Insurance Bad Faith: Pitfalls for Insurers in the Investigation of Coverage Claims

Strategies for Insurers to Avoid or Mitigate Liability and Policyholders to Prove Bad Faith and Obtain Damages

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BAD FAITH IN THE INVESTIGATION OF INSURANCE CLAIMS: Strategies For Pursuing And Defending Allegations Of Insurer Misconduct

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Duty Of Good Faith


First Party Claims

- Insurer either failed to perform its obligations to pay money when it was due or improperly delayed the processing and payment of a valid claim. Gruenberg v. Aetna Ins. Co., 9 Cal.3d 566 (1973) (insurer’s duty to accept reasonable settlement in third-party case and duty not to withhold unreasonably payments due under a first-party policy “are merely two different aspects of the same duty.”).

- Not all states recognize first-party bad faith claims. Talat Enterprises, Inc. v. Aetna Cas. and Sur. Co., 753 So.2d 1278, 1281 (Fla. 2000) (common law of Florida “did not recognize claims made by an insured against its own insurer for failing to act in good faith when settling a claim”).

- Brandt fees contrasted with punitive damages. Brandt v. Superior Court, 37 Cal.3d 813 (Cal. 1985).
Third Party Claims

- Insurer failed to properly defend policyholder in good faith or refused to settle underlying action against its policyholder.

- Focus on insurer’s handling of underlying claims brought by third party against policyholder.

- Policyholder may assign rights against insurer to a third party, typically the plaintiff bringing the underlying action.
Delay In Payment

- Situations that may give rise to actionable common law claims of bad faith in the first-party context include the delay, denial or withholding of payment of valid claims covered by contracts of insurance.

- United Fire & Cas. Co. v. Historic Preservation Trust, 265 F.3d 722, 729 (8th Cir. 2001) (recognizing that, under Missouri law, a policyholder may recover penalties and attorneys’ fees when an insurer denies a claim without reasonable cause or excuse). Gurule v. Illinois Mut. Life & Cas. Co., 734 P.2d 85 (Ariz. 1987) (affirming lower court’s holding that insurer breached its implied covenant of good faith and fair dealing by denying, without a reasonable basis, the policyholder’s claim).
Delay In Payment

- **See** White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1018 (Idaho 1986) (holding a policyholder may sue for bad faith, even if the claim is not covered, when the insurer “intentionally and unreasonably” delays payment on a claim and the delay harms the policyholder).

Burden Of Proof Standard

A. The burden of proof varies among jurisdictions.


Bad Faith Without Coverage

Courts may not always require a finding of coverage to find bad faith. *Wilson v. 21st Cent. Ins. Co.*, 42 Cal. 4th 713 (2007) (even if coverage is debatable, and the insurer did not investigate, insurer could be liable for bad faith); *Avery Dennison Corp. v. Allendale Mut. Ins. Co.*, 310 F.3d 1114 (9th Cir. 2002) (“Except perhaps in highly extraordinary circumstances, California does not permit recovery on a bad faith claim unless insurance benefits are due under the policy.”).
Investigation Of Liability And Coverage

A. The Standards For Determining An Adequate And Appropriate Investigation

– Prohibit insurer from misrepresenting facts or coverage, failing to timely disclaim, failing to attempt a good faith settlement, failing to settle claims promptly or to investigate or pay claims, or failing to promptly provide a reasonable explanation of its basis for denying coverage. Must show a general business practice.

– Remedies can include actual and consequential damages, costs and attorneys’ fees, punitive and treble damages.

Investigation Of Liability And Coverage

1. What Law Governs The Determination Of An Adequate And Appropriate Investigation

Investigation Of Liability And Coverage

2. State Insurance Statutes And Regulations
   a. Uniform Claims Practices Act
   b. California Statutes And Regulations
   c. Other Examples

3. Industry Standards And Custom And Practice

4. Standards Based upon Specific Case Law
Uniform Unfair Claims Practices Act

Enumeration of unfair claim settlement practices

The following are unfair claim settlement practices:

1. Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue.
2. Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies.
3. Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies.
4. Refusing to pay claims without conducting a reasonable investigation based upon all available information.
5. Failing to affirm or deny coverage of claims within a reasonable time after proof of loss statements have been completed.
6. Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear.
7. Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds.
Uniform Unfair Claims Practices Act
(cont’d)

(8) Attempting to settle a claim for less than the amount to which a reasonable individual would have believed the individual was entitled by reference to written or printed advertising material accompanying or made part of an application.

(9) Attempting to settle claims on the basis of an application that was altered without notice to or knowledge or consent of the insured.

(10) Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which the payments are being made.

(11) Making known to insureds or claimants a policy of appealing from arbitration awards in favor of insureds or claimants for the purpose of compelling them to accept settlements or compromises less than the amount awarded in arbitration.

(12) Delaying the investigation or payment of claims by requiring an insured, a claimant, or the physician of either to submit a preliminary claim report and then requiring the subsequent submission of formal proof of loss forms, both of which submissions contain substantially the same information.

(13) Failing to promptly settle claims, where liability has become reasonably clear, under one (1) portion of the insurance policy coverage in order to influence settlements under other portions of the insurance policy coverage.

(14) Failing to promptly provide a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.
Useful Discovery


- Personnel files. Zilisch v. State Farm Mut. Auto Ins. Co., 995 P.2d 276 (Ariz. 2000) (jury could find that salaries and bonuses paid to claims representatives were influenced by how much the representative paid out in claims).
Investigation Of Liability And Coverage

Useful Discovery (cont’d)


Use of Expert Witnesses

- Experts can testify on the standards and practices in the insurance industry for the handling of claims. *Hanson v. Prudential Co. of Am.*, 783 F.2d 762 (9th Cir. 1985).

