintiff obtained his judgment against Scott, an involuntary bankruptcy petition was filed requesting that Scott be declared bankrupt. The trustee in bankruptcy assigned Scott's bad faith claim to the plaintiff.[83] Shelter was left exposed to liability approaching $4,000,000, not including punitive damages.

Ganaway demonstrates an insurer's arbitrary and reckless conduct. Shelter knew that the plaintiff's injuries were grievous and that its insured's liability was certain. Scott would almost certainly be bankrupted by any judgment for the plaintiff. The plaintiff's attorneys repeatedly communicated well-reasoned demands to Shelter, outlining their client's entitlement to medical payment under the policy. Nonetheless, Shelter refused to part with an additional $5,000.

1. The Insured Objects to Settlement.

A liability insurer is obligated to inform its insured of settlement offers, and to keep its insured advised about case developments, strategy and the insured's exposure. It is not uncommon for an insured to assume an active role in the defense. Many corporate insureds employ in-house counsel, regular outside counsel, or sophisticated risk managers. Corporate insureds frequently have large deductibles, self-insured retentions (SIR's) or retrospective premiums, giving them a significant financial stake in any litigation. Professionals, such as physicians, are sensitive to their reputations and the effect of litigation on their practices, and thus demand involvement in their defense. Even individual insureds may have the legal wherewithal to influence defense strategy or settlement negotiations.

An insured's and an insurer's defense positions may conflict in connection with proposed settlements, which an insured may view as a reputational injury or an admission of wrongdoing, or which may consume the insured's SIR or deductible. On the other hand, insurers view settlements from a simple cost-benefit perspective. As a rule, and assuming its reasonable conduct, an insurer does not act in bad faith when it settles a case within policy limits over the

82 *Id.* at 560.

83 *Id.*

insured's objections.[84] This is true even if the insured's deductible or SIR funds the settlement, or the settlement increases the insured's retrospective premium.[85] The standard policy language granting the insurer the right to settle as it deems expedient trumps the insured's financial interest.[86]

There may be an exception to this rule appearing in the form of professional liability insurance policies. An insurer's settlement of a professional malpractice claim within policy limits against the professional's wishes may amount to bad faith.[87] This possible exception stems from the perceived reputational injury to the insured professional. Of course, an insured professional who insists on litigation to "clear his name" waives his right to indemnity beyond the amount of any proposed settlement, and he should be required to bear all related defense costs. Likewise, the malpractice insurer cannot be held liable for any excess judgment.[88]

An insured's direction to try a case after being fully informed about the risks involved erects a nearly insurmountable barrier to a later bad faith claim.[89] *Eklund v. Safeco Insurance Co. of America*[90] arose out of an automobile accident involving David Laurita, a minor. The Laurita family staunchly opposed any settlement notwith-

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84 *See, e.g., In re* Allstate Ins. Co., 722 S.W.2d 947, 951-52 (Mo. 1987) (en banc); Marginian v. Allstate Ins. Co., 481 N.E.2d 600, 603 (Ohio 1985).

85 *See, e.g.*, Nationwide Mut. Ins. Co. v. Public Serv. Co. of N.C., Inc., 435 S.E.2d 561, 563-65 (N.C. Ct. App. 1993); American Home Assur. Co. v. Hermann's Warehouse Corp., 117 N.J. 1, 3-8, 563 A.2d 444, 445-48 (1989); Corrado Bros., Inc. v. Twin City Fire Ins. Co., 562 A.2d 1188 (Del. 1989) (retrospective premium).

86 *American Home*, 563 A.2d at 448; *Nationwide*, 435 S.E.2d at 564-65. *But see* St. Paul Fire & Marine Ins. Co. v. Edge Memorial Hosp., 584 So. 2d 1316, 1327 (Ala. 1991) (holding that if an insured must ultimately pay a settlement as part of a deductible, the insured must consent to settlement).

87 In Rogers v. Robson, Masters, Ryan, Brummond and Belom, 407 N.E.2d 47, 48 (Ill. 1980), the Illinois Supreme Court allowed a doctor to proceed with a legal malpractice claim against an insurance defense firm that settled a malpractice claim against the doctor within policy limits. The doctor had previously indicated that he did not want the case settled, even though his policy gave the insurer the right to settle without his consent. *See id.* The *Rogers* court did not reach the question of whether the plaintiff could state a bad faith claim or breach of contract claim against his insurer. *See id.* at 49. *Rogers* potentially opens the door for such claims, however, since with defense counsel's liability should come the insurer's liability. The negligent or willful conduct of insurance defense counsel is imputed to the insurer for bad faith purposes. *See* Pacific Employers Ins. Co. v. P.B. Hoidale Co., Inc., 789 F. Supp. 1117, 1122-23 (D. Kan. 1992).

88 *See* Shuster v. South Broward Hosp. Dist. Physicians Prof. Liab. Ins. Trust, 591 So. 2d 174, 177-78 n.3 (Fla. 1992).

89 *See* Puritan Ins. Co. v. Canadian Universal Ins. Co., Ltd., 775 F.2d 76, 80 (3d Cir. 1985).

90 579 P.2d 1185 (Colo. Ct. App. 1978).

standing the apparent threat of an excess judgment.[91] David's father informed Safeco that were the case settled, he would cancel all of the family's Safeco policies.[92] The case went to trial and the jury returned a verdict in excess of policy limits. David Laurita then filed for bankruptcy.

The trustee in bankruptcy sued Safeco for the excess judgment, alleging its negligence and bad faith in failing to settle.[93] The *Eklund* court made short work of the trustee's claims. The Lauritas' insistence that Safeco try the underlying case rather than settling it barred any bad faith claims.[94]

In summary, the fact that settlement was avoided at an insured's direction provides liability insurers with an affirmative defense to subsequent extracontractual claims. This rule makes sense. An insurer, under a duty to consult its insured with respect to settlement, should not be penalized for honoring the insured's wishes. Of course, the insured must understand the consequences of refusing to settle, and that decision must be knowingly and voluntarily made.

2. Special Problems Accompanying the Duty to Settle: Multiple Claims.

An insurer's duty to meet a reasonable settlement demand within its policy limits is straightforward. Unfortunately, an insurer is sometimes faced with multiple claims, each likely to outstrip the available coverage. In such a situation, the insurer's problems increase logarithmically.[95]

a. *Attempted Solutions to the Problem of Multiple Claims.*

Courts have developed several general rules or guidelines regarding the resolution of multiple claims exceeding policy limits. These include the "first to judgment" rule, the "pro rata" rule and the "first to settle" rule.

Of the various rules applied by courts, the first to judgment rule has received the least attention and the rarest judicial approval. The first to judgment rule holds that those claimants who first obtain judgments against the insured shall receive first priority

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91 *Id.* at 1186.
92 *Id.*
93 *Id.*
94 *Id.* at 1187.
95 *See* Peckham v. Continental Cas. Ins. Co., 895 F.2d 830, 835 (1st Cir. 1990).

in payment from insurance proceeds.[96] The vintage of the decisions applying this rule suggest its disfavor. As a practical matter, the widespread adoption of third-party bad faith and the length of time between filing and judgment common in modern litigation have combined to erase the first to judgment rule.

The pro rata rule is now the general rule.[97] Under the pro rata rule, if three claimants each have damages of $50,000, and the insured has policy limits of $100,000, each claimant would receive one-third of the available coverage, or $33,333. Pro rata distribution is essentially an equitable approach.

Most of the reported decisions involve the first to settle rule. In other words, the insurer has settled with some but not all claimants, and the settlements that have been concluded have either completely or nearly exhausted policy limits. The majority rule is that an insurer may in good faith settle some of the multiple claims with which it is presented even if those settlements work a preference for those claimants, or impair or foreclose the rights of other injured parties.[98]

> The insurer's goal should be to try to effect settlement of all or some of the multiple claims so as to relieve its insured of so much of his potential liability as is reasonably possible, considering the paucity of the policy limits . . . . So long as it acts in good faith, the insurer is not held to standards of omniscience or perfection; it has leeway to use, and should consistently employ, its honest business judgment.[99]

Exhaustion of an insurer's policy limits does not automatically subject it to excess liability.[100] Absent evidence that a given individual settlement is unreasonable, a court is unlikely to intervene.[101] Were the rule otherwise, an insurer would be forced to decline even the most favorable settlement opportunities and would instead be required to await the reduction of all claims to judgment.[102] Such a policy would often leave insureds with adjudicated

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96 *See, e.g.*, Ward Trucking Corp. v. Philadelphia Nat'l Ins. Co., 4 N.J. Super. 434, 438-41, 67 A.2d 480, 483-83 (App. Div. 1949); Lumbermens Mut. Cas. Co. v. Yeroyan, 5 A.2d 726 (N.H. 1939); Pisciotta v. Preston, 10 N.Y.S.2d 44, 45 (Misc. 1938).

97 *See* Allstate Ins. Co. v. Ostenson, 713 P.2d 733, 735 (Wash. 1986) (en banc); Christlieb v. Luten, 633 S.W.2d 139, 139-40 (Mo. Ct. App. 1982).

98 Allstate Ins. Co. v. Evans, 409 S.E.2d 273, 274 (Ga. Ct. App. 1991); *see, e.g.*, Babcock v. Liedigk, 497 N.W.2d 590, 593-94 (Mich. Ct. App. 1993).

99 *Peckham*, 895 F.2d at 835.

100 *See* McConnell v. St. Louis County, 655 S.W.2d 654, 658 (Mo. Ct. App. 1983) (en banc).

101 *See, e.g.*, Voccio v. Reliance Ins. Cos., 703 F.2d 1, 2-3 (1st Cir. 1983).

102 Walston v. Holloway, 416 S.E.2d 109, 110 (Ga. Ct. App. 1992).

liability well in excess of their policy limits.[103] Requiring the reduction of claims to judgment would also encourage and prolong litigation.[104]

b. *Bad Faith.*

Despite insurers' impressive track record in defending subsequent multi-claim bad faith actions, carriers have incurred extracontractual liability (1) where they failed to effect a global settlement; and (2) where they settled a single claim that dramatically depleted policy limits.

In *Farmers Insurance Exchange v. Schropp*,[105] the insurer was confronted with one large personal injury claim that alone exceeded its $50,000 policy limits and five other claims, each approximating $4,000 - $5,000.[106] Schropp was the worst-injured of the claimants and Farmers initially offered to pay his medical bills, as well as making at least one settlement overture. Farmers ultimately declined to settle with Schropp.[107] Farmers filed a declaratory judgment action asking that its obligations to the various potential plaintiffs (all of whom it named as defendants) be determined by the court. Farmers paid its $50,000 policy limits into court when it filed the declaratory judgment action.[108] Schropp counter-claimed, alleging Farmers' negligence and bad faith in the handling of his claim.[109] He ultimately received a verdict in excess of policy limits.

The Supreme Court of Kansas noted that the liability of Farmers' insured was clear and that all of the claimants were available for consultation.[110] Even so, no settlement offers were actually made. The court outlined the alternatives available to Farmers:

> Under the circumstances, Farmers could well have notified all of the potential claimants involved that the value of the claims would doubtless exceed policy limits, and invite them or their attorneys to participate jointly in efforts to reach agreement as to the disposition of the available funds. Alternatively, Farmers could have attempted to settle claims within the policy limits as they were presented. Or as a third alternative, Farmers could have promptly and in good faith commenced an interpleader action, and paid its policy limits into court . . . . *The first of these*

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103 *Id.*
104 *See id.*
105 567 P.2d 1359 (Kan. 1977).
106 *Id.* at 1367.
107 *Id.* at 1363.
108 *Id.*
109 *Id.* at 1364.
110 *Id.* at 1367.

> *alternatives is preferable, where the claimants are readily available, and such a procedure may avoid litigation.*[111]

Inasmuch as Farmers pursued none of these three alternatives, the *Schropp* court had no trouble concluding that the verdict was substantially supported.

Most recently, in *Texas Farmers Insurance Co. v. Soriano*,[112] a Texas appellate court upheld a bad faith verdict when the insurer settled with one claimant but not others. In *Soriano*, the insured, Richard Soriano, tried to pass a truck while driving drunk. Soriano collided head-on with another vehicle, killing his passenger, Adolfo Lopez.[113] The four occupants of the car Soriano struck, the Medina family, were all injured.

Soriano was minimally insured under his parents' policy with Texas Farmers; the policy limits were only $10,000 for any one injury and $20,000 in the aggregate. Texas Farmers initially attempted to settle with the Medinas by offering the entire $20,000. The Medinas refused the offer and hired an attorney to ascertain Soriano's true worth.[114] The parents of Adolfo Lopez then hired an attorney. Thereafter, the Medinas and the Lopez family sued Soriano. The cases were consolidated for trial. As the jury was being selected, Texas Farmers settled the Lopez case for $5,000 without prior notice to the Medinas.[115] The Medinas' case proceeded to trial and they obtained a $172,000 judgment against Soriano. Soriano then assigned to the Medinas all rights he had against the insurer in exchange for a covenant not to execute.[116]

The Medinas later sued Texas Farmers in Soriano's name. A jury found that the insurer was negligent and grossly negligent in handling the Medinas' claims, and that it breached the duty of good faith and fair dealing it owed Soriano.[117] The court of appeals affirmed the verdict, reasoning:

> [I]t was [the insurer's] duty to offer Soriano the full extent of protection available under his insurance policy; there was no question that the limits of the policy were inadequate under the particular facts; . . . of all the injuries sustained as a result of the accident, those received by Mr. Medina and Mrs. Medina were the most severe and, in fact, substantially exceeded the value of

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111 *Id.* (emphasis added) (citation omitted).
112 844 S.W.2d 808 (Tex. Ct. App. 1992).
113 *Id.* at 813.
114 *Id.*
115 *Id.*
116 *Id.* at 813-14.
117 *Id.* at 814.

> the entire policy coverage and the Lopez claim; the appellant was made clearly aware prior to the Lopez settlement that the Lopez family and the Soriano family were friends, and that it was very probable that the Lopez family had no intention of pursuing the lawsuit against the Sorianos; the Lopez claim was worth considerably less than the Medinas' claims . . . the appellant was clearly aware that the Medinas would not settle any of their four claims for less than the $20,000 that had originally been offered to them; the appellant had originally reserved the entire policy limits for the Medina family and, in fact, offered the Medina family the policy limits . . . and, [Texas Farmers] was advised by the Medina attorney that the Medinas were willing to settle their entire claim for the policy limits prior to the Lopez settlement.[118]

In short, the *Soriano* court substituted its judgment for the insurer's.

Soriano is an intellectual Black Hole. There was no evidence that the Medinas would have settled for less than $20,000, leaving Farmers to face two potential excess judgment suits (Lopez being the other) instead of one.[119] For the *Soriano* majority to suggest that the Lopez family would not have pursued their wrongful death claim ignores the fact that they filed suit and appeared at trial. Obviously, Adolfo Lopez's parents were willing to pursue their cause of action. The *Soriano* court essentially held that if an insurer does not pay its entire policy limits to the most seriously injured claimant as determined by a jury or court with the benefit of hindsight, it can later be held liable for any excess judgment.[120] *Soriano* thus heralds a "comparative-seriousness rule" in Texas multiple-claimant cases.[121]

Following *Soriano*, Texas insurers facing multiple claims exceeding their coverage can only avoid extracontractual liability by pursuing interpleader actions. Indeed, the Texas alternative in multiple-claimant cases is apparently strict liability.

C. *What Constitutes Bad Faith?*

"Bad faith" conduct defies uniform definition.[122] Among the earliest cases in which a court attempted to formulate a definition

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118 *Id.* at 817.

119 *Id.* at 842 (Peeples, J., dissenting).

120 *See id.*

121 *See id.*

122 *See* Walbrook Ins. Co., Ltd. v. Liberty Mut. Ins. Co., 7 Cal. Rptr. 2d 513, 518 (Ct. App. 1992); Jerry, *supra* note 31, at 116.

of bad faith is *Brown v. Guarantee Insurance Co.*.[123] In *Brown*, a California court of appeal identified eight factors to be weighed in determining whether an insurer acted properly in refusing to settle an action. Those factors are:

> [(1)] [T]he strength of the injured claimant's case on the issues of liability and damages; [(2)] attempts by the insurer to induce the insured to contribute to a settlement; [(3)] failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; [(4)] the insurer's rejection of advice of its own attorney or agent; [(5)] failure of the insurer to inform the insured of a compromise offer; [(6)] the amount of financial risk to which each party is exposed in the event of a refusal to settle; [(7)] the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and [(8)] any other factors tending to establish or negate bad faith on the part of the insurer.[124]

The *Brown* factors have been adopted by other courts.[125]

The Michigan Supreme Court in *Commercial Union Insurance Co. v. Liberty Mutual Insurance Co.*[126] described bad faith conduct as the "arbitrary, reckless, indifferent, or intentional disregard of the interests of [the insured]."[127] As in *Brown*, the *Commercial Union* court identified a number of bad faith factors. Unlike *Brown*, however, the Michigan court looked beyond the settlement context. The *Commercial Union* factors include: (1) failure to inform the insured of relevant litigation developments; (2) failure to keep the insured informed of all settlement demands outside policy limits; (3) failure to solicit a settlement offer or to initiate settlement negotiations when warranted; (4) failure to accept a reasonable compromise offer of settlement in situations when the facts demonstrate blatant liability and serious injury; (5) rejecting a reasonable settlement offer within policy limits; (6) attempting to coerce or obtain an involuntary contribution from the insured in order to settle within policy limits; (7) failure to properly investigate a claim before rejecting a settlement offer; (8) disregarding the advice of an adjuster or attorney; (9) serious and recurrent negligence by the insurer; (10) undue delay in accepting a settlement offer within policy limits where the potential verdict is high;

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123 319 P.2d 69 (Cal. Ct. App. 1958).

