

# Insurer's Bad Faith Liability in the Absence of Coverage: First-Party and Third-Party Claims

Advocating or Defending Extra-Contractual Claims for Improper Claims Handling

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Today's faculty features:

David J. McMahon, Partner, **Hinshaw & Culbertson**, San Francisco

C. Zachary Ransel, Shareholder, **Fisher Kanaris**, Chicago

David A. Shaneyfelt, Esq., **The Alvarez Firm**, Calabasas, Calif.

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# **Bad Faith Liability In The Absence of Coverage First and Third Party Claims**

**David A. Shaneyfelt**  
The Alvarez Firm  
A Law Corporation  
24005 Ventura Blvd.  
Calabasas, California 91302  
(818) 224-7077

**David J. McMahon**  
Hinshaw & Culbertson, LLP  
One California Street, 18<sup>th</sup> Floor  
San Francisco, California 94108  
(415) 362-4000

**C. Zachary Ransel**  
Fisher Kanaris, P.C.  
One South Wacker Drive  
31<sup>st</sup> Floor  
Chicago, Illinois 60606  
(312) 879-7445

# General Outline

- Introduction
- First Party Bad Faith
- Third Party Bad Faith
- Extra-Contractual Liability For Non-Covered Claims
- First Party Bad Faith Where Policy Benefits Are Paid
- Conclusion: Q&A

# I. Introduction

## A. Bad Faith in General

- The legal concept to describe a breach of the covenant of good faith and fair dealing implied by law in every contract: unreasonable conduct in the relation to an insurance company's duties owed under a policy of insurance. Implied in all contracts including insurance policies, is the covenant of good faith and fair dealing. In the insurance context this covenant requires the insurer to not place its own interests above the insured. *Comunale v. Traders & General Ins. Co.* 328 P.2d 198.2000(Cal.1958).

## **B. Typical Bad Faith Scenarios**

- 1. Failure to investigate first party claims
- 2. Failure to respond to and defend third party claims
- 3. Statutory or regulatory violations

## 2. The General Rule Requires a Covered Claim Before a Bad Faith Action May Proceed

- Many state courts have said no. For example, courts in California have held that "[t]he covenant of good faith is read into contracts in order to protect the express covenants or promises of the contract, not to protect some general public policy interest not directly tied to the contract's purposes."<sup>3</sup> For this reason, if there is no breach of contract of insurance, there can be no breach of the implied covenant of good faith and fair dealing.<sup>4</sup>

<sup>3</sup>*Foley v. Interactive Data Corp.*, 765 P.2d 373, 294 (Cal. 1988).

<sup>4</sup>*Jordan v. Allstate Ins. Co.*, 56 Cal. Rptr. 3d 312, 324 (Cal. Ct. App. 2007) ("An insurer's failure to investigate, upon which Jordan's claim of bad faith entirely rest, is not separately actionable if there is no coverage); see also *Waller v. Truck Ins. Exch., Inc.*, 900 P.2d 619, 639 (Cal. 1995).

# Kinds Of Bad Faith

- First Party

  - (Policyholder v. Insurance Company)

- Third Party

  - (Third Party v. Policyholder v. Insurance Company)

# Bad Faith – First Party

- Concerns Policyholder's Direct Benefits  
(Policyholder v. Insurance Company)
- Examples
  - Homeowner's Insurance
  - Life Insurance
  - Health Insurance
  - Disability Insurance
  - Auto Insurance

# Bad Faith – Third Party

- Concerns Claims Against Policyholder  
(Third Party v. Policyholder)
- Examples
  - General Liability
  - Director and Officer Insurance
  - Errors and Omissions Insurance
  - Employment Practices Liability

# Bad Faith – First Party

## Duties

- Insurance company agrees it will:
  - Investigate claim thoroughly and promptly
  - Not unreasonably delay or withhold payment of benefits

# Breach Of Duties

- Insurance company breaches covenant when it –
  - Fails to investigate claim reasonably
  - Unreasonably delays or withholds payment of benefits

# Failure To Investigate

## Did the Insurance Company –

- Gather facts accurately?
- Focus on the right issues?
- Investigate promptly, especially when facts are fresh?
- Intimidate any witnesses or solicit false information?
- Use properly trained personnel?
- Reflect balance or bias?
- Fairly evaluate the findings?
- Handle the claim consistent with industry practice?