- Anything shared with a testifying expert is discoverable.

- Some states have held that expert testimony is not necessary (AL, FL, NJ, PA).
Depositions: Useful Tips

- Obtain acknowledgment of insurer’s duties and obligations.
- Assume insurer is experienced in bad faith litigation and prepare by obtaining all relevant documents beforehand.
- Use insurance files as guide to questioning and as evidentiary support.
- Authenticate notes and materials created by the witness.
Investigation Of Liability And Coverage

B. Policyholder’s Obligations In Connection With An Insurer Conducting An Investigation

1. Duty To Cooperate

   a. Liability policies generally contain a provision requiring the policyholder to cooperate with the insurance company.
Investigation Of Liability And Coverage

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b. Insurance companies face obstacles denying coverage based on the policyholders’ failure to cooperate.


– Some courts require that the insured's failure to cooperate be "both material and substantial." See *Ex parte Clarke*, 728 So. 2d 135, 141 (Ala. 1998) (citations omitted).

Investigation Of Liability And Coverage

2. Specific Provisions In The Insurance Policy

3. Industry Standards And Custom And Practice
C. Problems Of Investigating When The Insurer Reserves Rights and/or Disclaims Coverage
Issues Relating To When The Insurer Disclaims Coverage

A. The general rule is that before an insurer can disclaim coverage, it must conduct an adequate investigation.


B. If an insurer disclaims coverage without making an adequate investigation, a policyholder may allege that the insurer acted in bad faith for failing to investigate.

- See Weitz Co., LLC v. Lloyd’s of London, 574 F.3d 885, 892 (8th Cir. 2009) (noting that bad faith “may be inferred from a flawed or inadequate investigation by the insurer”); Lozier v. Auto Owners Ins. Co., 951 F.2d 251, 254-55 (9th Cir. 1991) (insurer’s failure to adequately investigate accident, including failing to depose all relevant witnesses, exposed insurer to bad faith claims).
Issues Relating To When The Insurer Disclaims Coverage

C. However, there may be instances where an insurer can disclaim coverage, because no investigation is needed with respect to the grounds upon which coverage is being denied. For example:

- Coverage is sought from the wrong insurance company, which did not issue the insurance policy at all.
- Coverage is sought under an insurance policy which had been cancelled.

D. After the insurer disclaims, as a general rule, the insurer may develop additional facts to support its disclaimer provided that it conducted an adequate investigation prior to disclaiming on the same grounds.

E. An insurer must keep in mind that once it has disclaimed coverage, that insurer may no longer be entitled to obtain information from the insured.

- See Lafarge Corp. v. Hartford Cas. Ins. Co., 61 F.3d 389, 397-98 (5th Cir. 1995) overruled on other grounds Federated Mut. Ins. Co. v. Grapevine Excavation, 241 F.3d 396 (5th Cir. 2001) (once insurer disclaims coverage, it cannot rely on cooperation clause to gain access to information from insured).
A. If an insurer is going to deny or disclaim, here are some practical tips.

– Policyholders will usually argue that the investigation was inadequate, done in a manner favorable to the insurer, and without looking for any potential coverage.

– Therefore, before disclaiming, an insurer should make sure that as part of its investigation, it has investigated the particular grounds upon which the insured contended there was coverage and then document such investigation in the claims file.

– The insurer should ask the insured in writing to provide all documents and information which the insured wants the insurer to review as part of any investigation, and the insurer should ask the insured to confirm that the insured has no other documents or information and knows of no other documents or information that the insurer should investigate.

– Likewise, if there is going to be a denial, the insurer should not just rely on whatever documents and information were provided. Rather, the insurer should consider independent sources of documents and information to determine whether there is or is not coverage.
A. As a general rule, an insurer should investigate a claim in connection with reserving rights to defend or indemnify.

   – See **In re Foremost County Mut. Ins. Co.,** 172 S.W.3d 128, 130 (Tex. App. 2005); see also 7C John A. Appleman, Insurance Law and Practice § 4694 (noting that an insurer properly conducts an investigation or defense under a reservation of rights); **Am. Best Food, Inc. v. Alea London, Ltd.**, 168 Wn.2d 398, 405 (Wash. 2010) (finding that an insurer is entitled to investigate the facts and dispute insured’s interpretation, but should do so under a reservation of rights).

B. Depending upon what it learns in the investigation, the insurer may have to amend or supplement its reservation of rights.

   – See **Harleysville Lake States Ins. Co. v. Granite Ridge Builders, Inc.,** 2008 WL 4935974, at *6 (N.D. Ind. Nov. 17, 2008) (“Sometimes an insurer may need additional time to analyze the existence of coverage and thus it may send a general reservation of rights letter; however, the insurer must then supplement the reservation of rights letter as soon as it learns of its specific defenses”); see generally Allan D. Windt, Insurance Claims and Disputes, § 2:14 (5th Ed. 2007).

C. There are no set or fixed procedures or rules with respect to how an insurer should investigate when it reserves rights to deny coverage. That will depend upon the facts and circumstances of each particular claim, which generally will dictate how an investigation must be conducted.

D. There is a general rule of “proportionality.” The less significant the claim, the less extensively the insurer must investigate the claim. See **State Farm Fire & Cas. Co. v. Simmons,** 963 S.W.2d 42, 44-45 (Tex. 1998) (“The scope of the appropriate investigation will vary with the claim’s nature and value and the complexity of the factual issues involved”).
Issues Relating To When The Insurer Reserves Rights

E. The insurer has a reasonable amount of time to investigate.
   
   – See *City of Carter Lake v. Aetna Cas. and Sur. Co.*, 604 F.2d 1052, 1060 (8th Cir. 1979) (“An insurer has a right to a reasonable time to investigate a claim and decide whether to resort to policy defenses discovered”); *Employers Reinsurance Corp. v. Sarris*, 746 F. Supp. 560, 567 (E.D. Pa. 1990) (noting that insurer “is entitled to a reasonable time in which to investigate and determine whether it desires to avail itself of any defense that may be found to exist”) (citation omitted).

