MEALEY'S™ LITIGATION REPORT
Insurance Bad Faith

Who Killed Reverse Bad Faith? And Why It Could Make A Comeback

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Commentary

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I. Introduction

In every state in the union an insured can seek some form of compensation for an insurer's "bad faith" in adjusting a claim.[1] Yet only one state, Tennessee, currently allows an insurance company to recover damages caused by the insured's bad faith.[2] This imbalance has allowed "bad faith" litigation to become big business.[3] The tendency of courts to treat insureds like a disadvantaged class has created an uneven playing field for insurance companies in claims adjustment.[4]

Courts first adopted "bad faith" law based upon the principle that the parties to an insurance contract are bound by an implied covenant of good faith.[5] This covenant of good faith required that "neither party do anything [to] injure the right of the other to receive the benefits of the agreement."[6] The first courts to recognize the implied covenant of good faith noted that it applied equally to insurer and insured.[7]

Some states still recognize that the duty of good faith inherent in a contract applies to both the insurer and insured. California has long recognized that "the duty of good faith and fair dealing in an insurance policy is a two-way street, running from the insured to his or her insurer as well as vice versa."[8] As recently as 1996, a Florida court also recognized that the duty of good faith applies to both the insurer and the insured.[9] However, neither state has recognized that an insurer can bring a cause of action against an insured for "bad faith."

II. The Insurer's Duty Of Good Faith

The first cases to establish an insurer's duty of good faith beyond the express terms of the contract dealt with the insurers' conduct in settlement negotiations.[10] In those days insurers sometimes chose not to settle a claim if the plaintiff demanded settlement for the policy limits.[11] These insurers elected to go to trial and hope for a defense verdict recognizing that, at worst, they would only have to pay the policy limits.[12] Courts, however, found that this strategy breached the insurer's duty of good faith to its insured.[13] To counter this strategy, courts established that an insurer's good faith obligation to its insured required that it act with the degree of care and diligence that a man of ordinary care and prudence would exercise in the management of his own business.[14] An insurer that breached the good faith duty owed to the insured would be subject to a potential "bad faith" claim.[15]

III. The Insured's Duty Of Good Faith

Over the past half century, courts have failed to recognize that insureds also have opportunities to manipulate settlement negotiations to the detriment of their insurance carrier.[16] Many insureds are sophisticated large companies that have equal bargaining power when negotiating a settlement alongside an insurance carrier.[17] When insurance contracts contain a large deductible or SIR, the insured could have an opportunity to put its own interest ahead of the carrier.[18]

Where an insured with a large deductible or SIR is in settlement talks for an amount close to its deductible, it will not have an incentive to settle.[19] If liability is unlikely to exceed the policy limits, the insured would not face any additional risk by going to trial.[20] If the insured rejected a reasonable settlement in the hopes that it might obtain a zero verdict, it would unnecessarily expose the insurer to much greater risk.[21] This conflict of interest is virtually identical to the conflict facing insurers that lead to the creation of bad-faith law.[22] However, courts have not recognized a reciprocal cause of action to protect insurers from this situation.[23]

Furthermore, insureds are sometimes presented with an opportunity to obtain excess coverage by baiting their insurer into denying a valid third-party liability claim.[24] If an insured knows that it is facing potential damages in excess of its coverage limits, it has an incentive to delay or thwart the insurer's investigation.[25] The insured could then reach a stipulated settlement with the plaintiff for an amount in excess of the policy limits.[26]

IV. California's Flirtation With Reverse Bad Faith

In the 1990s many legal commentators believed that California would lead the way in establishing the "reverse bad faith" cause of action.[27] California first recognized the independent tort of bad faith in *Brown v. Guarantee Ins. Co*.[28] There the insurer declined the plaintiff's offer to settle for the policy limits and subsequently exposed the insured to damages in excess of the policy limits.[29] The insured filed for bankruptcy and assigned its claim to the trustee. The trustee filed suit against the insurer for bad-faith refusal to settle.[30] The court chose to apply the bad-faith standard in lieu of the negligence standard in assessing the insurer's conduct.[31]

In *Liberty Mutual v. Altfillisch*,[32] California courts finally confirmed that the duty of good faith applies to both the insurer and the insured.[33] In *Altfillisch*, the court faced the question of whether an insurance carrier could recover damages from the insured when the insured contracted away the carrier's right of subrogation.[34] The court found that the insured's act of contracting away the carrier's right to recover in subrogation breached the insured's implied covenant of good faith and fair dealing.[35] Thus, the carrier could recoup the payment it had made to the insured.[36] This ruling established that under California law, an insurer could enforce the implied covenant of good faith and fair dealing against the insured.[37]

In 1985, California became the first and only state to recognize the affirmative defense of comparative bad faith in *California Casualty Ins. Co. v. Superior Court*.[38] An insured brought suit against its insurer for bad faith in handling of a claim.[39] The insurer moved to amend its answer to assert a claim for comparative bad faith.[40] The trial court denied the insurer's motion to amend and the insurer appealed. [41]

On appeal the court reversed the trial court and found that that the insurer could amend its answer to raise the affirmative defense of comparative bad faith.[42] The court recognized although comparative bad faith had not been approved by another court this did not mean it was a "disfavored" defense.[43] In establishing comparative bad faith as a viable defense, the court noted that the duty of good faith was "a two-way street, running from the insured to his insurer as well as vice versa."[44] The court pointed out that the insured's claim for bad faith sounded in tort and should thus be subject to tort principles such as comparative fault.[45] This language gave hope to legal commentators that California would adopt the doctrine of reverse bad faith.

