MEALEY'S LITIGATION REPORT

# Insurance Bad Faith

## A Look Back At Some Of 2009's Significant Bad Faith Decisions

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# Commentary

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In recent years, bad-faith practitioners have seen the concept of "bad faith" evolve into an amorphous theory encompassing virtually every aspect of an insurer's conduct, and 2009 was no exception. This past year was filled with a series of small victories for insurers. The losses, however, served as reminders that missteps can prove costly, particularly when the decision is left in the hands of a jury. This article highlights some of 2009's significant decisions with respect to the accrual of bad-faith claims, pleading bad faith, discovery, and settlement negotiations.

### I. Accrual Of A Bad-Faith Claim And Allegations Of 'Ongoing' Bad Faith

When a bad-faith claim arises out of an insurer's alleged refusal to defend, there is a split in authority with respect to when the claim accrues. Some courts have taken the approach that the statute of limitations begins to run when an insurer denies coverage; others have found that the claim does not accrue until a final judgment is entered in the underlying suit.[1] A West Virginia appellate court adopted the former approach in *Noland v. Virginia Insurance Reciprocal*, finding that when an insurer refuses to defend its insured in an underlying case, any bad faith involved in that refusal to defend concludes when the denial is conveyed to the insured.[2] According to this view, the claim accrues and the statute of limitations begins to run when the insured knows or reasonably should have known of the insurer's refusal to provide a defense.

Along the same lines, the Eastern District of Pennsylvania found that a bad-faith claim accrues when the insurer unequivocally communicates its denial of coverage.[3] In *CRS Auto Parts, Inc. v. National Grange Mutual Insurance Co.*, the insured claimed that its bad-faith claim was not barred by the applicable statute of limitations because the insurer engaged in fifty-five separate actions constituting bad-faith denials of coverage over a period of time. According to the insured, the bad-faith claim was not time-barred because the alleged bad-faith conduct was ongoing in nature. The court entered summary judgment in favor of the insurer, explaining that each subsequent act related back to the initial act of alleged bad faith, which was the first denial of coverage. When the insurer clearly and unequivocally put the insured on notice that the claim was not covered, the statute of limitations on the bad-faith claim began to run. The insured could not avoid the limitations period by asserting that each continuing refusal to provide coverage was a separate act of bad faith.[4]

## II. Pleading Bad Faith: The Impact Of Iqbal

In May of 2009, the Supreme Court of the United States was called upon to assess the sufficiency of a complaint filed by a suspect alleging deprivation of constitutional protections while in federal custody.[5] While concluding that the detainee's complaint failed to plead sufficient facts to state a claim for purposeful and unlawful discrimination, the Court further refined the "notice pleading" standard under the Federal Rules of Civil Procedure.[6] To withstand a motion to dismiss under the *Iqbal* standard, a complaint must include sufficient factual allegations that, if accepted as true, would state a claim for relief that is plausible on its face.[7] A claim is facially plausible if the plaintiff pleads sufficient factual content to allow the court to draw a reasonable inference that the defendant is liable for the alleged misconduct.[8]

In 2009, insurers defending bad faith actions in federal court quickly added the *Iqbal* standard to their arsenal, seeking dismissal of claims premised upon conclusory allegations of bad faith. In *Johnson v. Liberty Mutual Fire Insurance Co.*, the insureds claimed that their auto insurer acted in bad faith when it failed to preserve the insured vehicle's taillights after a collision.[9] The complaint alleged that the insurer "knew, or should have known, of [the] evidentiary significance" of the taillights to the plaintiffs' claim.[10] The District of Colorado characterized this allegation as "entirely conclusory" because the complaint did not include facts indicating how or why the insurer "knew or should have known" of the significance of the taillights to future litigation. For example, the complaint did not allege that the insurer was aware of the plaintiffs' intentions to commence a civil suit, or offer any other explanation for the conclusion that the insurer "should have known" of the need to preserve the taillights. Relying upon *Iqbal*, the court dismissed the insureds' bad-faith claim because the plaintiffs failed to plead facts demonstrating the insurer's state of mind underlying its alleged unreasonable actions.[11]

The Southern District of Florida also relied upon *Iqbal* to dismiss a poorly pled claim pursuant to which the insured sought to impute an insurer's bad faith to its parent corporation.[12] In *Sandalwood Estates Homeowner's Ass'n, Inc. v. Empire Indemnity Insurance Co.*, the insured homeowners' association filed suit against its insurer and the insurer's parent corporation, alleging that both defendants acted in bad faith in processing the insured's claims. The association's complaint alleged that the insurer was a subsidiary of the parent corporation, that the parent corporation wrote insurance policies through its subsidiaries, and that the parent corporation controlled the insurer's claims handling and decisions because it employed all of the claims-handling personnel. The association claimed that, by issuing a policy through the underlying insurer, the parent corporation was liable for statutory bad faith.[13]