F. When an insurer reserves rights, the insurer may nonetheless investigate all coverage issues, including ones not identified in its reservation of rights letter.
   
   – See *Manzanita Park, Inc. v. Ins. Co. of N. Am.*, 857 F.2d 549, 556 (9th Cir. 1988) (rejecting argument that insurer should be bound by preliminary assessment of its coverage liability).
   
   – See *City of Utica v. Genesee Mgmt., Inc.*, 934 F. Supp. 510, 521-22 (N.D.N.Y. 1996) (insurer permitted to investigate potential avenues of disclaiming liability that were not expressly mentioned in reservation of rights letter).
A. Usually, an insurer does not have to investigate policy terms, drafting history, and applicable case law interpreting policy provisions.

B. However, there may be occasions where the insurer should investigate the terms of its own insurance policy. For example:
   - Manuscript policies or endorsements.
   - Specialty coverages or exclusions.
   - The role and involvement of the insured and its insurance broker in drafting/negotiating.

C. Likewise, there can be instances where a key term in an insurance policy is subject to important coverage determinations or rulings which are publicly reported. To be safe, an insurer may wish to have in-house counsel or outside counsel research coverage rulings and decisions and provide legal advice. There may be federal and state statutes or local rules of law that could bear on coverage issues, in which an insurer should investigate the statutes and rules.
D. When an insurer relies upon the investigation of law and coverage decisions done by its inside or outside counsel, that is usually considered privileged and therefore does not have to be disclosed to the insured or the insured’s counsel. There is a thorny issue of trying to demonstrate the adequacy of the investigation and not wanting to disclose privileged advice or work product. But see Cedell v. Farmers Ins. Co. of Wa., 176 Wash.2d 686, 295 P.3d 239 (Wash. 2013) (attorney-client privilege is not absolute and communications between outside attorney and insurer may be discoverable where attorney engaged in quasi-fiduciary task of investigating, evaluating and handling of insured’s claim).

E. On the other hand, if the claims handler for the insurer does these tasks, that may not be privileged and may have to be disclosed to the policyholder and the policyholder’s own lawyer.

F. The insurer will also need to consider whether and to what extent it will rely on the defense of advice of counsel where counsel has investigated the meaning of policy terms and the implications of coverage rulings and decisions.
Issues Relating To Any Investigation When An Insurer Is Determining Whether It Has Any Duty To Defend

Paul Koepff

A. In almost all jurisdictions, the general rule is that an insurer’s duty to defend will be based upon the allegations and claims in the complaint, and not what are the actual facts.


B. Therefore, as a general rule, when deciding whether to deny or disclaim any duty to defend, an insurer should limit its decision to the four corners of the complaint and not what the actual facts might show.

- See Stevens v. United Gen. Title Ins. Co., 801 A.2d 61, 67 (D.C. App. 2001) (insurer's duty to defend is based on whether four corners of complaint state cause of action within policy's coverage; the obligation to defend “is not affected by facts ascertained before suit or developed in the process of litigation”) (citation and internal quotations omitted); Colony Ins. Co. v. Barnes, 410 F. Supp. 2d 1137, 1139 n.3 (N.D. Fla. 2006) (“the insurer's duty to defend does not depend on the factual accuracy of the complaint”).

C. However, in some jurisdictions, the insurer may be subject to an implied duty to investigate extrinsic evidence which would show potential coverage even though that is beyond the allegations and claims set forth in the complaint. Eigner v. Worthington, 57 Cal. App. 4th 188, 198, 66 Cal. Rptr. 2d 808 (Cal. Ct. App. 1997). See also Mullen v. Glens Falls Ins. Co., 73 Cal. App. 3d 163, 170, 140 Cal. Rptr. 605 (Cal. Ct. App. 1977) (insurer had duty to defend insured when it had in its possession factual information which gave rise to potential liability under its policy even though allegations in underlying complaint were otherwise ambiguous on that point); Truck Ins. Exchange v. Van Port Homes, Inc., 147 Wn.2d 751, 761, 58 P.3d 276 (Wash. 2002) (Insurer may consider extrinsic evidence only to find facts supporting duty to defend; may not use extrinsic evidence to deny duty to defend).
Issues Relating To Any Investigation When An Insurer Is Determining Whether It Has Any Duty To Defend

D. Some courts have held that an insurer has constructive notice of those facts that it would have learned if it had pursued the requisite investigation. See KPFF Inc. v. California Union Insurance Co., 56 Cal. App. 4th 963, 973 (Cal. Ct. App. 1997).

E. On the other hand, there will be some circumstances where an insurer can deny any duty to defend without taking into account the allegations or claims in the suit or even conducting any investigation. For example:

1. The particular insurance policy at issue negates any duty to defend or has no provision obligating the insurer to defend.

2. The particular insurance policy does not insure the entity seeking coverage or the occurrence is outside the geographical scope of coverage.

F. Similarly, if there is some subsequent development or ruling in the underlying litigation, which the insurer learns about through an investigation, the insurer may take that into account in deciding whether to disclaim any duty to defend.