124 *Id.* at 75.

125 *See, e.g.*, Pruett v. Farmers Ins. Co., 857 P.2d 1301, 1305-06 (Ariz. Ct. App. 1993) (citing Clearwater v. State Farm Mut. Auto. Ins. Co., 792 P.2d 719, 722 (Ariz. 1990)); Helmbolt v. LeMars Mut. Ins. Co., 404 N.W.2d 55, 57 (S.D. 1987).

126 393 N.W.2d 161 (Mich. 1986).

127 *Id.* at 164.

(11) refusing to settle a case within policy limits following an excessive verdict when the chances of reversal on appeal are slight; and (12) failing to appeal following a verdict in excess of policy limits where there exist reasonable grounds for such an appeal.[128]

In *Centennial Insurance Co. v. Liberty Mutual Insurance Co.*,[129] the Ohio Supreme Court explained that bad faith requires more than negligence or poor judgment by an insurer. Rather, it "'imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partaking of the nature of fraud.'"[130] Other courts similarly require more than mere negligence to support a bad faith claim.[131] While it appears to be the majority rule that there must be some level of intentional wrongdoing by an insurer in order to support a bad faith claim,[132] a significant minority of states apply a negligence standard.[133] Of those states allowing bad faith recovery for an insurer's negligence, however, a number require intent for an insured to recover punitive damages.[134]

Regardless of the standard applied, it is inappropriate when

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128 *Id.* at 165-66.

129 404 N.E.2d 759 (Ohio 1980).

130 *Id.* at 762 (quoting Slater v. Motorists Mut. Ins. Co., 187 N.E.2d 45, 46 (Ohio 1962)).

131 *See* First Marine Ins. Co. v. Booth, 876 S.W.2d 255, 257 (Ark. 1994); Turner Const. Co. v. First Indem. of Am. Ins. Co., 829 F. Supp. 752, 762-64 (E.D. Pa. 1993) (Pennsylvania law); White v. Continental Gen. Ins. Co., 831 F. Supp. 1545, 1555 (D. Wyo. 1993); Wittmer v. Jones, 864 S.W.2d 885, 890-92 (Ky. 1993) (discussing Kentucky statute and punitive damage standard); General Star Nat'l Ins. Co. v. Liberty Mut. Ins. Co., 960 F.2d 377, 380 (3d Cir. 1992) (interpreting New York law); Universal Life Ins. Co. v. Veasley, 610 So. 2d 290, 295 (Miss. 1992); Matt v. Liberty Mut. Ins. Co., 798 F. Supp. 429, 434 (W.D. Ky. 1991), *aff'd*, 968 F.2d 1215 (6th Cir. 1992) (Kentucky law); Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 556 (Mo. Ct. App. 1990); Dolan v. AID Ins. Co., 431 N.W.2d 790, 794 (Iowa 1988); Insurance Co. of N. Am. v. Citizensbank of Thomasville, 491 So. 2d 880, 882 (Ala. 1986); *see also* Mission Ins. Co. v. Aetna Life and Cas. Co., 687 F. Supp. 249, 253 (E.D. La. 1988) ("Something more than mere error of judgment is necessary to constitute bad faith on the part of the insurer.").

132 *See* Braesch v. Union Ins. Co., 464 N.W.2d 769, 777 (Neb. 1991).

133 *See, e.g.*, Hartford Cas. Ins. Co. v. New Hampshire Ins. Co., 628 N.E.2d 14, 17 (Mass. 1994); Indiana Ins. Co. v. Plummer Power Mower & Tool Rental, Inc., 590 N.E.2d 1085, 1093 (Ind. Ct. App. 1992); Mock v. Michigan Millers Mut. Ins. Co., 5 Cal. Rptr. 2d 594, 607 (Ct. App. 1992); Shamblin v. Nationwide Mut. Ins. Co., 396 S.E.2d 766, 776 (W. Va. 1990); Gelinas v. Metropolitan Prop. & Liab. Ins. Co., 551 A.2d 962, 966 (N.H. 1988); Employers Equitable Life Ins. Co. v. Williams, 665 S.W.2d 873, 874 (Ark. 1984).

134 *See, e.g.*, Crossley v. State Farm Mut. Auto. Ins. Co., 415 S.E.2d 393, 396-97 (S.C. 1992).

reviewing the insurer's conduct to use "20-20 hindsight."[135] As the Michigan Supreme Court explained in *Commercial Union*:

> The conduct under scrutiny must be considered in light of the circumstances existing at the time. A microscopic examination, years after the fact, made with the luxury of actually knowing the outcome of the original proceeding is not appropriate. It must be remembered that if bad faith exists in a given situation, it arose upon the occurrence of the acts in question; bad faith does not arise at some later date as a result of an unsuccessful day in court.[136]

Many of the specific acts, decisions or omissions identified by the *Commercial Union* court may evidence a liability insurer's bad faith. These are easily understood to be part of an insurer's defense and indemnity obligations. Several categories of conduct merit discussion.

1. Unreasonable Delay or Dilatory Claims Practices.

An insurer's unreasonable delay or indifference to its insured's needs may sometimes constitute bad faith.[137] Among the most recent cases on point is *Pavia v. State Farm Mutual Automobile Insurance Co.*[138] In *Pavia*, a passenger in the insured's automobile suffered permanent brain damage and was paralyzed on one side of his body in an accident in which the insured's fault seemed clear. In July, 1987, the plaintiff's attorney wrote a demand letter to State Farm, in which he offered to settle any claims for the full amount of the policy ($100,000). The offer was to remain open for 30 days.[139]

State Farm never responded to the letter, nor did a claims representative tell the insureds that there had been a demand within policy limits. On December 1, 1987, State Farm finally convened a claims committee to weigh the offer. After a short meeting, the committee determined that the company should settle for its policy

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135 Commercial Union Ins. Co. v. Liberty Mut. Ins. Co., 393 N.W.2d 161, 166 (Mich. 1986).

136 *Id.* at 166; *see also* Nicolau v. State Farm Lloyds, 869 S.W.2d 543, 551 (Tex. Ct. App. 1993) ("When reviewing a bad faith claim, the relevant inquiry is what facts the insurance carrier had before it at the time it denied the claim.").

137 *See, e.g.*, Southern Gen. Ins. Co. v. Holt, 416 S.E.2d 274 (Ga. 1992) (time-restricted settlement offer); Garnett v. Transamerica Ins. Servs., 800 P.2d 656 (Idaho 1990); Lissmann v. Hartford Fire Ins. Co., 848 F.2d 50 (4th Cir. 1988); Grumbling v. Medallion Ins. Co., 392 F. Supp. 717 (D. Or. 1975), *aff'd*, 545 F.2d 686 (9th Cir. 1976) (time-restricted settlement offer).

138 589 N.Y.S.2d 510 (App. Div.), *rev'd*, 626 N.E.2d 24 (N.Y. 1993).

139 589 N.Y.S.2d at 513.

limits.[140] State Farm did not offer its policy limits until January 7, 1988. The plaintiff rejected State Farm's offer a few days later, asserting the insurer's delay as one of the principal reasons for his decision.[141]

At trial, evidence was introduced that State Farm's handling of the claim and demand contravened company policy as outlined in its claims manual. A judgment of $4,688,030 was ultimately entered against State Farm.[142]

On appeal State Farm argued that its conduct did not amount to bad faith because any delay in responding to the plaintiff's demand was not intentional or the product of deceit.[143] The intermediate appellate court rejected this approach. While noting that New York law requires more than mere negligence to support allegations of bad faith, the court reasoned that "gross disregard" of an insured's rights (the New York bad faith standard) could include unreasonable delay and lack of communication.

State Farm's belated offer of its policy limits was insufficient to shield it against bad faith liability. While an insurer's failure to act before an arbitrary settlement deadline is not dispositive of its bad faith, the record supported "the inference that State Farm's claims personnel had adopted an attitude of complete indifference to [the plaintiff's] settlement overture . . . ."[144] Indeed, State Farm had apparently ignored or overlooked the demand letter for months without so much as acknowledging its receipt.[145]

The Court of Appeals, New York's highest court, reversed the lower courts.[146] Applying long-established bad faith principles,[147]

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140 *See id.*

141 *Id.*

142 *Id.* at 514.

143 *See id.* at 515.

144 *Id.* at 516.

145 *Id.*

146 *Pavia*, 626 N.E.2d at 29.

147 As the court of appeals explained:

> The bad faith equation must include consideration of all of the facts and circumstances relating to whether the insurer's investigatory efforts prevented it from making an informed evaluation of the risks of refusing settlement. In making this determination, courts must assess the plaintiff's likelihood of success on the liability issue in the underlying action, the potential magnitude of damages and the financial burden each party may be exposed to as a result of the refusal to settle. Additional considerations include the insurer's failure to properly investigate the claim and any potential defenses thereto, the information available to the insurer at the time the demand for settlement is made, and any other evidence which tends to establish or negate the insurer's bad faith in refusing to settle. The insured's fault in delaying or ceasing

the *Pavia* court concluded that State Farm's failure to abide by the plaintiff's settlement deadline did not constitute bad faith.

> Permitting an injured plaintiff's chosen timetable for settlement to govern the bad-faith inquiry would promote the customary manufacturing of bad-faith claims, especially in cases where an insured of meager means is covered by a policy of insurance which could finance only a fraction of the damages in a serious personal injury case. Indeed, insurers would be bombarded with settlement offers imposing arbitrary deadlines and would be encouraged to prematurely settle their insureds' claims . . . in contravention of their contractual right and obligation of thorough investigation.[148]

While State Farm could have acted more expeditiously, there was no evidence that it failed to investigate the claim, failed to evaluate settlement opportunities, or refused to offer its policy limits before trial once the weaknesses in the insured's position were fully assessed.[149] The Court of Appeals therefore reasoned that State Farm did not exhibit gross disregard for its insured's interests. State Farm's conduct amounted only to poor judgment or administrative delay.[150]

Pavia is an important decision from a policy standpoint. By rejecting time-restricted settlement offers as a bad faith predicate, the Court of Appeals essentially signalled that the duty of good faith and fair dealing should provide a shield for insureds, and not a sword to be used by calculating lawyers to collect otherwise uncollectible judgments.[151]

2. The Insurer's Failure to Investigate.

An insurer's obligation to thoroughly investigate claims is essential to its relationship with its insured. Some scholars have termed an insurer's obligation to investigate claims a "duty," much like the duties of defense and indemnity.[152] Regardless of whether it stands alone, or is more properly viewed as part of an insurer's

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> settlement negotiations by misrepresenting the facts also factors into the analysis . . . .

Id. at 28 (citations omitted).

148 *Id.* at 28-29.

149 *Id.* at 29.

150 *See id.*

151 Evan H. Krinick, *Time-Restricted Offers Create Problems*, NAT'L L.J., Feb. 28, 1994, at 27, 30.

152 *See, e.g.*, Guy O. Kornblum et al., *Environmental Claims and Bad Faith: Contractual Obligations That Mature into Extra-Contractual Lawsuits*, 52 OHIO ST. L.J. 1245, 1253 (1991).

duties of defense, indemnity, or settlement, the requirement that an insurer investigate each claim serves several legitimate purposes. The insured depends on the insurer to conduct an investigation in order to establish that it must in fact honor its bargain and defend or settle a claim. The insurer requires thorough investigation so that it does not unnecessarily expend time or money, or assume obligations beyond that for which it contracted.

An insurer's duty to investigate arises when the insurer receives actual notice of the claim.[153] The insured must notify the insurer in accordance with the requirements stated in the policy.[154] A policy's notice provision is to be construed strictly against the insurer.[155] The insured's duty to comply with the notice of loss provisions in the policy requires only a good faith effort at compliance. Additionally, an insurer's duty to investigate exists independent of the insured's duty to meet policy requirements. An insurer must therefore make an independent inquiry.

Refusing to defend an insured without conducting a thorough investigation, or refusing to settle a claim without investigating, may be a breach of the implied covenant of good faith and fair dealing.[156] *Republic Insurance Co. v. Stoker*[157] is an exemplary case. The *Stoker* plaintiff was involved in an automobile accident. Republic denied her claim even though its independent adjuster ignored the police report of the accident, never interviewed the reporting state trooper, never visited the accident site, declined to interview the insured and three witnesses, and failed to obtain photographs except for those provided by the insured.[158] The *Stoker* court had no trouble determining that the plaintiff stated a bad faith claim.

Not all jurisdictions embrace the principle that an insurer's failure to investigate a claim, standing alone, constitutes bad faith. The Iowa Supreme Court in *Reuter v. State Farm Mutual Automobile Insurance Co.*[159] held that an improper invitation in the face of an objectively reasonable basis for denying a claim was not sufficient cause for bad faith recovery. Rather, the court reasoned, "an insurer's intentional, reckless, or negligent failure to investigate or

153 *Id.* at 1267; *see* Zurich Ins. Co. (U.S. Branch) v. Killer Music, Inc., 998 F.2d 674, 680 (9th Cir. 1993) (applying California law).

154 United Ins. Co. of Am. v. Cope, 630 So. 2d 407, 412 (Ala. 1993); California Shoppers, Inc. v. Royal Globe Ins. Co., 221 Cal. Rptr. 171, 202 (Ct. App. 1985).

155 Kremer v. American Family Mut. Ins. Co., 501 N.W.2d 765, 767 (S.D. 1993)

156 *See* Ruwe v. Farmers Mut. United Ins. Co., 469 N.W. 2d 129, 135 (Neb. 1991); Betts v. Allstate Ins. Co., 201 Cal. Rptr. 528, 539 (Ct. App. 1984).

157 867 S.W.2d 74 (Tex. Ct. App. 1993).

158 *Id.* at 79.

159 469 N.W.2d 250 (Iowa 1991).

evaluate a claim" is but one element by which an insured may prove bad faith.[160] Under *Reuter*, an insurer's inadequate investigation cannot in and of itself support a bad faith claim.[161]

3. Compelling An Insured to Contribute to Settlement.

Occasionally, an unscrupulous claims representative may attempt to compel or require an insured to contribute toward the settlement of a third-party claim. This is easily done when it appears that any potential judgment would significantly exceed the insured's policy limits. Of course, such coercion offends the insurer's duties to defend and settle or pay claims. Additionally, insurer coercion ignores economic reality; that is, plaintiffs seldom pursue tortfeasors beyond the limits of their insurance because of collection difficulties. Most plaintiffs would prefer an assignment of the insured's rights against the insurer. It is almost always the insurer that alone bears the risk of extracontractual damages. Coercive settlement practices illustrate classic third-party bad faith.

IV. Bad Faith In The First-Party Setting

First-party bad faith claims are brought by insureds to recover for their own losses or injuries allegedly covered by disability,[162] fire,[163] health,[164] homeowners,[165] automobile or uninsured motorist,[166] and various property[167] insurance policies. Insureds or third-party beneficiaries may sue life insurers for their alleged bad

160 *Id.* at 254.

161 *Accord* Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 520 (Ind. 1993); Pace v. Insurance Co. of N. Am., 838 F.2d 572, 584 (1st Cir. 1988) (interpreting Rhode Island law).

162 *See, e.g.*, Stegall v. Guardian Life Ins. Co. of Am., 320 S.E.2d 575, 575 (Ga. Ct. App. 1984); Biundo v. Old Equity Life Ins. Co., 662 F.2d 1297, 1298 (9th Cir. 1981).

163 *See, e.g.*, Lebron v. Allstate Ins. Co., 578 N.Y.S.2d 239, 240 (App. Div. 1992); Stevenson v. Union Standard Ins. Co., 746 S.W.2d 39, 40 (Ark. 1988).

164 *See, e.g.*, Parsaie v. United Olympic Life Ins. Co., 29 F.3d 219 (5th Cir. 1994); White v. Continental Gen. Ins. Co., 831 F. Supp. 1545, 1548 (D. Wyo. 1993); Alsobrook v. National Travelers Life Ins. Co., 852 P.2d 768, 769 (Okla. Ct. App. 1992); Hagel v. Blue Cross and Blue Shield of N.C., 370 S.E.2d 695, 697 (N.C. Ct. App. 1988).