# Failure To Investigate

## Did the Insurance Company –

- Violate any state statutes or administrative regs?
- Rely on unverified information?
- Adequately document its findings?
- Reach a decision before concluding investigation?
- Reach a decision based on isolated facts or events?
- Refuse to re-consider additional evidence?
- Refer claim to a rubber-stamp committee?

# Failure To Investigate

## Special Circumstance

- Insurance company's use of an expert –

# When Expert Is Involved

- Is the report accurate or does it contain errors indicating the investigation was not conducted carefully?
- Is the report objective or does it appear biased?
- Does the report contain speculations or conclusions with no basis in fact?
- Does the report address all relevant information reasonably available to the expert?
- Does the report leave facts undeveloped and unresolved?

# When Expert Is Involved

- Did the insurance company rely exclusively on expert's report or did it consider info from other sources?
- Did insurance company follow up leads from records reviewed or witnesses contacted?
- Does expert have the appropriate qualifications to evaluate the claim?
- Did insurance company limit any info to the expert?
- Were policyholder's experts more qualified than those of the insurance company?

# Unreasonable Delay

## Did the Insurance Company –

- Delay payment of benefits “unreasonably”?
- Delay payment of benefits “without proper cause”?
- Did company employ abusive or coercive tactics ?
  - Even after coverage litigation commences?

# Fairly Debatable Doctrine

- Under the "fairly debatable" standard, an insurer may be liable for bad faith only when a denial or delay in payment lacked any reasonable basis. Where the insurer's position was one on which reasonable minds could differ, the insurer will not be liable as a matter of law.
- If an insurer denies coverage with a reasonable basis, it acts without bad faith, even if it made a mistake on its coverage determination
- Bad faith conduct requires some element of bad intent or conscious disregard of an insured's rights during the course of a claim.

# Fairly Debatable Doctrine

- *Guebara v. Allstate Ins. Co.*, 237 F.3d 987 (9<sup>th</sup> Cir. 2001)
  - Involved a “battle of the experts”
  - Announced that the genuine dispute doctrine would now be applied to factual disputes as well as legal ones, but maintained that the existence of a “genuine dispute” must be determined case-by-case, and the reliance on “[e]xpert testimony does not automatically insulate insurers from bad faith claims based on biased investigations.”
  - *Guebara* found that a trial court should consider whether: (1) the insurer is guilty of misrepresenting the nature of the investigatory proceedings, ... (2) the insurer's employees lie during the depositions or to the insured; (3) the insurer dishonestly selected its experts; (4) the insurer's experts were unreasonable; and (5) the insurer failed to conduct a thorough investigation.

# Fairly Debatable Doctrine

- ***P&M/Mercury Mechanical v. West Bend Mutual Ins. Co.*, 483 F.Supp.2d 601 (N.D. Ill 2006)**
  - Under Illinois law, an insurer does not act vexatiously and unreasonably when:
    - ◆ (1) there is a bona fide dispute concerning the scope and application of insurance coverage;
    - ◆ (2) the insurer asserts a legitimate policy defense;
    - ◆ (3) the claim presents genuine legal or factual issue regarding coverage; or
    - ◆ (4) the insurer takes a reasonable legal position on an unsettled issue of law.