- See Charter Oak Fire Ins. Co. v. Sumitomo Marine and Fire Ins. Co., 750 F.2d 267, 272 (3d Cir. 1984) (no duty to defend where plaintiff in underlying suit had filed pre-trial narrative statement that clarified issues for trial to the point where it was clear that claim to be tried fell outside policy’s coverage); see also Am. Home Products Corp. v. Liberty Mut. Ins. Co., 565 F. Supp. 1485, 1499 (S.D.N.Y. 1983) (“even if a complaint states a basis for possible recovery, once an insurer is able to ‘confine the claim’ [in the underlying lawsuit]—exclude the possibility of a recovery for which it has provided insurance—the insurer has no further duty to defend”); Minkler v. Safeco Ins. Co. of Am., 49 Cal. 4th 315, 327 n. 4, 232 P.3d 612 (Cal. 2010) (“if an insurers investigation discloses that there is, in fact, no possibility of coverage . . . the insurer’s duties to defend and indemnify cease from that time forward”).
Practical Tips With Respect To Any Investigation In Connection With Deciding Any Obligation To Defend

A. Consider what law is applicable to this issue, because that can vary from state to state.

B. Obtain advice as to whether and to what extent in deciding the duty to defend, under applicable law, the insurer must go beyond the four corners of the complaint and make a further investigation to determine whether there is any potential coverage triggering any duty to defend.

C. Consider asking the insured questions about the allegations and claims in the complaint.

D. Include appropriate documentation in the claim file if there is any such investigation.
A. There are important differences between an insurance policy that has an obligation to defend, as distinct from an insurance policy in which there is only an obligation to indemnify for defense costs.

B. An insurer that has an obligation to defend may have certain obligations to the insured with respect to:
   – How to defend
   – Whether and when to settle
   – Whether and when to appeal

C. On the other hand, an insurer with the obligation to indemnify for defense costs most likely does not have any obligation with respect to defending, settling, or appealing.

D. An insurance policy that has an obligation to defend may mean that the insurer must defend the entire action, including non-covered claims. A policy in which the insurer is only obligated to indemnify may mean that the insurer only has to pay for defense costs for covered claims, because there may be an allocation. See Paul R. Koepff, *When to Allocate Defense Costs in Covered and Non-Covered Claims*, Claims Journal, Spring 2012, at 38.
Specific Issues Relating To Investigations Of Claims

A. Timing Of Investigation Upon Receipt Of Notice Of Occurrence Or Claim
Generally, after receiving notice of an occurrence or claim, the insurer should promptly conduct an investigation as to liability and coverage.

- See Mid-Continent Cas. Co. v. Eland Energy Inc., 2009 WL 3074618, at *28 (N.D. Tex. Mar. 30, 2009) (“It is well established that an insurer has a duty to conduct a timely and fair investigation of an insured's claims”) (emphasis added); Gutierrez v. Yochim, 23 So.3d 1221, 34 Fla. L. Weekly D2324 (Fla. Dist. Ct. App. 2009) (insurer’s duty to timely and properly investigate claim against insured is not relieved simply because insurer is waiting to receive information from the claimant’s attorney).

- See also Cal. Code. Regs., Title 10 § 2695.5 (upon receiving notice of claim, insurer has 15 days to “begin any necessary investigation of the claim”).

An insurer may need to have written “standards” with respect to investigations.

Written “standards” about a prompt investigation are required by many statutes and the Model Unfair Claims Practices Act.

For example: Cal. Ins. Code § 790.03(h) defines “unfair claims settlement practices” to include, among other things:

- “Failing to adopt and implement reasonable standards for the prompt investigation and processing of claims”.

When To Commence An Investigation

Paul Koepff
When To Commence An Investigation

As another example, the Unfair Claims Practices Act defines an “unfair claims practice” to include:

- Failing to adopt and implement reasonable standards for the *prompt investigation* and settlement of claims arising under its policies.

- *Unreasonably delaying the investigation* or payment of claims by requiring both a formal proof of loss form and subsequent verification that would result in duplication of information and verification appearing in the formal proof of loss form.

- *See Maslo*, 227 Cal. App. 4th at 638 (finding bad faith under Cal. Ins. Code § 790.03(h) where insurer failed to properly investigate the claim despite having all necessary documentation and instead unreasonably demanded arbitration to “stonewall” claimant).
There is an important difference between “standards” and “procedures”.

- Policyholders and their lawyers often confuse the two concepts.
- A “standard” would be the general qualitative criteria for an investigation – independent, adequate, reasonable, prompt, and so on.
- Procedures would be the specific steps to be taken in an investigation, which is different from the “standards” in conducting an investigation.
- It is almost impossible to specify what procedures must be followed, because there are no general procedures that must be followed in every investigation and the procedures will vary from claim to claim.

Policyholders and their lawyers often seek to obtain claims manuals and written claims procedures to demonstrate no standards have been adopted and no procedures have been set forth.

- As a practical matter, it is virtually impossible for a claims manual or written claims procedures to address every possible way of investigating claims.
Issues Relating To Investigations
Under Excess Insurance

Paul Koepff

- It is hard to generalize whether an excess insurer has any obligation to investigate at all and when it must
  2:02[d] (5th Ed. 2010).

- One needs to consider:
  1. Provisions of the excess policy
  2. Applicable law
  3. The facts and circumstances of the particular occurrence or claim
  4. Whether and to what extent underlying limits have been exhausted or impaired
  5. The likelihood of substantial damages being recovered

- If the occurrence or claim does not implicate its excess policy, the excess insurer will have no obligation
  to investigate. See Pac. Group v. First State Ins. Co., 70 F.3d 524, 527-29 (9th Cir. 1995).