165 *See, e.g.*, Minton v. Tennessee Farmers Mut. Ins. Co., 832 S.W.2d 35, 36 (Tenn. Ct. App. 1992); Frankenmuth Mut. Ins. Co. v. Keeley, 461 N.W.2d 666, 667 (Mich. 1990).

166 *See, e.g.*, Globe Indem. Co. v. Superior Court, 8 Cal. Rptr. 2d 251, 252 (Ct. App. 1992); McLeod v. Continental Ins. Co., 591 So. 2d 621, 622 (Fla. 1992); Buzzard v. Farmers Ins. Co., 824 P.2d 1105, 1107 (Okla. 1991).

167 *See, e.g.*, Perzy v. Intercargo Corp., 827 F. Supp. 1365, 1367 (N.D. Ill. 1993) (marine all risk insurance policy); Turner v. State Farm Fire & Cas. Cos., 614 So. 2d 1029, 1030 (Ala. 1993) (builders risk policy).

faith.[168] Workers compensation insurance may also spawn first-party bad faith claims by insured businesses' employees.[169] The gravamen of first-party complaints is the insurer's wrongful denial of coverage.

While third-party bad faith quickly gained acceptance and is now widely-recognized as an independent tort, courts have been less willing to apply tort principles to the first-party insurance relationship.[170] In the third-party context, the insurer and insured

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168 *See, e.g.*, Sherrin v. Northwestern Nat'l Life Ins. Co., 2 F.3d 373, 380-81 (11th Cir. 1993); Bartlett v. John Hancock Mut. Life Ins. Co., 538 A.2d 997, 1002 (R.I. 1988).

169 *See, e.g.*, Boylan v. American Motorists Ins. Co., 489 N.W.2d 742, 742 (Iowa 1992); Aranda v. Insurance Co. of N. Am., 748 S.W.2d 210, 211 (Tex. 1988).

170 *See, e.g.*, Taylor v. Blue Cross/Blue Shield of Mich., 517 N.W.2d 864 (Mich. Ct. App. 1994) (refusing to recognize first-party bad faith); Yuen v. American Republic Ins. Co., 786 F. Supp. 531, 533 (D. Md. 1992) (no first-party bad faith in Maryland); Beck v. Farmers Ins. Exch., 701 P.2d 795, 798-800 (Utah 1985).

It is practically impossible to determine with any degree of certainty or confidence whether many states recognize first-party bad faith as an independent tort. Randy Papetti, Note, *The Insurer's Duty of Good Faith in the Context of Litigation*, 60 GEO. WASH. L. REV. 1931, 1941 n.53 (1992). As the supporting authority suggests, the following states apparently recognize as a common law tort the bad faith breach of a first-party insurance contract: *Alabama*: Coleman v. Gulf Life Ins. Co., 514 So. 2d 944, 946 (Ala. 1987); *Alaska*: State Farm Fire & Cas. Co. v. Nicholson, 777 P.2d 1152, 1156 (Alaska 1989); *Arizona*: Hawkins v. Allstate Ins. Co., 733 P.2d 1073, 1079-80 (Ariz.), *cert. denied*, 484 U.S. 874, *reh'g denied*, 484 U.S. 972 (1987); *Arkansas*: Aetna Cas. & Sur. Co. v. Broadway Arms Corp., 664 S.W.2d 463, 465 (Ark. 1984): *California*: Gruenberg v. Aetna Ins. Co., 510 P.2d 1032, 1038 (Cal. 1973); *Colorado*: Travelers Ins. Co. v. Savio, 706 P.2d 1258, 1275 (Colo. 1985); *Connecticut*: Grand Sheet Metal Prods. Co. v. Protection Mut. Ins. Co., 375 A.2d 428, 430 (Conn. Super. Ct. 1977); *Delaware*: Casson v. Nationwide Ins. Co., 455 A.2d 361, 368 (Del. Super. Ct. 1982); *Florida*: Allstate Ins. Co. v. Douville, 510 So. 2d 1200, 1202 (Fla. Dist. Ct. App.), *review denied*, 519 So. 2d 986 (Fla. 1987); *Idaho*: White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1017-19 (Idaho 1986); *Indiana*: Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 519 (Ind. 1993); *Iowa*: Dolan v. AID Ins. Co., 431 N.W.2d 790, 794 (Iowa 1988); *Kentucky*: Curry v. Fireman's Fund Ins. Co., 784 S.W.2d 176, 177-78 (Ky. 1989); *Mississippi*: Weems v. American Sec. Ins. Co., 486 So. 2d 1222, 1226 (Miss. 1986); *Montana*: Lipinski v. Title Ins. Co., 655 P.2d 970, 977 (Mont. 1982); *Nebraska*: Braesch v. Union Ins. Co., 464 N.W.2d 769, 776 (Neb. 1991); *Nevada*: Pemberton v. Farmers Ins. Exch., 858 P.2d 380, 382 (Nev. 1993); *New Jersey*: Pickett v. Lloyds, 252 N.J. Super. 477, 485-90, 600 A.2d 148, 152-55 (App. Div. 1991), *aff'd*, 131 N.J. 457, 481, 621 A.2d 445, 458 (1993); *New Mexico*: Chavez v. Chenoweth, 553 P.2d 703, 709 (N.M. Ct. App. 1976); *North Carolina*: Payne v. North Carolina Farm Bureau Mut. Ins. Co., 313 S.E.2d 912, 914 (N.C. Ct. App. 1984); *North Dakota*: Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co., 279 N.W.2d 638, 645 (N.D. 1979); *Ohio*: Hoskins v. Aetna Life Ins. Co., 452 N.E.2d 1315, 1320 (Ohio 1983); *Oklahoma*: Marshall v. Universal Life Ins. Co., 831 P.2d 651, 653-54 (Okla. Ct. App. 1991); *Rhode Island*: Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980); *South Carolina*: Carter v. American Mut. Fire Ins. Co., 307 S.E.2d 225, 226 (S.C. 1983); *South Dakota*: *In re* Certification of a Question of Law from the United States Dist. Court (Champion v. United States Fidelity & Guar. Co.), 399 N.W.2d 320, 322 (S.D. 1987); *Tennessee*: MFA Mut. Ins. Co. v. Flint, 574 S.W.2d 718, 721 (Tenn. 1978); *Texas*: Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d 165, 167 (Tex. 1987); *Wisconsin*: Anderson v. Continental Ins. Co., 271 N.W.2d 368, 376-77 (Wis.

share a special or fiduciary relationship arising out of the insurer's exclusive right to litigate or settle the claim. No similar fiduciary or special relationship exists in the first-party setting. "Generally, insurer and insured are in an adversary relationship whenever there is any claim by an insured for loss under any [first-party] insurance policy."[171] The insurer and insured do not deal in trust when a first-party claim is made. Absent a special relationship or a fiduciary duty, insureds do not need a tort cause of action in order to combat insurers who disregard their interests. By suing the insurer on its policy, the reasoning goes, an insured can usually obtain adequate relief.[172]

As is true in the third-party context, an insurer may act in bad faith even if the underlying loss is not covered.[173] The plaintiff in *Judah v. State Farm Fire & Casualty Co.*[174] made a claim under her homeowners policy for structural damage to her house following what was a seemingly innocuous landslide on her property two years before.[175] A State Farm adjuster visited Judah's home to observe the damage, which included cracking, foundation collapse, and structural shifts. Thereafter, State Farm sent Judah a reservation of rights letter which stated that because the policy excluded losses resulting from earth movement and water damage, her losses might not be covered.[176]

State Farm hired civil engineers to examine the plaintiff's home. The engineers noted that the damages were serious and might worsen in the future.[177] The engineers ultimately concluded that there were concurrent causes of Judah's damages: (1) water flowing downhill from a road catch basin clogged by the earlier landslide; and (2) inferior construction and negligence by the

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1978); *Wyoming*: McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 857-59 (Wyo. 1990).

171 Missouri *ex rel.* Safeco Nat'l Ins. Co. of Am. v. Rauch, 849 S.W.2d 632, 634 (Mo. Ct. App. 1993); *see also* Palmer v. Farmers Ins. Exch., 861 P.2d 895, 905 (Mont. 1993) (In an uninsured motorist case, the insured and insurer "are in adverse positions from the outset . . . .").

172 JERRY, *supra* note 31, at 123-24.

173 *See supra* notes 50-72 and the accompanying text.

174 266 Cal. Rptr. 455 (Ct. App. 1990), *review granted*, 268 Cal. Rptr. 541 (Cal. 1990), *review dismissed*, 281 Cal. Rptr. 766 (Cal. 1991). Because *Judah* was settled while on appeal and the appeal was therefore dismissed, the case may not be cited as precedent in California. William T. Barker & Paul E. B. Glad, *Bad Faith Without Coverage?*, FOR THE DEFENSE, Sept. 1991, at 9, 10.

175 266 Cal. Rptr. at 457.

176 *Id.*

177 *Id.* at 457-58.

home's builder.[178]

State Farm wrote Judah stating that there were no indications of third-party negligence as a concurrent cause. At the same time, without telling Judah, State Farm filed a subrogation action against the builder, alleging that he negligently designed and constructed the foundation of the plaintiff's home.[179] State Farm then denied coverage, asserting that all damages were attributable to the excluded perils of earth movement and surface or subsurface water.[180] The insurer affirmatively stated in its denial letter: "'There is no independent concurrent proximate cause of loss.'"[181]

Judah sued State Farm for bad faith, statutory violations, and breach of the implied covenant of good faith and fair dealing. The jury returned a $953,270 verdict and State Farm appealed.[182]

State Farm argued that it could not be liable, either under California's unfair claim settlement practices statute or for common law bad faith, because its policy did not cover the plaintiff's claim.[183] The *Judah* court rejected State Farm's argument in both contexts. Where an insurer's alleged act of bad faith is the wrongful denial of coverage, the tort necessarily requires a finding of coverage.[184] However, the plaintiff had alleged a number of statutory violations doubling as acts of common law bad faith wholly independent of State Farm's denial of coverage. These included misrepresentation, failing to act promptly in response to communications, failing to adopt or implement reasonable investigation standards, not attempting a prompt, equitable and fair settlement when liability was clear, and failing to provide a reasonable explanation of the factual and contractual bases for its refusal to pay the claim.[185] Inasmuch as State Farm's alleged failures to act in good faith or to deal fairly were not linked to coverage, it could still be held liable. The *Judah* court had "no trouble concluding that an insurer may become liable for its mismanagement of claims prior to and independently of a determination of coverage."[186]

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178 *See id.* at 458.
179 *Id.*
180 *Id.* at 459.
181 *Id.*
182 *Id.* at 457-63.
183 *See id.* at 460-65.
184 *See id.* at 464-65.
185 *Id.* at 463 n.10.
186 *Id.* at 463.

A. The Development of First-Party Bad Faith As An Independent Tort.

The dawn of first-party insurance bad faith litigation was signalled by a California court of appeal in *Fletcher v. Western National Life Insurance Co.*[187] In *Fletcher*, an insurer was held liable in tort for damages caused by its refusal to indemnify its insured under a disability policy. Comparing third-party principles with the situation before it, the *Fletcher* court stated:

> We think that, similarly, the implied-in-law duty of good faith and fair dealing imposes upon a disability insurer a duty not to threaten to withhold or actually withhold payments, maliciously and without probable cause, for the purpose of injuring its insured by depriving him of the benefits of the policy. We think that . . . the violation of that duty sounds in tort notwithstanding that it also constitutes a breach of contract.[188]

The suggestion in *Fletcher* was affirmed and energized by the California Supreme Court's landmark 1973 decision in *Gruenberg v. Aetna Insurance Co.*[189] The *Gruenberg* insurers denied liability for the plaintiff's fire loss. The insurers believed that the plaintiff committed arson in connection with a fire at his cocktail lounge and restaurant.[190] Explaining its willingness to recognize a bad faith cause of action in the first-party context, the court stated:

> [I]n *Comunale* and *Crisci* we made it clear that "'[l]iability is imposed [on the insurer] not for a bad faith breach of contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.'" (*Crisci, supra*, 66 Cal.2d at p. 430, 58 Cal. Rptr. at p. 17, 426 P.2d at p. 177). In those two cases, we considered the duty of the insurer to act in good faith and fairly in handling the claims of third persons against the insured, described as a "duty to accept reasonable settlements"; in the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy. These are merely two different aspects of the same duty. That responsibility is not the requirement mandated by the terms of the policy itself—to defend, settle, or pay. It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal *fairly and in good faith* with its insured by refusing, without proper cause, to compensate its insured for

187 89 Cal. Rptr. 78 (Ct. App. 1970).
188 *Id.* at 93.
189 510 P.2d 1032 (Cal. 1973).
190 *See id.* at 1034-35.

> a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.[191]

Gruenberg remains the starting point for first-party bad faith analysis.

Some states have only recently recognized a tort cause of action for first-party bad faith.[192] Indiana recognized first-party bad faith in 1993 in *Erie Insurance Co. v. Hickman.*[193] New Jersey applied tort theory to first-party insurance for the first time in 1991,[194] as did Nebraska. In *Braesch v. Union Insurance Co.*,[195] the Nebraska Supreme Court identified three factors justifying the application of tort principles to the decidedly contractual first-party relationship. First, the insurance industry is affected with a public interest, as "plainly evidenced" by extensive state regulation.[196] The public character of risk and loss distribution requires that all those having to do with it be driven by good faith.[197] Second, the non-commercial character of insurance distinguishes insurance policies from other kinds of contracts for which breaches do not sound in tort.[198] The public purchases insurance to protect against calamity, and for security and peace of mind. Third, the disparity of bargaining power between insurers and insureds differentiates insurance policies from "run-of-the mill" contracts.[199] In *McCullough v. Golden Rule Insurance Co.*,[200] a 1990 decision, the Wyoming Supreme Court reasoned that acknowledging first-party bad faith as a tort would offer insurers "additional impetus for good faith."[201]

B. First-Party Bad Faith Defined and Examined.

Courts regularly describe first-party bad faith as an insurer's refusal to pay a claim without a lawful or reasonable basis, or refusing to compensate an insured for a covered loss without proper

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191 *Id.* at 1037 (emphasis in original).

192 Several states consider first-party bad faith claims to be contractual, but afford plaintiffs a wider range of damages, including punitive damages. *See* McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 857 (Wyo. 1990).

193 622 N.E.2d 515, 519 (Ind. 1993).

194 Pickett v. Lloyds, 252 N.J. Super. 477, 490, 600 A.2d 148, 155 (App. Div. 1991), *aff'd*, 131 N.J. 457, 481, 621 A.2d 445, 458 (1993).

195 464 N.W.2d 769 (Neb. 1991).

196 *Id.* at 774.

197 *See id.*

198 *Id.* at 775.

199 *Id.*

200 789 P.2d 855 (Wyo. 1990).

201 *Id.* at 859.

cause.[202] The unreasonableness of the insurer's conduct is the essence of this tort.[203] The insured generally must establish (1) the unreasonableness of the insurer's conduct *and* (2) that the insurer knew or should have known that it was being unreasonable.[204] The reasonableness of an insurer's conduct must be considered in light of all of the surrounding circumstances.[205] An insurer maintains the right to deny invalid or questionable claims without being guilty of bad faith.[206] A reasonable insurer has a right to be wrong.

An insurer may pass one or both prongs of the first-party bad faith test, thus avoiding liability, by proving that its liability for the claim was "fairly debatable." In other words, were there factual or legal questions concerning the insurer's obligations that account for its delay or refusal to pay a claim?[207] Insurers are entitled, and perhaps even obligated, to challenge fairly debatable claims.[208]

In *Standard Fire Insurance Co. v. Rominger*,[209] a fire insurer denied its insured's claim because it concluded that his house fire was the result of arson. The insurer filed a declaratory judgment action and the insured counterclaimed for bad faith. There was considerable evidence that the fire was incendiary. The insurer's fire investigator and the local police both concluded that the fire was caused by arson; fire debris samples showed the presence of petro-

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202 *See, e.g.*, London v. Trinity Ins. Cos., 877 P.2d 620, 622 (Okla. Ct. App. 1994); Hillman v. Nationwide Mut. Fire Ins. Co., 855 P.2d 1321, 1324 (Alaska 1993); Pemberton v. Farmers Ins. Exch., 858 P.2d 380, 382 (Nev. 1993); Dowling v. Home Buyers Warranty Corp. II, 400 S.E.2d 143, 144 (S.C. 1991).

203 Alsobrook v. National Travelers Life Ins. Co., 852 P.2d 768, 770 (Okla. Ct. App. 1992); *see, e.g.*, Tomaselli v. Transamerica Ins. Co., 31 Cal Rptr. 2d 433 (Ct. App. 1994); Chester v. State Farm Ins. Co., 789 P.2d 534, 537 (Idaho Ct. App. 1990).