# Strategies for Avoiding Bad Faith Claims/Judgments

- Prior to challenging an insured's claim, an insurer should:
  - Gather all of the known facts and complete a comprehensive investigation
  - Retain independent, credible and objective experts/consultants
  - Ensure that retained experts and consultants receive *all* pertinent claim information
  - Ensure that the policy provision(s) being applied to exclude or limit coverage has/have convincing legal support to be applied in such a fashion; and
  - Maintain open communication with the insured regarding the status and progress of the claim investigation

# Bifurcation of the Bad Faith Claim

- Bifurcation of trials avoids prejudice and confusion to the jury on any fact issues by focusing solely on the coverage matter.
- Assessing relative strengths of coverage and defense of claims handling dispute
  - Will the claims handling activities color the coverage dispute?
  - Conversely, do claim decisions such as advance payments bolster coverage position?
- Majority of courts recognize the merits of bifurcating and resolving the coverage issue first

# Bifurcation/Staying of the Bad Faith Claim

- Several courts have ruled that when the resolution of the underlying coverage dispute disposes of the bad faith claim, it is reasonable for the court to permit the coverage matter to proceed while staying the bad faith issue.
  - ***Smith v. Allstate Ins. Co.*, 403 F.3d 401, 407 (6th Cir. 2005)**
    - ◆ “because the merits of the bad faith claim depended on whether the limitations provision was valid, it was reasonable for the court to resolve the validity question before allowing the bad faith claim to proceed.”
  - ***Karpenski v. American General Life Co.*, 916 F. Supp. 2d 1188 (W.D. Wash. 2012)**
    - ◆ Ruled in the interest of expeditious case management and judicial economy, it was in both party’s interest to bifurcate the bad faith claim which will result in focused discovery and motion practice before expending time and resources on the bad faith issues.

# Bad Faith – Third Party

## Duties

- Insurance company agrees it will:
  - Defend and indemnify its policyholder against covered claims
  - Attempt to effect a reasonable settlement within policy limits

# Breach Of Duties

- Insurance company breaches covenant when it –
  - Fails to provide a defense when it is reasonably required to do so
  - Fails to settle a third party claim timely or reasonably within policy limits

# Failure To Provide Defense

## Critical Questions

- Is the claim “potentially covered”?
- Could facts turn in favor of coverage?
- Did insurance company reject defense cavalierly
- Can reasonable showing of coverage be made?
- Did insurance company unreasonable delay response?
- Did litigation deadline pass?
- Was policyholder prejudiced in defense of case?

# Failure To Settle Timely

## Critical Questions

- Did insurance company let settlement demand lapse?
- Did it have reasonable opportunity to accept it?
- Could it have initiated settlement negotiations?
- Did Plaintiff ever communicate interest in settlement?
- Was insurance defense overly aggressive?
- Is insurance policy a “burning limits” policy?

# Failure To Settle Reasonably

## Critical Questions

- Was third-party's settlement demand reasonable?
- Was it within the policy's limits of liability?
- Did the insurance company reject it?
- Was judgment entered in excess of policy limits?

# Failure To Settle Reasonably

## What Is A “Reasonable” Demand?

- A demand for an amount that represents a figure within policy limits, but could well justify amounts in excess of policy limits, given the damages claimed and the probable liability of the policyholder

# Strategies For Pursuing Claims

## Be Prepared; Be Resolved

- Insurance companies do not take lightly an accusation they have acted in bad faith and they will defend against such claims vigorously

# Strategies For Pursuing Claims

## Three Approaches

- Justifying risk of excess policy limits damage
- Assignment of bad faith claim to third party
- Pursuit of bad faith litigation in discovery

# Strategies For Pursuing Claims

- Justifying Risk of Excess Exposure
- Demonstrate reasonableness of third-party claim
- Provide insurance company with all information available to justify liability

Note:

- Policyholder's financial status is irrelevant in determining insurance company's duty to settle
- But policyholder's consequential demise *is* relevant

# Strategies For Pursuing Claims

## Assignment of Claim To Third Party

- Claimant steps into shoes of policyholder
- Has same claim policyholder had against insurance company
- Policyholder accepts judgment and third party covenants not to execute it
- Cannot be collusive
- Damages minimally justifiable

# Strategies For Pursuing Claims

## Factors Governing Assignment Of Claim

- How much did policyholder pay for settlement?
- What was the value of the claims asserted?
- Comparison of similar awards in similar cases?
- Facts known to policyholder at time of settlement?
- Did viable defenses exist?