- An excess insurer may not have to conduct its own investigation but may rely upon the investigation of
  1991) (“The primary insurer, not the excess carrier, normally investigates the facts of the occurrence and
  undertakes the defense of the . . . lawsuit”).

- However, in certain circumstances, the excess insurer should conduct its own investigation, especially if
  the above factors indicate an investigation by the excess insurer is warranted. See Navigators Ins. Co. v.
  2013) (holding excess insurer could not rely on investigation of primary insurer where excess insurer
  knew claim exceeded limits of primary coverage and it disagreed with primary insurer's evaluation).
Specific Issues Relating To Investigations Of Claims

1. Investigation As To Liability
Objectives Of A Liability Investigation

◆ In conducting an investigation into liability, it is helpful to keep in mind the objectives:

- One objective of a liability investigation is to assess whether and to what extent the insured is potentially liable.

- A related objective of a liability investigation is to determine whether the particular claims against the insured should not be settled, but should be defended through trial and appeal.

- Another objective of a liability investigation is to determine whether the particular claims against the insured should be settled and what is a reasonable settlement.

- A related objective of a liability investigation is to provide information to the insurer in determining whether it should consent or withhold consent to a settlement.

◆ There are no fixed rules or procedures for conducting a liability investigation. Rather, the manner in which a liability investigation is conducted will depend upon the facts and circumstances and the particular claims against the insured.
What Is A Reasonable Settlement – Luria Doctrine

Under New York law, an insurer must consider the Luria Doctrine in connection with determining whether a settlement of a claim or lawsuit is reasonable. See Luria Bros. & Co. v. Alliance Assurance Co., 780 F.2d 1082, 1091 (2d Cir. 1986).

In Luria, the Second Circuit set forth the applicable standard:

- “[T]o recover the amount of the settlement from the insurer, the insured need not establish actual liability to the party with whom it has settled ‘so long as . . . a potential liability on the facts known to the [insured is] shown to exist, culminating in a settlement in an amount reasonable in view of the size of possible recovery and degree of probability of claimant's success against the [insured].’” Luria Bros., 780 F.2d at 1091 (quoting Diamonti v. A/S Inger, 314 F.2d 395, 397 (2d Cir. 1963)).


- New York courts applying Luria require that the insured meet the “potential liability” criteria by showing that liability may exist vis-à-vis the underlying facts, not the allegations. See, e.g., Texaco A/S (Denmark) v. Commercial Union Ins. Co. of Newark, 160 F.3d 124, 130 (2d Cir. 1998) (holding that Luria did not release insured from having to prove that the facts of its claim fell within requirements for indemnity under policy).

Moreover, evidence related to the reasonableness of a settlement includes, but is not limited to: views of defense counsel, opinions of experts, mock trials, verdicts in comparable cases, the likelihood of favorable or unfavorable rulings on liability, defenses to liability, damages, prospects of appeal, and other issues relevant to the potential liability of the insured.

Primary and excess insurers often object to a settlement or decline to provide full policy limits to fund a settlement, because in their view such a settlement is unreasonable.

Primary and excess insurers can be held liable for amounts in excess of their limits if they in bad faith failed to consent to a settlement and/or failed to contribute their policy limits where there is a likelihood of damages in excess of policy limits.


Whether an insurer is liable for not consenting to a settlement or not contributing its policy limits will turn on the facts and circumstances of the particular case. It will also turn on the applicable legal standards in a particular jurisdiction. But as a general rule, the insurer will not be liable if it acts in good faith and there is a reasonable basis for its objecting to the settlement and/or not contributing its limits.

In demonstrating it acted in good faith and reasonably, the insurer will usually need to demonstrate it conducted an adequate and good faith investigation of the claim. Courts have held that such an investigation may insulate the insurer from liability for an excess judgment against the insured. The basis for this ruling is that the insurer conducted an adequate and reasonable investigation and there was a good faith basis to decline the settlement offer.

- See Walbrook Ins. Co. Ltd., 5 Cal. App. 4th at 1454-59 (finding that insurer acted in good faith in part because of exhaustive investigation and fact that settlement offers were weighed by counsel and several layers of insurer’s personnel).

On the other hand, there are decisions that hold where the insurer in a mistaken exercise of judgment, declined a settlement offer within policy limits, that insurer will be held liable for an excess verdict because it did not conduct an adequate investigation.


Also, conducting a prompt and adequate investigation may also give an insurer a basis for not settling or declining to settle until it finishes its investigation, provided it is acting promptly and in good faith. See Pavia v. State Farm Mut. Auto. Ins. Co., 82 N.Y.2d 445, 455-56 (1993).
Specific Issues Relating To Investigations Of Claims

2. Investigation As To Coverage
Length Of Time To Conduct A Coverage Investigation

Paul Koepff

- There are no set rules or principles with respect to how long an insurer has to investigate coverage issues, because that will turn on the coverage issues that need to be investigated, the facts and circumstances that are being investigated, the availability of documents and information, and a host of other factors.

- One court has held that the length of time for a coverage investigation will depend upon the circumstances of the claim “which make it reasonable for the insurer to take more or less time to make, complete, and act diligently on its investigation of its coverage or breach of conditions in its policy.” Allstate Ins. Co. v. Gross, 27 N.Y.2d 263, 317 N.Y.S.2d 309, 265 N.E.2d 736, 739 (1970).

- If the basis for disclaimer of coverage is “readily apparent” from the face of the claim, it has been held that even relatively short periods of delay in the investigation are unreasonable as a matter of law. See, e.g., Milbank Hous. Dev. Fund v. Royal Indem. Co., 17 A.D.3d 280, 794 N.Y.S.2d 23 (1st Dep’t 2005) (insurer’s 60-day delay unreasonable); NYAT Operating Corp. v. GAN Nat’l Ins. Co., 46 A.D.3d 287, 288, 847 N.Y.S.2d 179 (1st Dept’ 2007) (insurer lost right to disclaim when it failed to give insured notice of disclaimer as soon as reasonably possible).