204 *See* Brown v. Liberty Mut. Ins. Co., 513 N.W.2d 762, 763 (Iowa 1994); Galusha v. Farmers Ins. Exch., 844 F. Supp. 1401, 1404 (D. Colo. 1994) (Colorado law); Transportation Ins. Co. v. Moriel, 879 S.W. 2d 10, 18 (Tex. 1994); Weatherly v. Blue Cross Blue Shield Ins. Co., 513 N.W.2d 347, 354 (Neb. Ct. App. 1994); Turner v. State Farm Fire & Cas. Cos., 614 So. 2d 1029, 1032 (Ala. 1993); Ness v. Western Sec. Life Ins. Co., 851 P.2d 122, 125 (Ariz. Ct. App. 1992).

205 Kyle v. United Servs. Auto Ass'n, 30 Cal. Rptr. 163, 168 (Ct. App. 1994); Forcucci v. United States Fidelity & Guar. Co., 11 F.3d 1, 2 (1st Cir. 1993).

206 Clark-Peterson Co. v. Independent Ins. Assocs., Ltd., 514 N.W.2d 912, 914 (Iowa 1994); State Farm Mut. Auto. Ins. Co. v. Laforet, 632 So. 2d 608, 609 (Fla. Dist. Ct. App. 1993); Beaumont Rice Mill, Inc. v. Mid-American Indem. Ins. Co., 948 F.2d 950, 952 (5th Cir. 1991).

207 *See* Larsen v. Allstate Ins. Co., 857 P.2d 263, 266 (Utah Ct. App. 1993) (fairly debatable claims may concern matters of fact or law), *cert. denied*, 862 P.2d 1356 (Utah 1993).

208 Jordan v. Union Ins. Co., 771 F. Supp. 1031, 1033 (D.S.D. 1991); *see also* Dirks v. Farm Bureau Mut. Ins. Co., 465 N.W.2d 857, 861 (Iowa 1991) (insurer entitled to debate fairly debatable claim).

209 827 F. Supp. 1277 (S.D. Tex. 1993).

leum distillate; the insured was in dire financial straits and the house had been on the market for months; and the insured sent his estranged wife a videotape of the fire scene accompanied by a soundtrack of songs about fire.[210] The *Rominger* court dismissed the bad faith counterclaim, holding that Standard had a reasonable basis for denying the underlying claim.[211]

The plaintiff in *Lyons v. Millers Casualty Insurance Co. of Texas*[212] prevailed at trial on the theory that Millers Casualty wrongfully denied her claim for wind damage to her home. Before denying the claim, the insurer twice had the house inspected by engineers, both of whom concluded that the damage was caused by the settling of the foundation. There was no evidence that the experts were biased, or that the insurer's reliance on their reports was misplaced.[213] Holding that "the issue of bad faith focuses not on whether the claim was valid, but on the reasonableness of the insurer's conduct in rejecting the claim[,]" the Texas Supreme Court affirmed an intermediate appellate court reversing the verdict.[214]

In *Robinson v. State Farm Fire & Casualty Co.*,[215] the plaintiff alleged that State Farm breached its duty of good faith and fair dealing when it offered to pay her substantially less for a fire loss than she claimed.[216] The plaintiff's only argument supporting her allegations was that the insurer employed an improper method of calculating her loss.[217] The *Robinson* court made short work of the plaintiff's case. State Farm based its offer on estimates prepared by an experienced adjuster, and by two knowledgeable contractors.[218] Because there was a bona fide dispute as to the amount of the plaintiff's loss, there could be no bad faith.[219] *Robinson* is a favorable opinion for insurers because the Fifth Circuit Court of Appeals placed great stock in an experienced adjuster's opinion. Of course, insurance companies rely heavily on their field adjusters to value claims.

Insurers cannot be held liable for bad faith if they assert legiti-

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210 *Id.* at 1279.

211 *Id.* at 1280.

212 866 S.W.2d 597 (Tex. 1993).

213 *See id.* at 601.

214 *Id.*

215 13 F.3d 160 (5th Cir. 1994).

216 *Id.* at 162.

217 *Id.* at 163.

218 *Id.* at 162.

219 *Id.* at 163.

mate coverage defenses to a claim.[220] An insurer may similarly avoid bad faith liability if its obligation to pay a claim is an open legal question,[221] or if it changes its position and promptly resolves a claim when it learns of legal authority supporting the insured's position.[222] It is not bad faith for an insurer to deny a claim based on a fairly debatable policy interpretation even if that interpretation is later rejected by the courts.[223] When faced with questions about their legal responsibilities, insurers usually seek judicial clarification or determinations of their duties. This is accomplished by way of a declaratory judgment action. An insurer's legitimate resort to a judicial forum is not an act of bad faith.[224] A majority of courts will not penalize an insurer for litigating an issue of first impression.[225]

As is true in the third-party context, a number of specific acts or categories of conduct may constitute bad faith by a first-party insurer. These include deceptive practices or deliberate misrepresentations to avoid paying claims,[226] inadequate investigation,[227] deliberate misinterpretation of records or policy language to avoid coverage,[228] unreasonable litigation conduct,[229] and unreasonable

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220 First Dakota Nat'l Bank v. St. Paul Fire & Marine Ins. Co., 2 F.3d 801, 811-12 (8th Cir. 1993).

221 *See* Aceves v. Allstate Ins. Co., 827 F. Supp. 1473, 1484 (S.D. Cal. 1993); J.H. France Refractories Co. v. Allstate Ins. Co., 626 A.2d 502, 510 (Pa. 1993); Frost v. Liberty Mut. Ins. Co., 828 S.W.2d 915, 920 (Mo. Ct. App. 1992).

222 *See, e.g.*, Harrington v. Guaranty Nat'l Ins. Co., 628 So. 2d 323, 326-27 (Ala. 1993).

223 *See* Mills v. Regent Ins. Co., 449 N.W.2d 294, 297 (Wis. Ct. App. 1989), *review denied*, 451 N.W.2d 297 (Wis. 1990).

224 Ballinger v. Security Conn. Life Ins. Co., 862 P.2d 68, 70 (Okla. 1993); *see, e.g.*, Wierck v. Grinnell Mut. Reins. Co., 456 N.W.2d 191, 194 (Iowa 1990).

225 Gordon & Hirsch, *supra* note 1, at 57; *see, e.g.*, First Fin. Ins. Co. v. Rainey, 401 S.E.2d 490, 491-92 (Ga. 1991); Pressman v. Aetna Cas. and Sur. Co., 574 A.2d 757, 758-60 (R.I. 1990); CUNA Mut. Ins. Soc'y v. Norman, 375 S.E.2d 724, 725-27 (Va. 1989); Armacost v. State Farm Mut. Auto. Ins. Co., 644 P.2d 403, 405-06 (Kan. 1982).

226 *See, e.g.*, State Farm Fire & Cas. Co. v. Gros, 818 S.W.2d 908, 912-13 (Tex. Ct. App. 1991); Hampton v. State Farm Mut. Auto. Ins. Co., 778 S.W.2d 476, 479 (Tex. Ct. App. 1989); Independent Life & Accident Ins. Co. v. Peavy, 528 So. 2d 1112, 1114 (Miss. 1988); Bankers Life & Cas. Co. v. Crenshaw, 483 So. 2d 254, 270-73 (Miss. 1985), *aff'd*, 480 U.S. 915 (1987); Timmons v. Royal Globe Ins. Co., 653 P.2d 907, 910-11 (Okla. 1982).

227 *See, e.g.*, Standard Plan, Inc. v. Tucker, 582 So. 2d 1024, 1030-32 (Ala. 1991); Industrial Indem. Co. of the N.W. v. Kallevig, 792 P.2d 520, 526-28 (Wash. 1990); Morgan v. Golden Rule Ins. Co. 568 So. 2d 184, 188-89 (La. Ct. App. 1990).

228 *See, e.g.*, Hall v. Svea Mut. Ins. Co., 493 N.E.2d 1102, 1104-05 (Ill. App. Ct. 1986).

229 White v. Western Title Ins. Co., 710 P.2d 309, 316-17 (Cal. 1985), *abrogated by statute as stated in* Focus Inv. Assocs., Inc. v. American Title Ins. Co., 797 F. Supp. 109, 113 n.1 (D.R.I. 1992).

delay in resolving a claim.[230] Among other indicia of bad faith are an insurer's use of improper standards to deny a claim, arbitrary or unreasonable demands for proof of loss, and abusive practices or coercion to compel compromise of a claim.[231] Insurers' abusive and coercive tactics are sometimes amazing. One insurer employed a state trooper "'to go out there and scare the people so they would settle.'"[232] Another insurer tried to bully its insured into settling, telling her that she "'did not know how big business is handled'" and that she was "'just a dumb broad from a hick town in Arkansas.'"[233] An insurer threatened its Indiana policyholder that her rates would go "'sky high'" were she to file a claim.[234]

1. The Dual Client Doctrine and First-Party Bad Faith.

To protect its insured's rights and interests when suit is filed, a liability insurer hires defense counsel from a panel of firms with which the carrier regularly works. The result is the creation of a tripartite relationship between the insurer, the insured, and chosen defense counsel.[235] Defense counsel's dual representation in third-party actions may spawn later first-party bad faith claims.[236] The term "dual representation" and the "dual client doctrine" refer to the widespread recognition that insurance defense counsel are deemed to have two clients in any given case—the insured and the insurer.[237] When a conflict of interest arises and defense counsel advances the insurer's interests to the insured's detriment, the

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230 *See, e.g.*, Filasky v. Preferred Risk Mut. Ins. Co., 734 P.2d 76, 83 (Ariz. 1987) (months of delay included "such dilatory tactics as not returning [insured's] telephone calls, ignoring her pleas for personal assistance in completing forms, repeating requests with which [the insured] had already complied, and rejecting her claims but providing no reasons for doing so.").

231 Kornblum et al., *supra* note 152, at 1266.

232 Thomas v. Farm Bureau Ins. Co. of Ark., 698 S.W.2d 508, 509 (Ark. 1985).

233 Viking Ins. Co. of Wis. v. Jester, 836 S.W.2d 371, 374 (Ark. 1992).

234 Liberty Mut. Ins. Co. v. Parkinson, 487 N.E.2d 162, 166 (Ind. Ct. App. 1985), *reh'g denied*, 491 N.E.2d 229 (Ind. Ct. App. 1986).

235 *See, e.g.*, American Mut. Liab. Ins. Co. v. Superior Court, 113 Cal. Rptr. 561, 571 (Ct. App. 1974). "The three parties may be viewed as a loose partnership, coalition or alliance directed toward a common goal, sharing a common purpose" during the pendency of the litigation.

236 *See* Palmer v. Farmers Ins. Exch., 861 P.2d 895, 905 (Mont. 1993).

237 The existence of an attorney-client relationship between a liability insurer and the attorney it hires to defend its insured has been recognized by numerous courts. *See, e.g.*, Chi of Alaska, Inc. v. Employers Reins. Corp., 884 P.2d 1113, 1116 (Alaska 1993); Pennsylvania Ins. Guar. Ass'n v. Sikes, 590 So. 2d 1051, 1052 (Fla. Dist. Ct. App. 1991); Hartford Accident & Indem. Co. v. Foster, 528 So. 2d 255, 268 (Miss. 1988); Mitchum v. Hudgens, 533 So. 2d 194, 198 (Ala. 1988); Bogard v. Employers Cas. Co., 210 Cal. Rptr. 578, 582 (Ct. App. 1985); Central Nat'l Ins. Co. of Omaha v. Medical Protective Co., 107 F.R.D. 393, 394-95 (E.D. Mo. 1985); Nandorf v. CNA Ins. Cos., 479

insurer is guilty of first-party bad faith. An insurer whose counsel defends its insured while simultaneously advancing the insurer's interest is usually estopped from asserting coverage defenses, or is deemed to have waived them. Of course, an offending insurer may still incur considerable excess liability.

The most common conflict of interest arises where an insurer defends under a reservation of rights. There always exists the possibility that a liability insurer that reserves its rights has a diminished interest in its insured's defense, since it might later prevail on the coverage issue.[238] Not every defense under a reservation of rights creates a conflict of interest.[239] A conflict certainly arises, however, if counsel hired by the insurer can control the outcome of attendant coverage issues.[240]

This bad faith category is often overlooked. This is unfortunate, because first-party bad faith premised on a conflict of interest is particularly troubling. The insurer is exploiting the insured's trust in counsel and the attorney-client relationship, including privileged communications, to advance its own financial interest.

In *Parsons v. Continental National American Group*,[241] the insurer, CNA, hired counsel to defend its insureds, the Smitheys, in connection with their son's alleged assault on three neighbors. At the time they filed suit, the plaintiffs made a settlement demand within policy limits which CNA rejected. The defense attorney hired by CNA later obtained the Smithey boy's confidential file from the juvenile facility where he was incarcerated, and determined that his attack was deliberate and made knowingly. It therefore followed, the attorney told CNA, that the assault was intentional.[242] The CNA claims representative then issued a reservation of rights letter, informing the Smitheys that their son's assault may have been intentional and that their policy specifically excluded liability for intentional acts resulting in bodily injury.[243] The case proceeded to trial and the court directed a $50,000 verdict for the plaintiffs, which exceeded the Smitheys' $25,000 policy limits. Judgment was entered in the verdict amount.

N.E.2d 988, 991 (Ill. App. Ct. 1985); Lieberman v. Employers Ins. of Wausau, 419 A.2d 417, 423-25 (N.J. 1980).

238 *See* Missouri *ex rel.* Rimco, Inc. v. Dowd, 858 S.W.2d 307, 308 (Mo. Ct. App. 1993).

239 Blanchard v. State Farm Fire & Cas. Co., 2 Cal. Rptr. 2d 884, 887 (Ct. App. 1991); Johnson v. Continental Cas. Co., 788 P.2d 598, 600-01 (Wash. Ct. App. 1990).

240 *Blanchard*, 2 Cal. Rptr. 2d at 887.

241 550 P.2d 94 (Ariz. 1976).

242 *See id.* at 96.

243 *Id.*

The plaintiffs garnished CNA, which responded by offering its $25,000 policy limits. The plaintiffs declined CNA's offer. CNA successfully defended the garnishment action by asserting its intentional acts exclusion. The same attorney that represented the Smitheys at trial defended CNA in the garnishment action.[244]

The plaintiffs contended on appeal that CNA was estopped from denying coverage and waived its intentional acts exclusion because it exploited defense counsel's fiduciary relationship with the Smitheys' son.[245] The *Parsons* court agreed. Observing that the defense attorney obtained privileged and confidential information by virtue of the attorney-client relationship, the court stated:

> When an attorney . . . uses the confidential relationship between an attorney and a client to gather information so as to deny the insured coverage under the policy . . . we hold that such conduct constitutes a waiver of any policy defense, and is so contrary to public policy that the insurance company is estopped as a matter of law from disclaiming liability under an exclusionary clause in the policy.[246]

CNA was ultimately responsible for the entire amount of the judgment.[247]

Even more egregious conduct was exposed in *Employers Casualty Co. v. Tilley*.[248] The *Tilley* insurer filed a declaratory judgment action seeking a determination that its insured's late notice relieved it of any obligation to defend an underlying personal injury action.[249]

Prior to filing the declaratory judgment action, Employers obtained a non-waiver agreement from Tilley and hired counsel to defend the personal injury action. Defense counsel knew of Employers' late notice contention and of the insured's explanation for why he did not notify the insurer earlier. For nearly 18 months, the defense attorney represented Tilley while simultaneously and secretly developing evidence for employers on the coverage question.[250] The attorney took witness statements from five of the insured's employees to establish their knowledge of the accident and related communications with Tilley (contrary to Tilley's stated position); briefed the legal question of the late notice for Employers

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244 *Id.* at 97.
245 *Id.*
246 *Id.* at 99.
247 *Id.* at 99-100.
248 496 S.W.2d 552 (Tex. 1973).
249 *Id.* at 554.
250 *Id.*

without informing Tilley; interviewed two independent witnesses at the insurer's request to establish late notice; and wrote numerous letters and had multiple conversations with the insurance company pertaining to the development of its coverage defense, suggesting additional investigation, and offering legal advice.[251] This conduct became the basis for the declaratory judgment action filed by separate counsel.

The Texas Supreme Court concluded that under the circumstances it would be "untenable" to permit the insurer to disclaim its defense obligation based on late notice.[252] The question was not whether Employers' late notice defense was valid, but whether it was improperly developed. Because the insurer's conduct violated the "guiding principles and public policy" governing the insurer-insured relationship, the *Tilley* court held that Employers was estopped from denying its contractual duties.[253]

C. *Unfair Claims Practices Statutes.*

Many states have enacted unfair claims practices statutes.[254] Generally, these statutes and the causes of action they create or permit frequently preempt or supplant common law first-party bad faith actions.[255] Other states protect insureds from insurer miscon-

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251 *Id.* at 556.

252 *Id.* at 560.