The parent corporation moved to dismiss on the ground that the complaint failed to allege the requisite contractual relationship between itself and the homeowners' association. In granting the parent corporation's motion to dismiss, the court explained that the insured's complaint did not contain the factual allegations necessary to make a contractual relationship between itself and the parent corporation plausible and therefore failed to state a cause of action for statutory bad faith.[14]

## III. Evidence Of Bad Faith And The Boundaries Of Discovery

In 2009, several courts stretched the boundaries of discovery related to an insured's bad-faith claim. Notably, the ability to maintain and search electronic databases raised the bar when it came to the sufficiency of bad-faith discovery responses. For example, in *Beyer v. Medico Ins. Group*, the insured sought an order compelling her medical insurer to produce any and all documents relating to other denials of benefits or terminations of benefits similar to her claim.[15] Despite the insurer's contention that the discovery request encompassed over 200,000 claim files and its subsequent offer to produce all of these claim files for inspection, the District of South Dakota granted the insured's motion to compel. In doing so, the court acknowledged the insurer's claim that it would be forced to scan images to make them text-searchable or manually search for thousands of documents relating to similar denied claims, but the court found that this was not a sufficient reason to find the insured's request to be unduly burdensome.[16]

In *Graske v. Auto-Owners Insurance Co.*, the insureds moved to compel better responses to the insurer's responses to interrogatories and requests for production.[17] The insurer had previously produced nearly 7,000 documents which were bates-stamped, scanned onto discs, and divided into seven files. In response to the interrogatories at issue, the insurer directed the insureds to one or more of these files of documents. The court found that the insurer's responses were deficient because the documents were not accompanied by any indices or other tools to guide the insureds to the responsive documents. Furthermore, the insureds' ability to search electronically for key terms was not sufficient to discharge the duty to specifically identify the location of the responsive documents.[18]

With respect to proprietary materials, a Washington appellate court took a hard stance regarding the production of documents that the insurer claimed to be protected by the trade-secret privilege.[19] In *McCallum v. Allstate Property and Casualty Insurance Co.*, the insurer sought discretionary review of the trial court's denial of a protective order to limit the discovery of its claim manuals, training manuals and claim bulletins in a bad-faith lawsuit. On behalf of the insurer, employees testified that competitors would gain an unfair advantage if given access to the company's manuals and bulletins. The insurer's employees also testified that the company devoted considerable time, manpower, and finances in developing the requested materials.[20] These witnesses, however, were unable to describe specific factual examples to support these statements. The appellate court affirmed the trial court's ruling explaining that the testimony of the insured's employees failed to provide concrete examples to illustrate how the insurer's strategies or procedures in handling claims were materially different from those of its competitors. The insurer's conclusory statements and unsubstantiated assertions were insufficient to establish that the manuals and bulletins contained trade secrets.[21]

Materials protected by the attorney-client privilege may also become discoverable in a bad-faith suit when the insured seeks to establish that the insurer's conduct was subjectively unreasonable or when the insurer seeks to offer proof that it believed its conduct was in good faith. As demonstrated by the following cases, the applicability of the attorney-client privilege sometimes hinges upon the admissibility of evidence of the insurer's subjective beliefs.

In an action for breach of the covenant of good faith and fair dealing in administering a workers' compensation claim, an Arizona appellate court found that the employer implicitly waived the attorney-client privilege on files maintained by its adjusters when it asserted that its adjusters' actions were subjectively reasonable, made in good faith, and based at least in part on advice that the adjusters received from counsel.[22] The court explained that, in the bad-faith context, when an insurer raises a defense based on factual assertions of subjective good faith, and that defense implicitly incorporates the advice or judgment of its counsel, it cannot deny an opposing party the opportunity to discover the foundation for those assertions.[23]

By contrast, a Florida appellate court held that documents exchanged between the insurer and its counsel were privileged in a first-party case where the plaintiff asserted a bad-faith claim.[24] The court noted that, because the statutory bad-faith claim at issue was subject to an objective test, proof of the claim did not depend upon evidence contained within attorney-client communications.[25]