- Difficulties in obtaining documents and information, especially if the insured does not provide that at all or does not provide that on a timely basis, will provide the insurer with a reason why it could not complete its coverage investigation on a more timely basis.
  - See Aboy v. State Farm Mut. Auto. Ins. Co., 2010 WL 727967 (S.D. Fla. Jan. 5, 2010) (insurer’s delay in completing investigation timely was reasonable where delay was caused by claimant’s failure to provide medical records and insurer’s need to review records to determine if damages indeed exceeded policy limits where other information about injury suggested it was not severe); Aetna Cas. & Sur. Co. v. Brice, 72 A.D.2d 927, 928-29, 422 N.Y.S.2d 203, 206 (4th Dep’t 1979) (disclaimer in death action 16 months after car accident not untimely where insurer had considerable difficulty in resolving who had been driving car); Allstate Ins. Co. v. Horn, 24 Ill. App. 3d 583, 589, 321 N.E.2d 285, 289-90 (Ill. App. Ct. 1974) (insurer’s delay in completing investigation and issuing disclaimer was reasonable where claimant did not furnish necessary materials until eighteen months after request).

- On the other hand, it is possible that a court will not excuse an insurer’s delay in disclaiming coverage merely because the insured failed to fully cooperate with the insurer’s investigation. See Hammersmith v. TIG Ins. Co., 480 F.3d 220, 249-50 (3d Cir. 2007) (insurer’s 11-month delay unreasonable despite fact that during this time insurer was conducting investigation of the late notice issue, and there was evidence that insureds were “less than forthcoming” with insurer).
Bad Faith Claims For Denial Of Coverage, The Defense That There Is A Genuine Dispute Over Coverage, And The Issue Of An Adequate Investigation

Policyholders typically base a bad faith claim on the ground that the insurer breached its obligation of good faith and fair dealing by denying coverage on a particular ground.

The policyholder will argue that in fact there is coverage and the ground for denial was utterly without merit.

In most jurisdictions, there can be no bad faith if it turns out that there is no coverage. See ReadyLink HealthCare v. Evanston Ins. Co., 2010 WL 2711329, at *1 (9th Cir. July 7, 2010) (“[b]ecause there was no coverage under the insurance policy, there can be no bad faith”); accord Yellowbird Bus Co. v. Lexington Ins. Co., 2010 WL 2766987, at *7 (E.D. Pa. July 12, 2010) (collecting cases). But see Lloyd v. State Farm Mut’l Automobile Ins. Co., 189 Ariz. 369, 377, 943 P.2d 729 (Ariz. 1996) (“The covenant of good faith and fair dealing can be breached even if the policy does not provide coverage”); St. Paul Fire & Marine Ins. Co. v. Onvia, Inc., 165 Wn.2d 122, 131, 196 P.3d 664 (Wash. 2008) (“an insurer can act in bad faith even where coverage is later determined to be unavailable”).

In most jurisdictions, there is no possible bad faith as a matter of law if there is a genuine issue or dispute over coverage.

For example, courts have dismissed bad faith claims even where the insurer ultimately lost on a coverage denial, but there was a genuine issue or dispute over coverage.

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See Hudson Universal, Ltd. v. Aetna Ins. Co., 987 F. Supp. 337, 342 (D.N.J. 2003) (noting that insurer’s decision would not constitute bad faith if coverage issue is “fairly debatable” at time of coverage decision, even where insurer lost in coverage action); Bellville v. Farm Bureau Mut. Ins. Co., 702 N.W.2d 468, 473, 485 (Iowa 2005) (although insurer “was wrong in concluding an insurer has no good faith duty to consent to its insured’s settlement,” the insurer is not liable for acting in bad faith, because the “issue was fairly debatable”).
On the other hand, some courts, especially in California, will not permit the insurer to rely on the genuine dispute defense if the insurer failed to conduct an adequate and good faith investigation.


In the view of these courts, an insurer should not be permitted to assert the genuine dispute defense because the insurer failed to conduct an adequate and good faith investigation.

– See *Hailey v. California Physicians’ Serv.*, 158 Cal. App. 4th 452, 472-73, 69 Cal. Rptr. 3d 789, 805-06 (Cal. App. Ct. 2007) (reversing summary judgment in favor of insurer where insurer breached obligation to thoroughly and fairly investigate even though genuine dispute as to coverage existed); *Maslo*, supra at 636-37 (“[i]t is] clear that there can be no genuine dispute in the absence of a thorough and fair investigation.”).
Some Practical Tips In Conducting A Coverage Investigation

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- Document the claims file:
  - When there are difficulties or problems in obtaining documents and information, especially from the insured.
  - With respect to subsequent efforts to obtain documents and information that were not previously available.
  - To indicate status of coverage investigation and what further investigation which is needed.
  - If more documents and information are needed, document that in the claims file.

- In other words, the claims file will contain documentation demonstrating the insurer’s efforts to conduct an adequate investigation.

- The insurer should confirm in writing that the insured has no additional documents or other information which the insured wishes the insurer to consider in the coverage investigation.
Specific Issues Relating To Investigations Of Claims

3. Whether, How, And When To Investigate When There Is Underlying Litigation Pending
Some Issues To Consider When There Is An Investigation While The Underlying Litigation Is Pending

- Will some or all of the documents and testimony gathered by the insurer be discoverable by the party suing the insured?
  - The use of a confidentiality agreement or common interest agreement.