253 *Id.*

254 *See, e.g.*, ALA. CODE § 27-12-24 (1975); ALASKA STAT. § 21.36.125 (1962); ARIZ. REV. STAT. ANN. § 20-461 (West 1993 Cum. Supp); CAL. INS. CODE § 790.03 (West 1993); COLO. REV. STAT. § 10-3-1104 (West 1987); CONN. GEN. STAT. § 38a-816(6) (West 1992); DEL. CODE ANN. tit. 18, § 2304(16) (1989); FLA. STAT. ANN. § 624.155 (West 1984); HAW. REV. STAT. § 431-643 (1985); IDAHO CODE § 41-1329 (1991); 215 ILL. ANN. STAT. 5/154.6 (West's Smith-Hurd 1993) (formerly ch. 73, para. 766.6 (Smith-Hurd 1991)); IND. CODE § 27-4-1-4.5 (West 1992); IOWA CODE § 507B.4(9) (West 1988); KAN. STAT. ANN. § 40-2404 (1993); ME. REV. STAT. ANN. tit. 24-A, § 2536-A (West 1990); MINN. STAT. § 72A.20 (West 1986); MO. REV. STAT. § 375.936 (West 1988); MONT. CODE ANN. § 33-18-201 (1993); NEB. REV. STAT. § 44-1525 (1988); NEV. REV. STAT. § 686A.310 (1991); N.M. STAT. ANN. § 59A-16-20 (1992); N.Y. INS. LAW. § 2601 (West 1985); N.C. GEN. STAT. § 58-63-15(11) (1993); N.D. CENT. CODE § 26.1-04-03 (1989); OR. REV. STAT. § 746.230 (1993); 40 PA. CON. STAT. ANN. § 1171.1 (West 1992); S.C. CODE ANN. § 38-59-20 (Law. Co-op. 1985); TENN. CODE ANN. § 56-8-104(8) (1993 Supp.); TEX. INS. CODE ANN. § 21.21-2 (West 1981); VT. STAT. ANN. tit. 8, § 4724(9) (1993); VA. CODE ANN. § 38.2-510 (Michie 1990); W. VA. CODE § 33-11-4(9) (1992).

255 *See* Bageanis v. American Bankers Life Assur. Co. of Fla., 783 F. Supp. 1141, 1149 (N.D. Ill. 1992) (Illinois statute does not confer private right of action); Kramer v. State Farm Fire & Cas. Ins. Co., 603 A.2d 192, 194 (Pa. Super. Ct. 1992); Hollar v. International Bankers Ins. Co., 572 So. 2d 937, 939 (Fla. Dist. Ct. App. 1990) (Florida statute creates first-party bad faith cause of action), *review dismissed*, 582 So. 2d 624 (Fla. 1991); Duncan v. Andrew County Mut. Ins. Co., 665 S.W.2d 13, 19-20 (Mo. Ct.

duct by way of consumer protection statutes.[256] Some jurisdictions specifically define or describe prohibited conduct. By way of example, the Kansas statute enumerates 14 acts or categories of conduct that constitute unfair claim settlement practices by insurers.[257]

Unfair claim practices statutes frequently prohibit "vexatious conduct" by insurers. The Missouri statute is typical:

> 375.420. Vexatious refusal, to pay claim damages for, exception. — In any action against any insurance company to recover the amount of any loss under a policy of automobile, fire, cyclone, lightning, life, health, accident, employers' liability, burglary, theft, embezzlement, fidelity, indemnity, marine or other insurance except automobile liability insurance, if it appears from the evidence that such company has refused to pay such loss without reasonable cause of excuse, the court or jury may, in addition to the amount thereof and interest, allow the plaintiff damages not to exceed twenty percent of the first fifteen hundred dollars of the loss, and ten percent of the amount of the loss in excess of fifteen hundred dollars and a reasonable attorney's fee; and the court shall enter judgment for the aggregate sum found in the verdict.[258]

In order to recover for an insurer's vexatious refusal to pay a first-party claim, an insured must demonstrate that the insurer's refusal was "willful and without reasonable cause."[259] This determination is made by applying a "reasonable and prudent person" test.[260] As is true generally, where there exists open questions of law or fact, an insurer may insist on their judicial determination without fear of penalty.[261] An insurer's rightful refusal to pay a claim will not subject it to statutory liability.[262] Thus, statutory standards sometimes differ little from the common law standard of unreasonableness.

App. 1983) (first-party common law cause of action preempted); Spencer v. Aetna Life & Cas. Ins. Co., 611 P.2d 149, 156-58 (Kan. 1980) (Kansas statute preempts first-party bad faith claims). *But see* Belco Pet. Corp. v. AIG Oil Rig, Inc., 565 N.Y.S.2d 776, 777-81 (1991) (New York unfair claim settlement practices statute did not preempt common law punitive damage claim).

256 *See, e.g.*, MASS. GEN. LAWS ANN. ch. 93A, § 2 (West 1984); N.H. REV. STAT. ANN. § 358-A: 2 (1984).

257 KAN. STAT. ANN. § 40-2404(9) (1993).

258 MO. REV. STAT. § 375.420 (West 1988).

259 Oliver v. Cameron Mut. Ins. Co., 866 S.W.2d 865, 870 (Mo. Ct. App. 1993).

260 Tate v. Golden Rule Ins. Co., 859 S.W.2d 831, 834 (Mo. Ct. App. 1993).

261 Mears v. Columbia Mut. Ins. Co., 855 S.W.2d 389, 394 (Mo. Ct. App. 1993); *see, e.g.*, Guity v. Commerce Ins. Co., 631 N.E.2d 75, 76-78 (Mass. App. Ct. 1994) (statutory right to multiple damages and attorneys' fees at issue).

262 Hermitage Ins. Co. v. Action Marine, Inc., 816 F. Supp. 1280, 1286 (N.D. Ill. 1993) (discussing Illinois statute).

The foregoing generalities aside, statutory enactments have proven to be a practical nightmare. Unfair claims practices statutes cause concern and confusion because their effects vary so widely between states. Such statutes have been held on one extreme to create a private right of action in addition to the common law right of action for bad faith and, in the other extreme, to preempt a cause of action for first-party bad faith.[263] Those courts recognizing private causes of action under unfair claims settlement practices statutes probably did not anticipate the complex pleading and proof problems their decisions would raise.[264] What a plaintiff must plead and prove in order to recover for an unfair claims practices act violation is in many jurisdictions among the most complicated and unsettled areas of insurance law.[265] As for consumer protection statutes, they vary so greatly that it is impossible to generalize about their application to insurance claims disputes.[266] Whether a consumer protection statute applies frequently turns on the definitions of "goods" or "services" as including insurance, and on whether an aggrieved insured is a "consumer" within the meaning of the statute.

While only insureds and third-party beneficiaries generally have standing to pursue common law bad faith claims, unfair claims practices acts usually encompass a wider range of potential plaintiffs.[267] The greatest effect of unfair claims practices statutes, however, is felt in their range of permitted damages and especially their preemption of punitive damages. Most statutes limit a plaintiff's recovery to interest and prescribed penalties on top of (and often based on) policy proceeds. Additionally, with statutory claims or causes of action often comes the ability to recover attorneys' fees.[268] The potential recovery of attorneys' fees is significant because, under the "American rule," each party bears its own costs absent contractual or statutory provision to the contrary.[269] Most jurisdictions follow the American rule in bad faith cases.[270]

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263 STEPHEN S. ASHLEY, BAD FAITH ACTIONS § 9:02 (1993).

264 *Id.* § 9:04.

265 *Id.*

266 *Id.* § 9:13.

267 *See id.* § 9:08.

268 *See, e.g.*, Daney v. Haynes, 630 So. 2d 949, 954-55 (La. Ct. App. 1993); Knasel v. Insurance Co. of Ill., 627 N.E.2d 137, 140 (Ill. App. Ct. 1993).

269 *See* Alyeska Pipeline Serv. Co. v. Wilderness Soc'y, 421 U.S. 240, 247 (1975).

270 Guy O. Kornblum, *Defending An Insurance Bad Faith Action in the 1990's: Strategy and Tactics*, Insurance: Third Party Liability Problems Seminar (Defense Research Inst., Philadelphia, PA.), June 20-21, 1991, at E-1, E-25 (materials on file with the author); *see, e.g.*, Kuhn v. Allstate Ins. Co., 510 N.W.2d 826, 831 (Wis. Ct. App. 1993).

V. AFFIRMATIVE DEFENSES AVAILABLE TO INSURERS

Although insurers frequently are on the losing end of bad faith claims, they are not defenseless. An insurer may of course raise universal defenses, such as the statute of limitations,[271] and the plaintiff's failure to state a claim upon which relief can be granted. Insurers also have available affirmative defenses specifically identified with the industry, including their reliance on the advice of counsel, their privilege to consider their own interests, and the insured's failure to cooperate. Health, life and disability insurers providing group coverage may be able to defend common law first-party bad faith actions and statutory claims based on their preemption by federal law.

But see Olympic S.S. Co. v. Centennial Ins. Co., 811 P.2d 673, 681 (Wash. 1991) ("[A]n award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of [the] insurance contract, regardless of whether the insurer's duty to defend is at issue."); Carpenter v. Federal Ins. Co., 637 A.2d 1008, 1012-13 (Pa. Super. Ct. 1994) (insured recovered fees from defense of underlying action and declaratory judgment suit); Estate of Jordan v. Hartford Accident & Indem. Co., 844 P.2d 403, 413-14 (Wash. 1993) (awarding attorneys' fees to insured's assignee).

[271] It is important to determine when a limitation period begins to run. With respect to third-party claims for failure to settle within policy limits, the cause of action accrues when the excess judgment against the insured becomes final. Tibbs v. Great Am. Ins. Co., 755 F.2d 1370, 1375 (9th Cir. 1985) (California law); Sandbulte v. Farm Bureau Mut. Ins. Co., 343 N.W.2d 457, 463 (Iowa 1984); Torrez v. State Farm Mut. Auto. Ins. Co., 705 F.2d 1192, 1202 (10th Cir. 1982). In the first-party context, the limitation period starts when the insurer denies the claim. Brown v. Liberty Mut. Ins. Co., 513 N.W.2d 762, 764 (Iowa 1994) (workers' compensation claim); Matsumoto v. Republic Ins. Co., 792 F.2d 869, 871 (9th Cir. 1986) (California law); Safeco Ins. Co. of Am. v. Sims, 435 So. 2d 1219, 1222 (Ala. 1983).

Another issue surrounding first-party claims is whether a bad faith action is an action "on the policy" for purposes of applying the one-year limitation period specified in most policies. Colorado, Ohio, Oklahoma, Washington and Wisconsin courts have concluded that bad faith actions are *not* limited by a policy's time-to-sue provision. Flickinger v. Ninth Dist. Prod. Credit Ass'n, 824 P.2d 19, 24 (Colo. Ct. App. 1991); Plant v. Illinois Employers Ins. of Wausau, 485 N.E.2d 773, 775 (Ohio Ct. App. 1984); Lewis v. Farmers Ins. Co., 681 P.2d 67, 69-70 (Okla. 1983); Simms v. Allstate Ins. Co., 621 P.2d 155, 158 (Wash. Ct. App. 1980); Warmka v. Hartland Cicero Mut. Ins. Co., 400 N.W.2d 923, 924-25 (Wis. 1987). Arizona, Iowa, and Connecticut courts have reached the opposite conclusion. Home Fed. Sav. & Loan Ass'n v. Dooley's of Tucson, Inc., 716 P.2d 1042, 1046 (Ariz. Ct. App. 1985); Stahl v. Preston Mut. Ins. Ass'n, 517 N.W.2d 201, 204 (Iowa 1994); Hawley Enterprises, Inc. v. Reliance Ins. Co., 621 F. Supp. 190, 191-93 (D. Conn. 1985), *aff'd*, 788 F.2d 5 (2d Cir. 1986). California courts do not know what to do. It appears to be the law in California that bad faith actions are not ordinarily actions on the policy. Associates Nat'l Mortgage Corp. v. Farmers Ins. Exch., 266 Cal. Rptr. 56, 58-60 (Ct. App. 1990). At the same time, if the subject claim is "'fundamentally a claim on the policy,'" or is a "transparent attempt" to avoid the contractual limitation period, the one-year provision controls. Magnolia Square Homeowners Ass'n v. Safeco Ins. Co. of Am., 271 Cal. Rptr. 1, 9 (Ct. App. 1990); Prieto v. State Farm Fire & Cas. Co., 275 Cal. Rptr. 362, 366 (Ct. App. 1990).

A. Advice of Counsel.

"An insurer may defend itself against allegations of bad faith and malice in claims handling with evidence the insurer relied on the advice of competent counsel."[272] The advice of counsel defense is offered to prove that the insurer acted reasonably or had proper cause for its actions, even though the advice it received proves erroneous or unsound.[273] If an insurer intends to rely on advice of counsel as a bad faith claim defense, that advice becomes an issue of fact and the plaintiff is entitled to discover whether an opinion was obtained, its content and what conduct was advised.[274] Thus, assertion of the defense constitutes a limited waiver of the attorney-client privilege.[275] Whether the defense waives the work-product doctrine remains unsettled.

It is an open question whether an insurer's claimed reliance on its counsel's advice is a true affirmative defense, or simply a factor to be weighed when evaluating the reasonableness of the insurer's conduct. In *Boston Symphony Orchestra, Inc. v. Commercial Union Insurance Co.*,[276] the Massachusetts Supreme Court apparently treated Commercial Union's reliance on the advice of counsel as an absolute defense.[277] The Colorado Court of Appeals took the same approach in *Brandon v. Sterling Colorado Beef Co.*.[278] It appears to be the majority rule, however, that an insurer's reliance on counsel is but one bad faith factor. In *Larsen v. Allstate Insurance Co.*,[279] the Utah Court of Appeals held that the insurer's reliance on the advice of counsel was one factor suggesting that the claim was fairly debatable, thus absolving Allstate of bad faith liability.[280] A California court held in *State Farm Mutual Automobile Insurance Co. v. Superior Court*[281] that advice of counsel need not be affirmatively alleged as a defense.[282] *State Farm* thus suggests that advice of counsel is but one factor to be considered when evaluating an in-

272 State Farm Mut. Auto. Ins. Co. v. Superior Court, 279 Cal. Rptr. 116, 117 (Ct. App. 1991).

273 *Id.* at 118.

274 Vicinanzo v. Brunschwig & Fils, Inc., 739 F. Supp. 891, 894 (S.D.N.Y. 1990).

275 Transamerica Title Ins. Co. v. Superior Court, 233 Cal. Rptr. 825, 829 (Ct. App. 1987); *see Vicinanzo*, 739 F. Supp. at 894.

276 545 N.E.2d 1156 (Mass. 1989).

277 *See id.* at 1160.

278 827 P.2d 559, 560-61 (Colo. Ct. App. 1991).

279 857 P.2d 263 (Utah Ct. App.), *cert. denied*, 862 P.2d 1356 (Utah 1993).

280 857 P.2d at 266.

281 279 Cal. Rptr. 116 (Ct. App. 1991).

282 *Id.* at 119. *But cf.* Worden v. Tri-State Ins. Co., 347 F.2d 336, 340 (10th Cir. 1965) (insurer waived advice of counsel affirmative defense by not raising it in its answer).

surer's conduct. This approach is similarly indicated by the Alabama Supreme Court's discussion in *Davis v. Cotton States Mutual Insurance Co.*.[283] On the other side of the coin, an insurer's rejection of its attorney's advice may evidence its bad faith.[284]

Good faith reliance on the advice of counsel may help an insurer avoid punitive damages for its bad faith conduct. In *Gorman v. Southeastern Fidelity Insurance Co.*,[285] the insurer denied coverage based on the opinion of outside counsel.[286] A pertinent statute was unclear and there was a dearth of case law on point. It turned out that its attorney's opinion and advice were incorrect. The *Gorman* court held that Southeastern Fidelity was entitled to rely on the advice of counsel, thereby defeating the plaintiff's punitive damage claim.[287] The court in *Melorich Builders, Inc. v. Superior Court*[288] held that a complete defense exists to a claim of outrageous conduct when the evidence proves that (1) the defendant acted on the advice and opinion of counsel; (2) counsel's advice was based on full disclosure and factual familiarity with the case; and (3) the defendant's reliance on the counsel's advice was in good faith.[289] The *Melorich Builders* reasoning should apply to the intent required for punitive damages.

If an insurer does not assert its reliance on the advice of counsel when its conduct is challenged, an attorney's advice is immaterial to any bad faith inquiry.[290] An insurer that does not provide its counsel with all facts or information necessary to offer an accurate opinion or advice cannot invoke the defense.[291] Similarly, an insurer cannot bootstrap its incorrect coverage decision by later consulting with counsel.[292] The insurer in *Beacon National Insurance Co. v. Reynolds*[293] wrongfully denied its insured's homeowners claim. The insured complained to the State Board of Insurance.