## IV. Bad Faith Arising Out Of Settlement Negotiations

Summary judgments are few and far between in bad-faith suits. However, courts do occasionally find that the insurer's conduct precludes a finding of bad faith as a matter of law, especially where the insurer promptly settles a claim by tendering its policy limit. In one such case out of the Northern District of Georgia, the claimants demanded that the insurer pay the $25,000 policy limit in exchange for a release of the insurer, but refused to release the insured.[26] After the insurer accepted the demand, the claimants filed a wrongful-death suit against the insured. Unbeknownst to the insurer, the insured entered into a $4 million stipulated settlement agreement pursuant to which the insured assigned her rights to assert a bad-faith claim against the insurer. Subsequently, the claimants alleged that the insurer acted in bad faith by paying the policy limit without conditioning payment upon a release of the insured.[27]

In a separate declaratory-judgment action, the insurer argued that the insured breached the duty to cooperate, that the assignment was a fraudulent scheme concocted to expose the insurer to extra-contractual liability, and that it was not liable for amounts in excess of the policy limit. The court entered judgment in favor of the insurer finding that it could not be liable for bad-faith failure to obtain a settlement of the claims against the insured. In order for extra-contractual liability to arise, the court explained that the insurer must, at a minimum, have an opportunity to settle the claim against its insured within the policy limit. Here, the evidence revealed that the claimants never offered to settle their claims against the insured within the policy limit and explicitly stated, more than once, that they refused to release the insured for a settlement at the policy limit.[28]

Another case considered an insurer's obligation to seek releases of all of its insureds when the claimant refuses to release one of those insureds. In *Shin Crest PTE, Ltd. v. AIU Insurance Co.*, the insured manufacturer filed suit against its commercial general liability insurer alleging that the insurer acted in bad faith in settling a products-liability claim asserted against an additional-insured retailer.[29] During the course of the settlement negotiations, the insurer made several substantial offers. In return, the claimant demanded amounts in excess of the policy limit and repeatedly demonstrated an unwillingness to execute a release in favor of the manufacturer. After reaching an impasse at mediation, the insurer agreed to a settlement that exhausted the policy proceeds. In exchange, the insurer obtained a release of the retailer, but not a release of the claims against the manufacturer. Thereafter, the claimant filed suit against the manufacturer and the parties entered into a stipulated settlement for an amount in excess of the policy limit.[30]

The insured manufacturer filed suit against the insurer seeking to recover the settlement amounts. In support of its bad-faith claims, the manufacturer argued that the insurer should have affirmatively offered its policy limit at the mediation in exchange for a release of the claims against both the manufacturer and the retailer and, by neglecting to do so, the insurer failed to protect both of its insureds.[31] The insurer maintained that it settled the claim in good faith given the manufacturer's disputed liability and the claimant's unwillingness to release the manufacturer. Under the circumstances, the court agreed and found that the insurer had an obligation to settle the claim against the retailer alone in the absence of a possibility of obtaining a release as to both insureds. Consequently, the court granted the insurer's motion for summary judgment on the bad-faith claim.[32]

In *Taylor v. Sentry Group of Companies,* the Ninth Circuit found that an insurer did not act in bad faith by failing to pursue settlement opportunities above the policy limit.[33] In that case, the insurer tendered its policy limit to the injured accident victim on three separate occasions; however, the claimant rejected the offers. Nonetheless, the claimant argued that the insurer had an ongoing duty to conduct settlement negotiations designed to reach the most favorable settlement terms available, regardless of the policy limit. He contended that the insurer failed to investigate his reasons for rejecting the settlement offers and should have done "everything possible" to continue "fighting for settlement."[34] The court disagreed and affirmed the entry of summary judgment in favor of the insurer who had satisfied its obligation to make a good-faith attempt to effect settlement.

Under a limited set of circumstances, however, an insurer may be liable for bad faith for failing to pursue an excess settlement, even when the insurer promptly offers and tenders the policy limit. In *Allstate Insurance Co. v. Miller*, the insurer offered its policy limit to the claimant within thirteen days of the accident and subsequently issued a check for the policy limit made payable to the claimant, his attorneys, and the lienholder hospital.[35]

The claimant rejected the multiple-party joint check and advised the insurer that he was willing to release the insured from all liability if the insurer would agree to file an interpleader action. The insurer initially refused, but later agreed to file the interpleader action. By that time, the claimant had withdrawn his prior offer and demanded that the insurer consent to a stipulated settlement in excess of the policy limit. After the insurer rejected this proposal, the claimant obtained an excess judgment. In the bad-faith suit that ensued, the insured alleged that the insurer breached its duty of good faith by failing to file the interpleader action, failing to adequately inform the insured of a settlement offer in excess of the policy limit, and refusing to agree to a stipulated judgment in excess of the policy limit.[36] The Supreme Court of Nevada held that the insurer's offer of the policy limit within thirteen days of the accident and its subsequent issuance of a check for the policy limit was not enough to relieve the insurer of its potential bad-faith exposure.[37] The court explained that the insurer had a duty to adequately inform the insured of the claimant's offer to release the insured from liability if the insurer filed an interpleader action. At that point, the insured could have chosen to hire independent counsel to review the offer and pursue any available options, such as initiating an interpleader action at his expense or contributing additional funds. Additionally, under the factual circumstances presented, the court found that the insurer's refusal to file an interpleader action on behalf of an insured could be considered as evidence of bad faith, even if such an interpleader action would have resulted in a conflict of interest.[38]