# Strategies For Pursuing Claims

## Pursuit of Bad Faith Discovery

- Did it weigh facts in light of applicable standards?
- Did it consider all the evidence on either side?
- Did it consider probabilities of adverse verdict?
- Did it consider past results of similar claims?
- Did it consider experience and capabilities of counsel?
- Did it consider plaintiff to be sympathetic?
- Did it consider policyholder to sympathetic?
- Did it consider policyholder's recommendations about exposure and risk of loss?

# Strategies For Pursuing Claims

## Pursuit of Bad Faith Discovery

- The Claims File
- The Underwriting File
- Internal Policies, Procedures, Guidelines
- Training Materials
- Advertising Materials
- Pattern And Practice Discovery
- Claims Personnel

## IV. EXTRA CONTRACTUAL LIABILITY FOR NON-COVERED CLAIMS

### A. Breach of Covenant

#### 1. Obligations Imposed By the Implied Covenant

- In the first-party context, the implied covenant requires a thorough and prompt investigation of the claim as well as payment of policy benefits without unreasonable delay.<sup>1</sup> In the third-party context, the implied covenant requires: (1) a reasonable and prompt investigation of the claim; (2) a defense of the insured where a potential for coverage exists; and an attempt to settle the claim within policy limits whenever there is a substantial likelihood of a recovery in excess of those limits.<sup>2</sup>

<sup>1</sup>See, e.g., *Cal. Shoppers, Inc. v. Royal Globe Ins. Co.*, 221 Cal. Rptr. 171, 200 (Cal. Ct. App. 1985).

<sup>2</sup>See, e.g., *Egan v. Mutual of Omaha Ins. Co.*, 620 P.2d 141, 145-146 (Cal. 1979); *Johansen v. California State Auto Assn. Inter-Ins. Bureau*, 538 P.2d 744 (Cal. 1975)

### 3. TRENDS WITH EXCEPTIONS TO THE GENERAL RULE

#### A. First Party Claims

- (1) South Carolina – *Tadlock Painting Co. v. Maryland Casualty Co.*, 473 S. E.2d 52 (S.C. 1996)
- (2) Arizona – *Deeso v. State Farm Mutual Automobile Insurance Co.*, 838 P.2d 1265 (Ariz. 1992)
- (3) Ohio – *Poneris v. Pa. Life Insurance Co.*, 2007 WL 3047232 (S.D. Ohio 2007)

## B. Assumption of defense imperfectly

- (1) Hawaii – *Del Monte v. State Farm Fire and Casualty Co.* 975 P.2d 1159 (Haw. 1999).
- (2) Arizona – *Lloyd v. State Farm Mutual Automobile Insurance Co.*, 943 P.2d 729 (Ariz. App. 1996).

## C. Statutory violation situations

- (1) Unfair claims handling practices examples
  - See Cal. Fair Practices Regs, Cal. Insurance Code § 790.03(h)
- (2) Washington State – *St. Paul Fire and Marine Insurance Co. v. Onvia, Inc.*, 196 P.3d 664 (Wash. 2008).

## V. FIRST PARTY BAD FAITH WHERE POLICY BENEFITS ARE ACTUALLY PAID

- A. General Rule: No claim
- B. Exceptions to Rule
  1. *Rawlings v. Apodaca*, 151 Ariz. 149 (1986)
  2. *McMillin Scripps North Partnership v. Royal Ins. Co. of Am.*, 19 Cal. App. 4th 1215 (1993)
  3. *Schwartz v. State Farm Fire and Cas. Co.*, 88 Cal. App. 4th 1329 (2001)
  4. *Julson v. Federated Mutual Ins. Co.*, 562 N.W. 2d 117 (S.D. 1997)

## VI. Summary of Presentation

- An insurer risks liability beyond that defined in its policy of insurance where its acts or omissions in handling and adjusting a claim amount to bad faith. Some courts have held liability may be imposed even where the claim is not covered by the policy.