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283 604 S.2d 354, 359 (Ala. 1992).

284 *See, e.g.*, Thompson v. Commercial Union Ins. Co. of N.Y., 250 So. 2d 259, 260 (Fla. 1971); Kinder v. Western Pioneer Ins. Co., 42 Cal. Rptr. 394, 398-99 (Ct. App. 1965). For a cynical discussion of an insurer's reliance on the advice of counsel, see Lozier v. Auto Owners Insurance Co., 951 F.2d 251, 255-56 (9th Cir. 1991) (Arizona law).

285 775 F.2d 655 (5th Cir. 1985) (interpreting Mississippi law).

286 *See id.* at 657.

287 *Id.* at 659-60.

288 207 Cal. Rptr. 47 (Ct. App. 1984).

289 *Id.* at 50.

290 Aetna Cas. & Sur. Co. v. Superior Court, 200 Cal. Rptr. 471, 475 (Ct. App. 1984).

291 *See, e.g.*, Insurance Co. of N. Am. v. Smith, 375 S.E.2d 866, 868-70 (Ga. Ct. App. 1988).

292 *See* Employers Mut. Cas. Co. v. Tompkins, 490 So. 2d 897, 900-05 (Miss. 1986).

293 799 S.W.2d 390 (Tex. Ct. App. 1990).

Months after denying the claim, and only then in response to the Board's demand, Beacon National sought the advice of counsel.[294] The insurer attempted to introduce its lawyer's letter at trial to evidence its reasonable refusal of coverage and reliance on counsel.[295] The trial court refused to permit the letter's introduction and the Texas Court of Appeals affirmed. The *Beacon* court reasoned that the insurer could not have relied on its counsel's advice in good faith given the timing of the letter.[296]

An insurer cannot avoid extracontractual liability by claiming reliance on advice that it knew or had reason to know was incorrect.[297] The majority rule always permits a court to inquire into whether it was reasonable under the circumstances for the insurer to rely on the advice of counsel.

B. The Insurer's Privilege to Consider its Own Interests.

To justify its conduct and therefore escape liability, an insurer may assert its privilege to act in its own best economic interests.[298] This claimed privilege may be explained as follows:

> Privilege is the modern term for the early common-law defenses of justification or excuse to intentional torts. Generally, privilege is synonymous with the exercise of the defendant's right to further an interest of social importance that is entitled to protection, even if it causes harm to the plaintiff. As applied to insurance, it pertains to social interests that are served when the privilege is exercised in connection with settlement negotiations.[299]

Insofar as an insurer's conduct is attributable to its good faith efforts to resolve a claim, its activities are privileged.[300] An insurer's claim of privilege is therefore coextensive with the principle that insurers generally are not liable for exploring their legal obligations in connection with "fairly debatable" claims. Indeed, ascribing a privilege to insurers may be no more than a purely academic or intellectual exercise.

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294 *Id.* at 397.

295 *Id.*

296 *Id.*

297 *See* Allen v. Allstate Ins. Co., 656 F.2d 487, 489-90 (9th Cir. 1981) (insurer's reliance on the obviously poor strategic advice of defense counsel did not shield it from bad faith claim under California law).

298 JOHN C. MCCARTHY, 1 RECOVERY OF DAMAGES FOR BAD FAITH § 1.20 (5th ed. 1990).

299 *Id.* § 1.20 (citation omitted).

300 Pittman v. Republic Franklin Ins. Co., 787 F. Supp. 151, 152 (S.D. Ind. 1992) (quoting Vernon Fire & Cas. Ins. Co. v. Sharp, 349 N.E.2d 173, 181 (Ind. 1976)).

Many jurisdictions have adopted the "directed verdict rule," under which an insured must be entitled to a directed verdict on a breach of contract claim in order to avoid a directed verdict for the insurer on a bad faith cause of action.[301] An insurer does not commit bad faith by forcing an insured to seek legal redress, so long as the insurer's position is grounded in fact or law.[302] Where there is no bona fide factual or legal issue, however, compelling insureds to litigate their entitlement to insurance proceeds may constitute bad faith or vexatious refusal.[303]

C. *The Insured's Failure to Cooperate.*

Cooperation clauses in insurance policies obligate insureds to assist insurers in the conduct and defense of third-party actions.[304] In the third-party context, the insured's duty to cooperate "is essentially the flipside of the insurer's duty to defend."[305] In any given case an insured must attend depositions, hearings and trial; provide evidence, or assist in discovery; cooperate in or support settlement negotiations; and enforce the insurer's subrogation rights.[306] First-party insurance policies do not explicitly state that the insured "shall cooperate," instead imposing specific obligations on the insured that effectively require the insured's cooperation. Insureds are routinely required to facilitate the insurer's inspection of property, give recorded statements, submit to examinations under oath, and produce otherwise confidential documents or records.[307] An

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301 *See* United States Fidelity & Guar. Co. v. Wigginton, 964 F.2d 487, 492 (5th Cir. 1992) (Mississippi law); Burkett v. Burkett, 542 So. 2d 1215, 1218-19 (Ala. 1989); Corrente v. Fitchburg Mut. Fire Ins. Co., 557 A.2d 859, 861-63 (R.I. 1989). The directed verdict rule is also known as the "*Dutton* rule," attributable to its announcement by the Alabama Supreme Court in National Savings Life Insurance Co. v. Dutton, 419 So. 2d 1357, 1362 (Ala. 1982).

302 *See* McCarthy, *supra* note 298, at § 1.20 (1991 Supp.).

303 *See, e.g.*, Norman v. American Nat'l Fire Ins. Co., 555 N.E.2d 1087, 1100-1111 (Ill. App. Ct. 1990).

304 *In re* Environmental Ins. Declaratory Judgment Actions, 259 N.J. Super. 308, 316, 612 A.2d 1338, 1342 (App. Div. 1992).

305 Jerry, *supra* note 31, at 555.

306 "[I]nsureds are generally required to provide all such information and assistance as the insurer may require." *In re Environmental Insurance*, 308 N.J. Super. at 316, 612 A.2d at 1342.

307 *See generally* State Farm Fire & Cas. Co. v. Walker, 459 N.W.2d 605, 609 (Wis. Ct. App.) (Fifth Amendment did not prevent insured from answering insurer's arson-related questions under oath), *review denied*, 465 N.W.2d 655 (Wis. 1990); West v. State Farm Fire & Cas. Co., 868 F.2d 348, 350-52 (9th Cir. 1989) (when insured could not document loss, insurer rightfully insisted on examination); Ransom v. Selective Ins. Co., 229 N.J. Super. 43, 47-48, 550 A.2d 1006, 1008 (Law Div. 1988) (insured required to submit to examination under oath and to produce various financial records, including tax returns); Stover v. Aetna Cas. & Sur. Co., 658 F. Supp. 156, 160-61 (S.D.

insured may also be required to submit to a physical examination by a doctor of the insurer's choice.[308]

An insurer has the right to require its insured to comply with its policy terms, including the cooperation clause.[309] The insured's and the insurer's obligations under the cooperation clause are reciprocal.[310] The insured must not only cooperate with the insurer, but the insurer must also exercise reasonable diligence in obtaining the cooperation of the insured.[311] The insurer's required diligence is significant. In *DiMarzo v. American Mutual Insurance Co.*,[312] for example, the Massachusetts Supreme Court held that insurers have "a duty to take affirmative steps to secure the cooperation of a *vanished policyholder*."[313]

If an insured substantially and materially breaches the duty to cooperate, and if that breach prejudices the insurer, the insurer's obligations are terminated.[314] An insured's failure to cooperate certainly provides a defense to a bad faith claim following the insurer's conclusion of its investigation or withdrawal of a defense.[315] The key analytical element is prejudice to the insurer.[316] Whether an insurer has been prejudiced is ordinarily a question of fact.[317]

It is impossible to formulate a bright line rule relative to particular acts as evidence of an insured's failure to cooperate and their prejudicial effect. In only extreme cases does demonstrating

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W. Va. 1987) (plaintiff's vague answers in examination and failure to produce tax returns amounted to non-cooperation, entitling insurer to summary judgment).

308 *See, e.g.*, Lockwood v. Porter, 390 S.E.2d 742, 743 (N.C. Ct. App. 1990).

309 Diamonds & Denims, Inc. v. First of Ga. Ins. Co., 417 S.E.2d 440, 441 (Ga. Ct. App. 1992).

310 *See* American Guar. and Liab. Ins. Co. v. Chandler Mfg. Co., 467 N.W.2d 226, 229 (Iowa 1991).

311 *Id.* at 229; Shelter Mut. Ins. Co. v. Page, 873 S.W.2d 534, 536 (Ark. 1994); Bowyer v. Thomas, 423 S.E.2d 906, 911 (W. Va. 1992).

312 449 N.E.2d 1189 (Mass. 1983).

313 *Id.* at 1199 (emphasis added).

314 *Compare* S.G. v. St. Paul Fire & Marine Ins. Co., 460 N.W.2d 639, 643 (Minn. Ct. App. 1990) ("must be a substantial *and* material breach . . . .") (emphasis added); Brown v. Employers Reins. Corp., 539 A.2d 138, 142 (Conn. 1988) (requiring "the substantial *or* material breach of the cooperation provisions . . . .") (emphasis added).

315 *See* Cherry v. Anthony, Gibbs, Sage, 501 So. 2d 416, 420 (Miss. 1987) ("[I]t is difficult to see how the insurance adjuster can be faulted for bad faith when it is clear that the [insureds] did not cooperate with him in his investigation.").

316 *See* Chemical Leaman Tank Lines, Inc. v. Aetna Cas. & Sur. Co., 817 F. Supp. 1136, 1160 (D.N.J. 1993); King v. Federal Ins. Co., 788 F. Supp. 506, 506-07 (D. Kan. 1992), *aff'd*, 996 F.2d 311 (10th Cir. 1993); Pickwick Park Ltd. v. Terra Nova Ins. Co., 602 A.2d 515, 518-19 (R.I. 1992).

317 Sequoia Ins. Co. v. Royal Ins. Co. of Am., 971 F.2d 1385, 1394 (9th Cir. 1992); Gabor v. State Farm Mut. Auto. Ins. Co., 583 N.E.2d 1041, 1043 (Ohio Ct. App. 1990).

prejudice pose few difficulties.[318] If the insurer can show that the insured's cooperation would have allowed it to negate liability, prejudice will be demonstrated.[319] In first-party cases, an insured's refusal to produce records or to submit to an examination under oath generally invalidates coverage. In a third-party case the subsequent discovery of key evidence or witnesses previously unknown because of the insured's failure to cooperate might be sufficient to establish that the outcome would have been different had the insured cooperated.[320]

The plaintiff in *McNicholes v. Subotnik*[321] sued her psychologist after they became involved in a sexual relationship while she was a patient. The psychologist, Subotnik, tendered the matter to St. Paul Fire & Marine Insurance Co., his malpractice carrier. St. Paul hired defense counsel for Subotnik, but denied coverage and defended under a reservation of rights.[322] Before trial, McNicholes notified the attorney hired by St. Paul that she wanted to settle the case. St. Paul continued to deny coverage and declined to negotiate with the plaintiff.[323] Curiously, St. Paul did not file a declaratory judgment action. McNicholes then informed St. Paul that she intended to negotiate directly with Subotnik.[324] Subsequently, McNicholes and Subotnik settled the case for $650,000. McNicholes stipulated that she would only attempt to collect from St. Paul.[325]

McNicholes garnished St. Paul, which responded by denying coverage and alleging that the settlement was void. St. Paul contended that the settlement was void because Subotnik breached his duty to cooperate by negotiating directly with the plaintiff, and because the settlement was the product of fraud and collusion.[326] The plaintiff successfully moved for summary judgment on St. Paul's claims and the insurer appealed.[327]

The *McNicholes* appellate panel affirmed the district court. Although Subotnik had a duty to cooperate with St. Paul, the court observed, he also had a right to protect himself against the plain-

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318 JERRY, *supra* note 31, at 425.
319 *Id.*
320 *Id.*
321 12 F.3d 105 (8th Cir. 1993).
322 *Id.* at 107.
323 *Id.*
324 *Id.*
325 *Id.*
326 *Id.*
327 *Id.*

tiff's claim.[328] "When an insurer denies coverage, an insured defendant does not breach his duty to cooperate by entering [into] a settlement with the plaintiff that serves the insured's best interests; indeed, the defendant is expected to do so."[329] While it may superficially appear unfair to the insurer to allow the insured to negotiate a one-sided settlement using the insurer's money, an insurer is not without recourse.[330] An insurer can obtain a judicial determination as to whether coverage exists and can attack a settlement agreement as being fraudulent or collusive.[331] Certainly, settlements that result from fraud or that are the product of collusion are void and unenforceable. As the *McNicholes* court was quick to note, St. Paul never pursued a declaratory judgment action.

St. Paul produced no evidence that fraud or collusion connected to the settlement. St. Paul could only contend that the settlement was fraudulent or collusive because Subotnik had testified that the amount of the settlement was irrelevant to him, and because Subotnik did not believe that the plaintiff had been damaged.[332] However, McNicholes could substantiate her claimed damages and there was ample evidence of large recoveries in similar cases.[333] In short, Subotnik's subjective beliefs were not evidence of fraud or collusion.[334]

McNicholes reflects the majority view. Facing the prospect of no coverage, insureds may act to protect their own interests and settle cases to their advantage, so long as there is no fraud or collusion.[335] Insureds are not expected to advance insurers' interests to their ultimate detriment in the name of cooperation. Insurers not wishing to be bound by settlements over which they have no control should seek declaratory judgments. Settlements under such circumstances do not impair an insured's rights against an insurer.[336]

Among the more unusual non-cooperation cases is *National Chiropractic Mutual Insurance Co. v. Cannon.*[337] In *Cannon*, chiro-

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328 *See id.* at 108.
329 *Id.*
330 *Id.*
331 *Id.*
332 *Id.* at 109.
333 *Id.*
334 *Id.*
335 Sanchez v. Truck Ins. Exch., 26 Cal. Rptr. 2d 812, 818 (Ct. App. 1994), *modified and reh'g denied*, No. H010911, 1994 WL 58243 (Ct. App. Feb. 25, 1994).
336 Aks v. Southgate Trust Co., 844 F. Supp. 650, 660 (D. Kan. 1994) (applying Kansas law).
337 Nos. 89-15903, 89-16013, 1991 WL 39887 (9th Cir. Mar. 20, 1991).

practor Donald Cannon (Cannon) was sued for malpractice in a California state court. Cannon tendered his defense to National Chiropractic Mutual Insurance Co. (NCMIC). Ultimately, the malpractice plaintiffs prevailed; however, Cannon's conduct significantly contributed to their success. Cannon refused to consent to settlement, fired NCMIC's chosen defense counsel shortly before trial, failed to obtain substitute counsel, attempted to remove the case to federal court, and failed to appear at trial.[338]

NCMIC filed an interpleader action in federal court seeking a declaratory judgment absolving it of liability in excess of its policy limits.[339] Cannon counter-claimed for NCMIC's breach of its duty of good faith and fair dealing.[340] The district court held that NCMIC breached its duty of good faith owed Cannon in connection with the underlying malpractice action by failing to inform him of a conflict of interest and his right to engage independent counsel of his choice.[341] The court further found, however, that Cannon's bizarre conduct constituted a breach of his duty to cooperate in NCMIC's defense.[342] In fact, the court further held that Cannon's conduct was unreasonable as a matter of law and proximately caused the malpractice award.[343] The district court entered summary judgment for NCMIC and the Ninth Circuit Court of Appeals affirmed.[344]

D. Federal Preemption.

Health, life and disability insurers may be able to defend bad faith claims based on their federal preemption[345] under the Employee Retirement Income Security Act (ERISA).[346] Congress en-

338 *Id.* at *2.
339 *Id.* at *1.
340 *Id.*
341 *Id.* at *2.
342 *Id.*
343 *Id.*
344 *Id.* at *2, *3.
345 The Supremacy Clause of the United States Constitution invalidates state laws that are contrary to or interfere with federal law. *See* Arkansas Platte & Gulf Partnership v. Van Waters & Rogers, Inc., 748 F. Supp. 1474, 1477 (D. Colo. 1990). Preemption under the Supremacy Clause occurs when compliance with both state and federal law is impossible, or when the state law stands as an obstacle to accomplishing and executing Congress' full purpose and objective. Jackson v. Rapps, 746 F. Supp. 934, 941 (W.D. Mo. 1990), *aff'd*, 947 F.2d 332, 339 (8th Cir. 1991). A state law is also preempted if it interferes with the methods by which the federal statute was designed to reach this goal. International Paper Co. v. Ouellette, 479 U.S. 481, 496-97 (1987). In determining whether state law is preempted by a federal statute, Congress' intent controls. FMC Corp. v. Holliday, 498 U.S. 52, 56 (1990).
346 29 U.S.C. §§ 1001-1464 (1988).

acted ERISA in 1974 for the primary purpose of protecting retirees' benefits and pensions.[347] ERISA includes one of the most expansive preemption clauses ever enacted.[348] The Act preempts bad faith claims under group insurance policies provided as employee benefit plans.[349] ERISA has spawned a complicated, complex and often confusing body of law unto itself. It generally may be said, however, that if the statutory requirements are met, ERISA preempts common law bad faith causes of action and claims or causes of action arising out of unfair claim settlement practices acts.[350]

Group insurers may also be able to raise preemption under the Federal Employees Health Benefits Act (FEHBA).[351] FEHBA governs federal employees' health benefits plans.[352] State law tort actions arising from the government's handling of an employee's benefits claim may be preempted by FEHBA.[353]

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347 ASHLEY, *supra* note 263, at § 9:14 (1993 Cum. Supp.).