## V. A Tale Of A Bad-Faith Trial

Timothy Moore obtained a policy from American Family Insurance Company insuring his duplex for $50,000.[39] Because the structure was located in a flood plain, the insured agreed to move the structure to a new location by a date certain. Approximately five weeks prior to that date, the duplex was destroyed in a fire. Apparently, based upon the timing of the loss in relation to the relocation deadline, the insurer denied Mr. Moore's claim alleging that Mr. Moore had intentionally set fire to the home.[40]

Mr. Moore filed suit against the insurer alleging breach of contract and bad faith. In support of his claims for damages, Mr. Moore presented evidence that the insurer had reported the claim to the Property Insurance Loss Register (PILR) indicating that the claim had been denied for arson and fraud. Mr. Moore testified that the PILR was a "scary scary thing" because it could have prevented him from obtaining insurance for the vehicles he needed to conduct his farming business.[41] The insured also testified that, had the fire not occurred, he intended to move the duplex to a new location where he could have obtained $1,000 per month in rent. Moreover, Mr. Moore and his wife offered testimony that they suffered severe emotional distress as a result of Mr. Moore being labeled an arsonist. Mr. Moore claimed that he experienced chest pain and started smoking more, and Ms. Moore stated that she was fearful of going to jail and concerned about how other members of the community viewed her.[42]

During jury deliberations, one of the jurors conducted his own internet research in an effort to determine the insurer's profits during the previous year. After this juror told the other members of the jury that he had conducted this research, the foreperson sent a note to the judge. This note stated that the juror had researched the insurer's profits, but had "not relayed his findings to the other jurors."[43] The insurer immediately moved for a mistrial; however, the trial court denied the motion and opted to dismiss the rogue juror instead. The jury ultimately awarded $48,414 on the breach-of-contract claim,$1.5 million in actual damages, and $1.5 million in punitive damages on the bad-faith claim.[44]

After trial, the insurer obtained an affidavit from the foreperson stating that the dismissed juror told the other members of the jury that the defendant insurer made "huge profits and [could] afford to pay."[45] Even after this revelation, the insurer's motion for new trial was denied. The trial court indicated that the juror's statement was not prejudicial because it was "not likely to be a major revelation."[46] On appeal, the insurer argued, among other things, that the evidence did not support the award of actual damages, that the award of punitive damages was excessive and unconstitutional, and that the trial court erred by not declaring a mistrial as a result of juror misconduct.

The Eighth Circuit concluded that the trial court did not abuse its discretion in denying the insurer's motion for a mistrial or its motion for a new trial. In support of its position, the court stated that "the misconduct here bordered on the innocuous since people know that insurance companies can generally afford to pay settlements."[47] The Eighth Circuit upheld the award of actual damages finding that the Moores' testimony was sufficient to support their claims for emotional distress, loss of reputation and loss of income. Furthermore, the court found that the insurer's "tortious" labeling of Mr. Moore as an arsonist — based upon what the court considered to be insufficient evidence — displayed an indifference towards the Moores' financial, emotional, and physical well-being that was sufficient to support the $1.5 million punitive-damages award.[48]

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### Endnotes

1. *Compare* Daugherty v. Allstate Ins. Co., 55 P.3d 224 (Colo. Ct. App. 2002), *and* Adamski v. Allstate Ins. Co., 738 A.2d 1033 (Pa. Super. Ct.1999)

(holding that the statute of limitations begins to run when an insurer denies coverage), *with* Tibbs v. Great Am. Ins. Co., 755 F.2d 1370 (9th Cir.1985), Brannon v. Continental Cas. Co., 137 P.3d 280 (Alaska 2006), *and* Sandbulte v. Farm Bureau Mut. Ins. Co., 343 N.W.2d 457 (Iowa 1984) (holding that the statute of limitations begins to run when a final judgment is entered in the underlying case or is tolled pending the outcome of the underlying action).