- Is the insured and/or its counsel concerned with the insurer conducting its own investigation or the scope of that investigation?
  - The insurer and insured reach an agreement concerning how to proceed.

- Does the insurer prefer to: (a) rely on privileged investigation reports supplied by the insured; (b) work with the insured’s counsel; or (c) defer aspects of the investigation to the insured, so long as those issues will be investigated on a timely basis?
  - Rely on the privileged investigation reports supplied by the insured and its counsel?

- What happens when the insured does not want to share privileged information?
  - The insurer should ask for updates from the insured, because the insurer will want to be apprised of developments in the underlying litigation.
Specific Issues Relating To Investigations Of Claims

B. Scope Of Investigation

1. Contacting Insured
   - Interviews
   - Obtaining Documents
2. Visiting The Site (If Applicable)
3. Contacting/Interviewing Non-Party Witnesses
4. Obtaining Documents
C. Need For Supplemental Or Additional Investigation

1. Claim For Coverage Made By Additional Insured

2. Following The Commencement Of Coverage Litigation
   a. Existence of insurance policy that provided coverage.
   b. Justification for insurer’s actions.
   d. Conduct that may give rise to consequential and punitive damages.
   e. Potential defenses suggested by the facts.
   f. Injury to public generally
Specific Issues Relating To Investigations Of Claims

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D. Whether And How To Investigate Or Renew An Investigation After Coverage Litigation Has Commenced

1. Factors in Deciding Whether to Conduct a Supplemental or Additional Investigation

   • If the insured presents new and/or different information in the course of the coverage litigation, the insurer may want to renew or supplement its prior investigation.

   • An insurer may wish to ask the insured to confirm in writing whether it has any new or additional facts, documents, or other information which the insured wants to bring to the attention of the insurer.
Conducting Any Investigation Once Coverage Litigation Has Commenced

- Generally speaking, an additional or supplemental investigation is not required.
  - See *Wells Dairy, Inc. v. Travelers Indemnity Co. of Illinois*, 241 F. Supp. 2d 945, 969 (N.D. Iowa 2003) (“[W]here an insurer has an objectively reasonable basis to deny coverage, it has no duty to investigate further before denying the claim.”) (citation omitted); *Douglas v. State Farm Lloyds*, 37 F. Supp. 2d 532, 541-42 (S.D. Tex. 1999) (same).

- Rather, the coverage action will be based upon what investigation had been done before or at least up to the institution of the coverage action.
  - See, e.g., *Adams v. Allstate Ins. Co.*, 187 F. Supp. 2d 1219, 1228-29 (C.D. Cal. 2009) (where insurer's initial investigation was deemed to be reasonable and adequate, evidence of other reports that surfaced during action against insurer which reached contrary conclusion were immaterial).

- However, in some jurisdictions, an insurer may have a continuing obligation to investigate after the coverage lawsuit has been filed, or at least to investigate certain issues after the lawsuit has been filed. See *White v. Western Title Ins. Co.*, 40 Cal. 3d 870, 221 Cal. Rptr. 509 (1985).

- The insurer must also consider how the investigation would be conducted.
  - One possible approach is to conduct the investigation through the usual procedures in a lawsuit.
  - Another approach is to have the claims handler conduct the investigation.
  - The insurer will need to consider important issues about invoking the attorney-client and work-product privilege, whether its coverage counsel could become a potential witness, and whether the insured would claim bad faith in the failure to conduct an adequate investigation.
Specific Issues Relating To Investigations Of Claims

E. Issues Relating to the Use Of Outside Adjusters To Conduct Investigation

- The same general rules apply investigations by outside adjusters as to investigations by insurers.
  - Generally speaking, the insurer is bound by what the outside adjuster did or did not do in determining the promptness and adequacy of an investigation. See Residential Constructors, LLC v. ACE Prop. and Cas. Ins. Co., 2006 WL 3149362, at *14-15 (D. Nev. Nov. 1, 2006) (independent adjuster handling investigation of claim for insurer is functional equivalent of insurer’s employee and attorney-client privilege attaches to communications between insurer’s attorney and the independent adjuster).
  - An adjuster’s reports, files, and all other communications are discoverable, just like those of the insurer’s own employees. See, e.g., D’Alonzo v. Hunt, 2006 WL 3511712, at *3 (E.D. Pa. Dec. 4, 2006) (work-product privilege does not bar deposition of independent claims adjuster hired by insurer to investigate accident involving its insured).

- If the adjuster does not perform a proper investigation, it could expose the insurer to a bad-faith claim.
  - The insurer should make sure the adjuster knows what issues as to liability and damages should be investigated and make sure that the adjuster continues to investigate as it learns information and obtains documents.
  - The insurer should make sure it obtains all documents gathered by the adjuster in the course of its investigation.
  - The insurer should be careful that the adjuster does not make coverage decisions, unless the adjuster is specifically asked to do so and has the necessary information to render a coverage decision.
Possible Effects Of An Inadequate Or Inappropriate Investigation

A. An Independent Or Private Cause Of Action Against The Insurer

B. Possible Effect On Coverage Determination


2. Third party liability policies – majority of jurisdictions hold that insurance companies have nothing to investigate in determining their duty to defend. That is determined by the underlying claim and the policy.

3. An insurance company’s inadequate or inappropriate investigation can be used to rebut insurance company’s “prejudice” based defenses.
Potential Bad Faith Liability

1. Bad faith claims can sometimes be resolved on summary judgment.
   - New York allows consequential damages in first-party bad faith cases.

2. Courts are more likely to find that bad faith is a question of fact for trial.
3. Pennsylvania state courts conduct court trials of statutory bad faith claims.
   