348 PM Group Life Ins. Co. v. Western Growers Assur. Trust, 953 F.2d 543, 545 (9th Cir. 1992).

349 *See* ASHLEY, *supra* note 263, at § 7:24 (1993 Cum. Supp.).

350 Pilot Life Ins. Co. v. Dedeaux, 481 U.S. 41, 57 (1987); *see, e.g.*, Custer v. Pan Am. Life Ins. Co., 12 F.3d 410, 416-20 (4th Cir. 1993); Greany v. Western Farm Bureau Life Ins. Co., 973 F.2d 812, 819 (9th Cir. 1992) (ERISA preempts Montana's unfair claim settlement practices statute); Hogan v. Kraft Foods, 969 F.2d 142, 144-45 (5th Cir. 1992) (ERISA preempted violations of Texas insurance code and common law causes of action); Tingey v. Pixley-Richards West, Inc., 953 F.2d 1124, 1133 (9th Cir. 1992) (Arizona common law bad faith); International Resources, Inc. v. New York Life Ins. Co., 950 F.2d 294, 298-301 (6th Cir. 1991) (ERISA preempts Kentucky common law and statutory claims), *cert. denied*, 112 S. Ct. 2941 (1992); Tomczyk v. Blue Cross & Blue Shield United of Wis., 951 F.2d 771, 775-76 (7th Cir. 1991) (Wisconsin common law bad faith), *cert. denied*, 112 S. Ct. 2274-75 (1992); Gonzales v. Prudential Ins. Co. of Am., 901 F.2d 446, 451-54 (5th Cir. 1990) (ERISA preempts Louisiana statutory claim); Kelley v. Sears, Roebuck & Co., 882 F.2d 453, 455-56 (10th Cir. 1989) (ERISA preempts Colorado common law bad faith and statutory causes of action); Kanne v. Connecticut Gen. Life Ins. Co., 867 F.2d 489, 493-94 (9th Cir. 1988) (ERISA preempts California statutory claim); Kelly v. Pan-American Life Ins. Co., 765 F. Supp. 1406, 1408 (W.D. Mo. 1991) (ERISA preempts Missouri statutory cause of action for vexatious refusal); Bishop v. Provident Life & Cas. Ins. Co., 749 F. Supp. 176, 177-78 (E.D. Tenn. 1990) (ERISA preempted common law breach of contract and bad faith claims brought under Tennessee statute); Duncan v. Provident Mut. Life Ins. Co., 427 S.E.2d 657, 658-59 (S.C. 1991) (ERISA preempts South Carolina common law bad faith cause of action); Ball v. Life Planning Servs., Inc., 421 S.E.2d 223, 227 (W. Va. 1992) (ERISA preempts claims under West Virginia's unfair claim settlement practices statute); Rizzo v. Travelers Ins. Co., 549 N.E.2d 810, 813-14 (Ill. App. Ct. 1989) (ERISA preempted Illinois common law breach of contract and negligence claims).

351 5 U.S.C.A. §§ 8901-13 (1994).

352 Travelers Ins. Co. v. Cuomo, 813 F. Supp. 996, 1009 (S.D.N.Y. 1993), *aff'd in part, rev'd in part*, 14 F.3d 708, 725 (2d Cir. 1993).

353 *See* Burkey v. Government Employees Hosp. Ass'n, 983 F.2d 656, 659-60 (5th Cir. 1993); Hayes v. Prudential Ins. Co. of Am., 819 F.2d 921, 925-26 (9th Cir. 1987), *cert. denied*, 484 U.S. 1060 (1988); Williams v. Blue Cross & Blue Shield of Va., 827 F. Supp.

VI. Comparative Fault, Comparative Bad Faith And Reverse Bad Faith

The implied duty of good faith and fair dealing is mutual; that is, the duty is owed by both insurers and insureds.[354] Both parties should therefore be held to specific standards of conduct during the adjustment,[355] investigation, negotiation and litigation of first-party and third-party claims.[356] Reason dictates that an insurer defending a bad faith claim should be able to raise as an affirmative defense the negligent or bad faith conduct of its insured.[357] As noted by a concurring justice in *Texas Farmers Insurance Co. v. Soriano*:[358]

> [T]he emerging idea of "comparative bad faith" is a logical extension of the notion that the factfinder, in its search for truth, should be able to look at the whole forest and not just a few of the trees. This should include a view of the insured's conduct as well as the insurer's cause of action.[359]

Indeed, the time has come for courts to scrutinize insureds' conduct just as they do insurers'.

A. *Comparative Fault.*

In the bad faith context, comparative fault refers to a comparison of the insured's negligence with the insurer's negligence or willful misconduct.[360] In those states with a bad faith standard more stringent than simple negligence, comparative fault principles seemingly result in an incongruity; specifically, an insured's negligence is being compared with an insurer's willful miscon-

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1228, 1229-30 (E.D. Va. 1993); Barr v. Arkansas Blue Cross & Blue Shield, Inc., 761 S.W.2d 174, 176 (Ark. 1988); Hartenstine v. Superior Court, 241 Cal. Rptr. 756, 763-66 (Ct. App. 1987), *cert. denied*, 488 U.S. 899 (1988). *But see* Eidler v. Blue Cross Blue Shield United of Wis., 671 F. Supp. 1213, 1216-17 (E.D. Wis. 1987) (FEHBA did not preempt Wisconsin bad faith tort claim).

354 Rawlings v. Apodaca, 726 P.2d 565, 569-70 (Ariz. 1986); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985); Commercial Union Assur. Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1041 (Cal. 1980); Modisette v. Foundation Reserve Ins. Co., 427 P.2d 21, 25 (N.M. 1967).

355 The "adjustment" of an insurance claim is a term of art describing the insurer's determination of the amount or extent of the loss, the existence or amount of coverage available to the insured (if any) and, if more than one insurance company is involved, the allocation of costs among carriers. The adjustment of a claim necessarily involves investigation, although the two terms are not necessarily synonymous.

356 Douglas R. Richmond, *Insured's Bad Faith As Shield or Sword: Litigation Relief for Insurers?*, 77 Marquette L. Rev. 41, 50 (1993).

357 *Id.*

358 844 S.W.2d 808 (Tex. Ct. App. 1992).

359 *Id.* at 832 n.2 (Biery, J., concurring).

360 Richmond, *supra* note 356, at 50.

duct.[361] At least two courts have rejected this comparison.[362] California, long a leader in fashioning tort remedies, recognized comparative fault in negligence versus willful misconduct personal injury cases in 1980.[363] Similarly, the comparison of the insured's fault in bad faith cases developed in California.

In 1990, comparative fault as an affirmative defense to an insurer's bad faith was explicitly recognized in *Patrick v. Maryland Casualty Co.*[364] The plaintiff in *Patrick* had homeowner's insurance with Maryland Casualty. In December, 1982, windstorms blew shingles from a portion of the plaintiff's roof. The plaintiff temporarily repaired the roof to prevent further damage, and submitted a claim. The parties' versions of events then diverged. Maryland Casualty claimed that the plaintiff was in no hurry to resolve the claim, communicated no sense of urgency about payment and mailed in the claim instead of hand-delivering it or calling. Maryland Casualty asserted that it acted reasonably promptly once the claim was received.[365] The plaintiff alleged that he told the adjuster with whom he dealt that water was pouring through holes in the roof and that he needed money to make necessary repairs. Things then went from bad to worse, according to the plaintiff:

> [Maryland Casualty], however, forced him to get needless documentation and estimates which caused seemingly endless delays; then told him the check was in the mail; then told him the check must have been lost; and then delayed further in issuing another one. As a result of this delay, three months later in early March of 1983 after further water damage to his house, [plaintiff] called . . . again to complain that he still needed the money, and that water damage to his house was continuing . . . . [Plaintiff], who was a carpenter . . . then got up on the roof again to do the necessary repairs himself. He claimed that [Maryland Casualty's] employee had told him to do this work himself, although he also later admitted that doing the work himself might have been his own idea after all.
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> In any event, once he got up on the roof again, [plaintiff] decided . . . he would need to replace the entire roof . . . . He went out to buy the necessary supplies, then later returned. While he

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361 *Id.*

362 *See, e.g.*, Stumpf v. Continental Cas. Co., 794 P.2d 1228, 1233 (Or. Ct. App. 1989) ("[I]t would be nonsensical to hold that an insured who has bargained away control of his own case nevertheless may be liable for conducting it negligently."); Washington v. Group Hospitalization, Inc., 585 F. Supp. 517, 521 n.6 (D.D.C. 1984).

363 Sorensen v. Allred, 169 Cal. Rptr. 441, 443-46 (Ct. App. 1980).

364 267 Cal. Rptr. 24 (Ct. App. 1990).

365 *Id.* at 26.

> was walking backward on the roof . . . he lost his balance and had to jump eight feet down onto the sidewalk. Both of his heels were severely injured. . . . He presented evidence showing that as a result he has been disabled from his job as a carpenter ever since.[366]

One of the causes submitted to the jury was Maryland Casualty's breach of the implied covenant of good faith and fair dealing.[367] The trial court refused the insurer's request that the jury be instructed to assess the fault of the parties by comparing its bad faith with the plaintiff's negligence.[368] The jury returned a plaintiff's verdict, awarding both compensatory and punitive damages, and Maryland Casualty appealed. The First District Court of Appeal reversed.

The *Patrick* court first noted that while comparative fault had not previously been considered, the absence of precedent was no good reason to reject it.[369] Indeed, most defenses now recognized in tort cases were once novel.[370] Second, the court saw no reason to reject the defense when it was recognized in products liability actions, in which a plaintiff's negligence is compared against a manufacturer's strict liability.[371] While the duty of good faith and fair dealing arises out of a contractual relationship, tort principles govern its breach and the ensuing damages.[372] Third, California courts already allowed the comparison of fault attributable to negligence and willful misconduct in personal injury actions.[373] As in the products liability context, the comparison appeared legally sound.

Finally, the court reasoned that comparative fault should not "be avoided by plaintiff's unilateral manipulation of the mere denomination of his claim where the defendant contends that, if there was any liability at all, it arose as a result of negligence; and where that theory is supported by the evidence."[374] The *Patrick* court thus concluded that comparative negligence may be an af-

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366 *Id.*

367 *See id.*

368 *Id.* at 27.

369 *Id.* at 28.

370 *Id.* (quoting California Cas. Gen. Ins. Co. v. Superior Court, 218 Cal. Rptr. 817, 821 (1985)).

371 *Id.*

372 *Id.*

373 *Id.* The application of comparative fault principles to negligent conduct on one hand and willful misconduct on the other was announced in Sorenson v. Allred, 169 Cal. Rptr. 441, 443-46 (Ct. App. 1980).

374 267 Cal. Rptr. at 29.

firmative defense to an insurer's bad faith claim.[375]

B. Comparative Bad Faith.

Comparative bad faith is based on the principle that an insurer should not be subjected to bad faith liability if the insured procured the policy through fraud, breached contractual obligations, or engaged in other misconduct.[376] Comparative bad faith is thus distinguishable from comparative fault—the former compares the insurer's *willful* misconduct against that of its insured.[377] As a practical matter, however, courts and scholars use the two terms interchangeably.[378]

The theory of comparative bad faith is not a new development. In recent years lecturers at continuing legal education seminars have given advice on how to "'set up'" insurers for bad faith claims.[379] Not coincidentally, liability insurers have argued that courts should allow them a special defense when a third-party claimant tries to "set up" a bad faith claim by way of sharp practice.[380] Comparative bad faith is simply insurers' desired "set up" defense described differently. Moreover, it is well-established that an insured's collusion with a third-party is a breach of the cooperation clause, as well as a breach of the duty of good faith and fair dealing.[381] Therefore, insurers that in the past have defended based on their insureds' collusive violation of cooperation clauses have essentially been comparing their insureds' bad faith.

Currently, only one court has directly addressed the concept of comparative bad faith.[382] In *California Casualty General Insurance Co. v. Superior Court*,[383] a California appellate court recognized and adopted the defense of comparative bad faith. The plaintiff in *California Casualty* allegedly suffered a loss compensable under the uninsured motorist coverage provided by her automobile liability insurance policy. *California Casualty* declined to pay the plaintiff's first-party claim. The plaintiff then successfully pursued the matter through arbitration. Thereafter, the plaintiff sued California Casu-

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375 *Id.* at 30.

376 *See* Richmond, *supra* note 356, at 56.

377 *Id.* at 50.

378 *Id.*

379 Texas Farmers Ins. Co. v. Soriano, 844 S.W.2d 808, 842 (Tex. Ct. App. 1992) (Peeples, J., dissenting).

380 *See* ASHLEY, *supra* note 263, at § 7:26 (1993 Cum. Supp.).

381 *See* Span, Inc. v. Associated Int'l Ins. Co., 277 Cal. Rptr. 828, 839 (Ct. App. 1991).

382 Richmond, *supra* note 356, at 57.

383 218 Cal. Rptr. 817 (Ct. App. 1985).

alty for its alleged breach of the duty of good faith and fair dealing, fraud, intentional infliction of emotional distress and certain statutory violations.[384] The insurer sought leave to amend its answer to include an affirmative defense of comparative bad faith by the plaintiff and her former attorney in the handling and management of her claim.[385] The trial court denied the motion, and the insurer took the issue to the court of appeal by writ of mandamus.

The plaintiff contended that there existed no authority recognizing comparative bad faith as an affirmative defense to an action for an insurer's bad faith. Thus, comparative bad faith was neither a cognizable legal defense, nor constituted a "disfavored defense."[386] The court made short work of the plaintiff's argument:

> Plaintiff's assertion that the defense of "comparative bad faith" would constitute a "disfavored" defense is not persuasive and, indeed, is a bit puzzling. If, as plaintiff[ ] seem[s] to suggest, the fact that "comparative bad faith" has not been heretofore recognized in a published appellate opinion as a partial or complete defense to a bad faith action renders it a "disfavored" defense, we reject that suggestion. Presumably, most defenses now recognized in tort cases were at one time novel and not expressly recognized in published judicial decisions. "Disfavored" defenses are such because of public policy considerations, not because they are novel.[387]

The *California Casualty* court was persuaded that, in an appropriate case, an insured's breach of the implied duty of good faith and fair dealing contributing to the insurer's untimely resolution of the subject claim might constitute at least a partial affirmative defense to the insurer's alleged breach.[388] The court noted that the duty of good faith and fair dealing is a two-way street.[389] Additionally, "[t]he specific content of each party's duty 'is dependent upon the nature of the bargain struck between the insurer and the insured and the legitimate expectations of the parties which arise from the contract.'"[390] There could be little question, the court observed, that an uninsured motorist carrier has a reasonable expectation that the insured suffering a loss will promptly and accurately furnish all known evidence and information relevant to the

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384 *Id.* at 818.
385 *Id.* at 818-19.
386 *Id.* at 820.
387 *Id.* at 821.
388 *Id.* at 822.
389 *Id.*
390 *Id.* (quoting Commercial Union Assur. Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1041 (Cal. 1980)).

claim.[391] Should insured's failure to do so delay or impede the insurer's investigation or payment of the claim, there exists no sound reason not to apply the doctrine of comparative fault to bad faith cases.[392]

The appellate court accordingly permitted the insurer to amend its answer and clearly allege the insured's comparative bad faith as an affirmative defense. Under the comparative bad faith principles established in *California Casualty*, the trier of fact must balance any bad faith by the insured against the insurer's bad faith while reducing any damage award in direct proportion to the assessed fault of the insured.[393]

Comparative bad faith was rejected by the Montana Supreme Court in *Stephens v. Safeco Insurance Co. of America*.[394] In *Stephens*, the plaintiffs sued Safeco when they were unable to settle their first-party claim flowing from an accidental fire in their automobile body shop.[395] At trial, Safeco compared the plaintiffs' fault, alleging that they violated their duty of good faith and fair dealing, failed to mitigate their damages, and interfered with Safeco's performance of its contractual duties.[396] The jury found the plaintiffs to be 53 percent at fault and Safeco 47 percent at fault; under Montana's modified comparative fault scheme, the plaintiffs recovered nothing.[397] On appeal, the plaintiffs argued that comparative fault did not apply to bad faith cases. The *Stephens* court agreed.