2. Noland v. Virginia Ins. Reciprocal, No. 34702, 2009 WL 3231361 (W. Va. Sept. 24, 2009).

3. CRS Auto Parts, Inc. v. National Grange Mut. Ins. Co., 645 F. Supp. 2d 354 (E.D. Pa. 2009).

4. *Id.* at 366.

5. Ashcroft v. Iqbal, 129 S. Ct. 1937 (2009).

6. *See id.* at 1951-52.

7. *Id.* at 1949 (*citing* Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 570 (2007)).

8. *Id.* (*citing* Bell Atlantic Corp. v. Twombly, 550 U.S. 544, 556 (2007)).

9. Johnson v. Liberty Mut. Fire Ins. Co., No. 08-01137, 2009 WL 2868841, at *1 (D. Colo. Sept. 2, 2009).

10. *Id.* at *10.

11. *Id.* The court noted that it would entertain a motion to amend the complaint if the Plaintiffs could demonstrate the ability to cure the pleading defect and also demonstrate good cause for an untimely motion to amend. *Id.* at *10 n.8.

12. Sandalwood Estates Homeowner's Ass'n, Inc. v. Empire Indem. Ins. Co., No. 09-80787, 2009 WL 3427973 (S.D. Fla. Oct. 20, 2009) (the published opinion does not specify whether this dismissal was with or without prejudice).

13. *Id.* at *2.

14. *Id.* at *4. C*ontra* ProCentury Ins. Co. v. Harbor House Club Condo. Ass'n, Inc., No. 08-5968, 2009 WL 2580356 (D.N.J. Aug. 19, 2009) (holding that allegations that insurer's subsidiary's name appeared on the declarations page of policy, and that insurer was the "strategic component" to subsidiary were sufficient to state a claim that the subsidiary joined with insurer in issuing the contested policy and acted in bad faith in doing so).

15. Beyer v. Medico Ins. Group, No. 08-5058, 2009 WL 3817211 (D. S.D. Nov. 13, 2009).

16. *Id.* at *5.

17. Graske v. Auto-Owners Ins. Co., 647 F. Supp. 2d 1105 (D. Neb. 2009).

18. *Id.* at 1108-09.

19. McCallum v. Allstate Prop. and Cas. Ins. Co., 204 P.3d 944 (Wash. Ct. App. 2009).

20. *Id.* at 947.

21. *Id.* at 951.

22. Mendoza v. McDonald's Corp., 213 P.3d 288 (Ariz. Ct. App. 2009).

23. *Id.* at 302.

24. West Bend Mut. Ins. Co. v. Higgins*,* 9 So. 3d 655 (Fla. Dist. Ct. App. 2009).

25. *Id.* at 658. The court went on to explain that even if the privilege were eliminated, such a nullification of privilege could not logically extend to communications made after the underlying first-party insurance dispute had been adjudicated.

26. ACCC Ins. Co. v. Carter, 621 F. Supp. 2d 1279 (N.D. Ga. 2009).

27. *Id.* at 1281-82.

28. *Id.* at 1285-86. The parties had previously stipulated to a set of facts, the and the court agreed to either resolve the legal issue of whether the insurer could be liable beyond the policy limit or certify the

issue to the Georgia Supreme Court.

29. Shin Crest PTE, Ltd. v. AIU Ins. Co., 605 F. Supp. 2d 1234 (M.D. Fla. 2009).

30. *Id.* at 1237-39.

31. *Id.* at 1239.

32. *Id.* at 1241-42.

33. Taylor v. Sentry Group of Companies, 331 Fed. Appx. 457 (9th Cir. 2009).

34. *Id.* at 458-59.

35. Allstate Ins. Co. v. Miller, 212 P.3d 318 (Nev. 2009).

36. *Id.* at 323-24.

37. *Id.* at 326.

38. *Id.* at 329. The insured also argued that the insurer had an independent duty to file an interpleader action; however, this argument was rejected.

39. Moore v. American Family Mut. Ins. Co., 576 F.3d 781 (8th Cir. 2009).

40. *Id.* at 784. The published opinion does not reflect the details of the insurer's investigation or the specific facts underlying the initial denial of coverage, however, the court characterized the insurer's investigation as "insufficient."

41. *Id.* at 790.

42. *Id.*

43. *Id.* at 787.

44. *Id.* at 784.

45. *Id.* at 787.

46. *Id.*

47. *Id.* at 788.

48. *Id.* at 790-91. Under North Dakota law, an insurer liable for bad faith may also be liable for punitive damages if it is "guilty by clear and convincing evidence of oppression, fraud, or actual malice." N.D. Cent. Code §32-03.2-11.1. ■

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