   
   - Bad faith claims brought under Pennsylvania law in federal court can be heard by a jury. See Allstate Property and Casualty Ins. Co. v. Wolfe, 39 MAP 2014, 2014 WL 7088147, __A.3d__ (Pa. December 15, 2014) (bad faith claim can be assigned, and removed case can be tried to a jury in Federal Court); Klinger v. State Farm Mutual Automobile Ins. Co., 115 F.3d 230 (3d Cir. 1997) (Seventh Amendment compels right to trial by jury).
Possible Effects Of An Inadequate Or Inappropriate Investigation

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4. A court may order a bifurcated trial on the issues of liability and damages.

- White v. Western Title Co., 40 Cal. 3d 870 (1985) (court determined the perceived legal question of liability and a jury determined the factual question of damages).

- Some states have statutes that mandate punitive damage claims be bifurcated.

  - See Georgia (GA. 51-12-5.1); Nevada (N.R.S. 42.005); Utah (U.C.A. 1953 Section 78-18-1). Other states require bifurcation if one party requests it. See California (Cal. Civ. Code Section 3295); Ohio (OH St. Section 2315.21); Texas (Tex. Civ. Prac. & Rem. Code Section 41.011).

- Discovery and trial on bad faith issues may be bifurcated from litigation of insurer’s duties to defend and indemnify.

5. Punitive Damages

- Punitive damage awards are limited by State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 426 (2003) (“courts must ensure that the measure of punishment is both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered”).

- A number of states have statutory limits on punitive damages.
  
  - Colo. Rev. State Section 13-21-102 (exemplary damages cannot exceed actual damages); Fla. Stat. Section 768.73 (punitive damages cannot exceed three times compensatory damages unless claimant demonstrates by clear and convincing evidence that award is not excessive); N.J. Stat. Section 2A:15-5.14 (capping punitive damages at the greater of five times actual damages or $350,000).

- Some states require an additional showing of ill-will or gross misconduct. Alberici v. Safeguard Ins. Co., 444 Pa. Super. 351, 664 A.2d 110 (1995) (must show insurer’s conduct was malicious, wanton, reckless, willful or oppressive); Erie Ins. Co. v. Hickman, 622 N.E.2d 515 (Ind. 1993) (insurer must have acted with malice, fraud, gross negligence or oppressiveness).

- Punitive damages may be permitted under exceptional circumstances where bad faith arises out of contract. Rocanova v. Equitable Life Assur. Soc’y, 83 N.Y.2d 603, 612 N.Y.S.2d 339, 634 N.E.2d 940 (1994) (punitive damages only available where conduct is of an egregious nature and directed to public generally).
Issues Relating To Privilege

A. The Use Of Counsel To Investigate

1. Possible Waiver Of Privilege
B. The Availability Of A Claim Of Privilege When The Claims Manager Or Claims Handler Is An Attorney


2. Insurer may place privileged communications “in issue” by claiming advice of counsel defense.

3. Insurer may not be permitted to benefit from protection against disclosure of “mental impressions, conclusions, opinions, or legal theories” even where it employs claims investigators who are attorneys because claims investigators do not function as attorneys. See *Fed. R. Civ. P. 26(3)(b)*; see also *Pete Rinaldi’s Fast Foods, Inc. v. Great Am. Ins. Co.*, 123 F.R.D. 198, 202 (M.D.N.C. 1988) (claims files not created in anticipation of litigation); Cedell, 176 Wash. at 701 (although outside counsel provides insurer advice as to law and strategy, where attorney also performs claims adjusting functions such as investigating, evaluating, negotiating and processing the claim, the attorney’s communications with insurer may not be protected in first-party bad faith claim).
Litigating The Adequacy Of An Investigation

A. Use Of Experts

1. Best To Use An Expert Witness From Within The Insurance Industry (Or A Broker)
Use Of Experts

2. Keep It Simple

a. When litigating the adequacy of an investigation, an insurer will more likely than not need an expert to opine on the adequacy of the investigation and other issues relating thereto, including promptness, the length of time to conduct, what documents and information were not necessary to review and so on.

b. Expert testimony will most likely be needed to assist in demonstrating how the insurer complied with statutes and regulations that addressed investigations, custom and practice with respect to investigations, and/or compliance with the insurer’s own claims manuals and claims procedures.

c. Expert testimony will not automatically insulate insurers from bad-faith liability, but it has an important role at any trial, especially to counter the arguments, contentions and opinions of the policyholders’ own expert.

d. An insurer should select an appropriate expert for the field or type of claim and of course make sure the expert has all relevant documents and information in order to base any opinions and views.
Use of Experts

3. Focus on:
   a. Documents (Not) Reviewed.
   b. Witnesses (Not) Interviewed.
   c. Sites (Not) Inspected.
   d. Tests (Not) Conducted.
   e. Internal Resources (Not) Utilized.
      i. Underwriting
      ii. Loss Control

4. Recency Of Investigation
   a. What Was Done Lately?
Litigating The Adequacy Of An Investigation

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B. Discovery

1. Documents
   - Claim file; underwriting file; loss control file; documents withheld or redacted due to alleged privilege; manuals/procedures; advertisements

2. Depositions (Videotape)
   - Past and present claim managers; underwriters; loss control engineers

C. Personnel Files
Litigating The Adequacy Of An Investigation

D. E-Discovery
   1. E-mails
   2. Contest Privilege Log If Disclosure Includes Outsiders
   3. Meta-data

E. Discovery Of Internal Procedures And Quality Control
   1. Manuals/Procedures
   2. Systems/Resources Available
      – Computerized
      – Bests’ Manuals
Strategies For Policyholders And Insurers

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