The *Stephens* court began its analysis grounded in the principle that only tort conduct can be compared.[398] If the insurer breaches the duty of good faith and fair dealing, the insured's cause of action sounds in tort. If the situation is reversed, however, the insured's breach amounts only to a breach of contract.[399]

The court determined that bad faith is a tort only when the parties have a special relationship.[400] While an insured shares a special relationship with his insurer, the converse is not true.[401]

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391 *Id.* at 822-23.
392 *Id.* at 823.
393 Richmond, *supra* note 356, at 59.
394 852 P.2d 565 (Mont. 1993).
395 *See id.* at 566.
396 *Id.* at 567.
397 *See id.*
398 *See id.* at 568.
399 *Id.* at 567-68.
400 *Id.* at 568.
401 Insureds share a special relationship with their insurers for five key reasons: First, the parties to a policy of insurance are in inherently unequal bargaining positions, with the insurer clearly having the upper hand. Second, the insured has a non-

The insurer's superior economic position frees it from the fear of oppression and the risk of financial harm with which an insured is burdened.[402] To compare an insured's fault with that of the insurer would impermissibly mix contract and tort theories and remedies. Comparing the parties' respective causes of action and remedies to "apples and oranges," the *Stephens* court reinstated the plaintiffs' jury verdict in its entirety.[403]

C. *Reverse Bad Faith.*

Assuming that an insurer may raise as an affirmative defense its insured's bad faith, may it similarly sue its insured for a breach of the duty of good faith and fair dealing? Phrased differently, does an insured's breach of the duty of good faith and fair dealing provide a basis for the insurer's affirmative relief? If the duty of good faith and fair dealing truly is a "two way street," the answer to this question should be yes. With mutual duties should come mutual remedies. An insurer suing its insured in tort for alleged bad faith may be deemed to be pursuing a "reverse bad faith" claim.[404]

In one of the few reverse bad faith cases reported, *First Lehigh Bank v. North River Insurance Co.*,[405] the court rejected the cause of action. In *First Lehigh*, the plaintiff bank sued North River to recover under a banker's blanket bond for a loss attributable to employee fraud. North River counterclaimed under three theories, including the bank's alleged breach of its duty of good faith and fair dealing.[406]

The bank filed a claim with North River, alleging that it suffered a loss of approximately $400,000 due to an employee's dishonest acts. The bank claimed that the employee concealed and entered into unauthorized loan transactions. North River began its investigation, and requested copies of minutes from directors' meetings, loan reports, and FDIC examination reports.[407] The bank informed North River that the information sought was confi-

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profit motive for entering into the insurance contract. Insureds seek protection and security through insurance. Third, contract damages will not make an aggrieved insured whole. For example, an insurer's bad faith may cause its insured emotional harm. Fourth, when insureds make claims they are usually in dire financial straits. Insureds are thus especially vulnerable to insurers' oppressive tactics. Fifth, the insurer, as author of the policy, is aware of its insured's vulnerability. *See id.*

402 *Id.*

403 *Id.* at 569.

404 Richmond, *supra* note 356, at 65.

405 Civ. A. No. 88-7746, 1989 WL 146654 (E.D. Pa. Dec. 4, 1989).

406 *Id.* at *1.

407 *Id.*

dential and that it would have to enter into a related confidentiality agreement. The parties attempted to negotiate a resolution but, before reaching agreement, the bank sued North River to collect its claim.[408] After a consent protective order was entered, discovery commenced. The bank provided North River with records apparently unrelated to the unauthorized loans at issue. North River later discovered that the records were altered before their production.[409] The insurer alleged that all references to the loans purportedly unauthorized or concealed were deleted, that loan reports reflecting a fraudulent letter of credit transaction were prepared, and that minutes of meetings were altered to reflect the dishonest employee's termination.[410]

North River's counterclaim for the bank's alleged breach of its duty of good faith and fair dealing posed a "novel issue" for the *First Lehigh* court.[411] The court recognized that "'the utmost fair dealing should characterize the transactions between an insurance company and the insured.'"[412] The court nonetheless dismissed North River's counterclaim. While the bank's breach of its duty of good faith might permit North River to avoid liability under its bond, it would not support a separate claim by North River for money damages.[413] The *First Lehigh* court offered no reasoning for its conclusion. The court noted, however, that North River remained free to sue the bank for malicious use of process should it prevail in the pending suit.[414]

Ohio rejected the reverse bad faith doctrine in *Tokles & Son, Inc. v. Midwestern Indemnity Co.*.[415] The *Midwestern Indemnity* plaintiff sued its insurer for breach of contract and bad faith when it denied the plaintiff's claim for the theft of a truck.[416] Midwestern counter-claimed for fraud and the insured's "'reverse bad faith.'"[417] The case proceeded to a bifurcated trial, with the insured's breach of contract claim being tried first. The insurer obtained a directed verdict and after the trial obtained summary judgment on the insured's bad faith claim. The trial court then

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408 *Id.*
409 *Id.*
410 *Id.*
411 *Id.* at *2.
412 *Id.* at *4 (quoting Dercoli v. Pennsylvania Nat'l Mut. Ins. Co., 554 A.2d 906, 909 (Pa. 1989)).
413 *Id.*
414 *Id.*
415 605 N.E.2d 936 (Ohio 1992).
416 *Id.* at 939.
417 *Id.*

dismissed *sua sponte* Midwestern's reverse bad faith counterclaim.[418]

The Ohio Court of Appeals reversed the directed verdict and the insurer's summary judgment on the bad faith claim, and affirmed the dismissal of Midwestern's counterclaim.[419] The Ohio Supreme Court affirmed the intermediate appellate court in part and reversed it in part.[420] The supreme court refused to recognize the tort of reverse bad faith,[421] reasoning:

> As the holder of the purse strings, the insurer has a certain built-in protection from such evils. On the other hand, the insured, who often finds himself in dire financial straits after the loss, must have the equal footing which is provided by the ability to sue the insurer for bad faith. There are other avenues for the insurer to pursue in the event that an insured submits a fraudulent claim. An insurer drafts the policy, can refuse the insured's claim, and could assert a cause of action against the insured for fraud.[422]

The *Midwestern Indemnity* court offered no other bases for its rejection of the insurer's reverse bad faith proposition.

First Lehigh and *Midwestern Indemnity* are not well-reasoned decisions. *First Lehigh* suggests a judicial preference for at least two related actions, unnecessarily burdening courts and litigants.[423] Furthermore, the *First Lehigh* court would deprive insurers of what might well be a compulsory counterclaim for no other reason than the nature of their business.[424] The court in *Midwestern Indemnity* rejected the concept of reverse bad faith based on insurers' assumed superior financial position.[425] Of course, bad faith has nothing to do with business acumen and financial resources; it has everything to do with malice and wrongful conduct. To the extent the *Midwestern Indemnity* court discounted reverse bad faith because

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418 *Id.*

419 *Id.* The Ohio Court of Appeals decision is reported only on Westlaw. *See* Tokles & Son, Inc. v. Midwestern Indem. Co., No. L-89-395, 1991 WL 355145 (Ohio Ct. App. Sept. 13, 1991).

420 The Ohio Supreme Court affirmed the Court of Appeals' reversal of the directed verdict, reversed relative to summary judgment on the bad faith claim, and reversed the judgment upholding the trial court's dismissal of Midwestern's counterclaim. *Tokles & Son, Inc.*, 605 N.E.2d at 940-45.

421 *Id.* at 945.

422 *Id.*

423 Richmond, *supra* note 356, at 66.

424 *Id.*

425 *See* Tokles & Son, Inc. v. Midwestern Indem. Co., 605 N.E.2d 936, 939 (Ohio 1992).

insurance policies are adhesion contracts,[426] that argument must also fail. The duty of good faith and fair dealing is implied by law; it does not flow from a clause that the insurers have drafted.[427] Finally, both the *First Lehigh* and *Midwestern Indemnity* courts put great stock in the insurers' other possible causes of action, including breach of contract. But insureds can sue for breach of contract, as well. Insureds sue in tort because of the available damages. Insurers should not have their remedies arbitrarily elected for them any more than should bankers or grocers or, for that matter, insureds.

D. What Does the Future Hold and How Should Courts Respond?

1. Comparative Fault and Comparative Bad Faith.

It is difficult to predict the future of comparative fault and comparative bad faith because of the contradictory precedent. Courts outside California have refused to instruct juries on comparative bad faith without expressly rejecting the doctrine. In *Alexander Underwriters General Agency, Inc. v. Lovett*,[428] the trial court refused to instruct the jury on the insured's alleged bad faith. The Georgia Court of Appeals affirmed, but grounded its decision in the lack of evidence in the record to support such an instruction. Indeed, the record reflected that the insured "did all he could" to honor his obligations.[429] In *Jessen v. National Excess Insurance Co.*,[430] the New Mexico Supreme Court affirmed the trial court's refusal to submit a comparative bad faith instruction. At the same time, the *Jessen* court clearly stated that it was not deciding "whether such an instruction necessarily would be inappropriate in another case."[431]

The two related doctrines have also met rejection. The United States District Court for the Southern District of Iowa held in *Kelly v. State Farm Mutual Automobile Insurance Co.*[432] that contributory fault is not an affirmative defense to a bad faith claim.[433] Affirming a judgment for an insured in a third-party case, a Florida appellate court in *Nationwide Property & Casualty Insurance Co. v. King*[434] held

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426 *See id.* at 939.

427 *See* Richmond, *supra* note 356, at 67; John F. Dobbyn, *Is Good Faith in Insurance Contracts a Two-Way Street?*, 62 N.D. L. REV. 355, 372 (1986).

428 357 S.E.2d 258 (Ga. Ct. App. 1987).

429 *Id.* at 265.

430 776 P.2d 1244 (N.M. 1989).

431 *Id.* at 1249.

432 764 F. Supp. 1337 (S.D. Iowa 1991).

433 *Id.* at 1340-41.

434 568 So. 2d 990 (Fla. Dist. Ct. App. 1990).

that a trial judge did not err by striking the insurer's comparative bad faith defense. Without discussion or citation to authority, the *King* court succinctly stated: "We decline to create a new affirmative defense of comparative bad faith."[435]

Adoption of the doctrines of comparative bad faith and comparative fault in the insurance context is logical.[436] An insured, as well as the insurer, may contribute to a particular loss.[437] The application of comparative fault and comparative bad faith ensures that plaintiffs who are responsible for some percentage of their losses recover proportional damages, thereby avoiding a windfall. Courts cannot fairly or logically promote tort remedies for the breach of the implied covenant of good faith and fair dealing, and simultaneously reject the concomitant defense of comparative fault.[438] "Fidelity to legal doctrine requires that if the tort is to be embraced—and it apparently is—it must be embraced in its entirety."[439]

The application of comparative fault and comparative bad faith takes nothing away from "innocent" insureds, nor does it appreciably shield insurers that act in bad faith.[440] Comparative bad faith and comparative fault instructions will not be given without evidentiary support.[441] Insureds' meritorious claims would be unaffected. At the same time, these defenses will discourage litigation in situations where the insured's conduct contributed to the loss.[442] This is not an insignificant factor; insureds' misconduct and excess litigation generate costs borne by all insurance consumers,[443] as do misconduct-generated delays and fraud.[444] These defenses there-

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435 *Id.* at 990-91.

436 *See* R. Kent Livesay, Comment, *Levelling the Playing Field of Insurance Agreements in Texas: Adopting Comparative Bad Faith as an Affirmative Defense Based on the Insured's Misconduct*, 24 TEX. TECH L. REV. 1201, 1211 (1993).

437 *Id.* at 1212.

438 Richmond, *supra* note 356, at 61.

439 *Id.*

440 *Id.* at 60.

441 *Id.*; *see, e.g.*, Alexander Underwriters Gen. Agency, Inc. v. Lovett, 357 S.E.2d 258, 262-66 (Ga. Ct. App. 1987).

442 Livesay, *supra* note 436, at 1218.

443 Insurers are subjected to numerous bad faith suits generating millions of dollars in defense costs. Insureds often "hit the jackpot" in bad faith litigation, receiving huge compensatory and punitive damage awards. These costs are ultimately passed on to the public in the form of escalating insurance premiums. *Id.*

444 An insured's misconduct hinders an insurance company's ability to adjust claims. If an insurer is prevented from processing claims expediently and effectively, its costs rise. These costs will be passed on to policyholders. Insurance fraud is a disturbing trend, costing society about $20 billion annually, and adding nearly ten percent to average premium prices. Fraud includes false claims and misrepresenta-

fore serve as a sort of civil penalty to combat otherwise exempt misconduct by insureds.

2. Reverse Bad Faith.

Based on the conflicting precedent now existing, it is difficult to predict courts' willingness to adopt the reverse bad faith cause of action. Will courts in the future take the California approach, or will they assume the restrictive posture of the *First Lehigh* and *Midwestern Indemnity* courts? Courts should recognize a reverse bad faith cause of action for insurers; indeed, to do so would require nothing more than an appreciation of the need for judicial consistency.[445]

Perhaps most troubling about the *Midwestern Indemnity* court's rejection of reverse bad faith is its overbroad or stereotyped basis for so deciding. The Ohio Supreme Court rested heavily on the parties' perceived unequal bargaining power and the fact that insurers, unlike their insureds, do not need a tort weapon for combatting bad faith.[446] While that observation may be true with respect to individual insureds or small businesses, it is not universally applicable. Commercial insureds with substantial assets and ready access to legal advice are on relatively equal footing with their insurers.[447] Such rough equality of bargaining power and sophistication removes the need for preferential judicial treatment.[448]

The strongest argument for recognizing a reverse bad faith cause of action can be made where an insured commits fraud when making a first-party claim. Here, the equities shift noticeably in the insurance company's favor.[449] The insurer must devote capital and human resources to investigate and adjust a claim made by the insured solely to reap an unfair and unintended economic windfall under the insurance policy. Such predatory conduct by an insured justifies the insurer's recovery of compensatory damages and may support a punitive damage award as well.[450] Should an insured

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tions to insurers. Most insurers do not have the necessary resources to investigate all questionable claims and therefore pay to avoid liability. *Id.* at 1218-19.

445 *See* Richmond, *supra* note 356, at 67.

446 Tokles & Son, Inc. v. Midwestern Indem. Co., 605 N.E.2d 936, 945 (Ohio 1992).

447 *See* Textron, Inc. v. Liberty Mut. Ins. Co., 639 A.2d 1358, 1366 (R.I. 1994); Slottow v. American Cas. Co., 10 F.3d 1355, 1362 (9th Cir. 1993).

448 *See id.* at 1362.

449 Richmond, *supra* note 356, at 69; Patrick E. Shipstead & Scott S. Thomas, *Comparative and Reverse Bad Faith: Insured's Breach of Implied Covenant of Good Faith and Fair Dealing as Affirmative Defense or Counterclaim*, 23 TORT & INS. L.J. 215, 226 (1987).

450 Richmond, *supra* note 356, at 69; Shipstead & Thomas, *supra* note 449, at 226.

submit a false or fraudulent first-party claim and then sue the insurer for bad faith when the claim is denied, a reverse bad faith cause of action is mandated.[451] First, the insurer is now saddled with the defense of the bad faith action and related damage exposure, having already borne the expense of adjusting and investigating the underlying claim.[452] Second, the insurer may not be able to plead or prove other causes of action, such as fraud or malicious prosecution. The insurer should be allowed to counterclaim for the tort actually committed.

VII. CONCLUSION

Insurance bad faith litigation has become the judicial equivalent of the Wheel of Fortune, with disastrous results for insurers and their policyholders, who ultimately bear the cost. Of course, insurers have contributed to the present adversarial climate. Insurers have too often abused their insureds or played fast and loose with their insureds' money when relatively little was at stake, or not much could be gained. The case law is replete with examples of insurer misconduct. Unfortunately, insurance bad faith litigation has gotten out of hand. When courts initially recognized bad faith as an independent tort they anticipated that such claims would be rare.[453] In fact, they should be. By and large insurers process a vast amount of claims in an ethical and responsible manner.[454] But now, almost every first-party action for an insurer's breach of contract includes a bad faith count,[455] and liability insurers are deliberately "set up" for bad faith claims.

What of the future? Probably more of the same. Courts presuppose a model of insurance company conduct and management that has never existed and never will exist,[456] and insurers will continue to mishandle some percentage of claims with tragic results.

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451 Richmond, *supra* note 356, at 69; Shipstead & Thomas, *supra* note 449, at 226-27.

452 Richmond, *supra* note 356, at 69.

453 *See* United Ins. Co. of Am. v. Cope, 630 So. 2d 407, 412 (Ala. 1993).

454 *See* ASHLEY, *supra* note 263, at § 10:01.

455 *Cope*, 630 So. 2d at 412.

456 ASHLEY, *supra* note 263, at § 10:28.