However, in 1990 a California Court of Appeal greatly reduced the prospects for reverse bad faith. The court held that "[a]n action by an insurer against its insured for breach of the covenant of good faith and fair dealing only sounds in contract and, thus, any recovery must be limited to contract damages."[46] The trial court had awarded an insurer attorney's fees after the insurer established that the insured had breached its duty of good faith. The insured had sued the insurer for bad faith after the insurer rescinded the policy for material misrepresentations. The jury found that the insured had lied to the insurer and the court awarded the attorney's fees as the damages caused by the insured's frivolous bad-faith suit. This ruling demonstrated that while the duty of good faith runs both ways the insurer may not be entitled to the same relief provided to the insured.

In 2000, the Supreme Court of California reversed *California Casualty Ins. Co. v. Superior Court* and held that there was no affirmative defense of comparative bad faith. This ruling noted that the insurer's right to enforce the covenant of good faith was limited to

enforcement of the contract. The insurer could not rely tort principles to enforce its right under the contract. The "scope of the insured's duty of good faith and fair dealing . . . is confined by the express contractual provisions of the policy."[47]

V. No State Court Has Recognized A Claim For Reverse Bad Faith

Over the past decade, multiple state courts have declined to create a cause of action for reverse bad faith. Tennessee is currently the only state in which an insurer can recover compensatory damages from its insured as compensation for bringing a claim in bad faith.[48]

A. Ohio

The Supreme Court of Ohio became the first state court to directly address an insurer's claim for reverse bad faith in *Tockles & Son, Inc. v. Midwestern Indemnity Company*.[49] There the insured had filed a claim for a stolen tractor-trailer after the insured's wife's brother, a former employee, stole the tractor-trailer.[50] The insured reported the theft to the police the next day but waited eight months to notify his insurance carrier of the loss.[51] The insurer denied the claim, and the insured sued for bad faith.[52] The carrier counterclaimed for fraud on the theory that the insured knew the vehicle was in the possession of his ex-wife who was still a part owner of the company.[53] The insurer also brought a reverse bad-faith claim asserting that the insured's bad-faith suit was frivolous and thus breached the duty of good faith arising from the insurance contract.[54]

The trial court dismissed each of the insurer's counter claims.[55] The Supreme Court of Ohio reversed the trial court and found that the claim for fraud was wrongly dismissed.[56] However, the court refused to recognize a cause of action for "reverse bad faith."[57] The court reasoned that the insurer had sufficient protection as the "holder of the purse strings."[58] It was not necessary to create a claim for reverse bad faith because "bad faith" was simply a tool to give the insured sufficient leverage to challenge the carrier.[59] Additionally, the court pointed out that insurers can seek relief through a cause of action for fraud.[60]

B. Iowa

The Iowa Supreme Court also declined to recognize the tort of reverse bad faith in *Johnson v. Farm Bureau Mutual Insurance Co.*[61] In *Johnson*, a farmer brought suit against a local electric cooperative when his wife was injured on his property by the cooperative's downed electrical line.[62] The cooperative countersued the farmer for his own negligence in injuring his wife.[63] The farmer notified his liability insurer of the countersuit, and the carrier denied a defense because the injury to the wife fell within the exclusion for injury to any insured.[64]

The jury awarded damages to the wife and apportioned 80% fault to the cooperative and 20% to the farmer.[65] The farmer then brought suit against the carrier for breach of contract and bad faith for its refusal of a defense and indemnification.[66] The carrier counterclaimed for reverse bad faith on the basis that the insured's "bad faith" claim was frivolous.[67] The trial court granted the carrier's motion for summary judgment and denied the farmer's claim for bad faith.[68] However, the trial court also found that the insured had not acted in bad faith in bringing its claim against the carrier, and both parties appealed.[69]

On appeal, the Supreme Court of Iowa recognized that the covenant of good faith inherent in an insurance contract runs from the insurer to the insured and vice versa.[70] The court recognized that several commentators had begun to discuss the adoption of reverse bad faith.[71] However, the court noted that no other jurisdiction had in fact adopted the tort of reverse bad faith.[72] The court found that a claim for abuse of process[73] provided an adequate remedy to insurers that faced frivolous claims.[74] Remarkably, the court then confirmed that the insurer's claim for abuse of process had been properly denied.[75]

C. Oklahoma

In 1996 Oklahoma addressed an insurer's claim for reverse bad faith in *First Bank of Turley v. Fidelity and Deposition Ins. Co. of Maryland*.[76] In *First Bank of Turley*, a bank sought coverage from its insurer when sued by a customer for invasion of privacy.[77] The insurer denied coverage on its belief that the allegations demonstrated a willful and intentional violation of the customer's statutory right to privacy.[78] The insured hired defense counsel.[79] Defense counsel learned that the insured had a viable defense to the allegations because the information it provided to the I.R.S. was a permitted exception to the statutory right to privacy.[80]

The fact that the insured had not violated the privacy statute also meant that the insurance policy applied to cover the insured for the customer's allegations.[81] Defense counsel advised the insured that the insurer had wrongfully denied coverage but advised the insured not to inform the insurer of its mistake.[82] Eight months later the insured asked the insurer to reevaluate its coverage position and the insurer offered to defend under a reservation of rights.[83] In reviewing the underlying documents the insurer learned that the insured had not promptly informed the insurer that it was entitled to coverage.[84] The insurer offered to pay the insured's legal fees incurred after the insured had requested the second evaluation of coverage.[85] The insured sought coverage from the entirety of the defense and demanded full reimbursement for all past defense costs.[86]

The insured brought suit for bad faith against the insurance carrier.[87] The carrier countered that the insured had acted in bad faith in failing to promptly notify the carrier of facts that the insured believed changed the coverage analysis.[88] The insurer asked the court to reduce the potential award of defense costs on the basis of comparative bad faith or reverse bad faith.[89]

The court recognized that California had adopted comparative bad faith as an affirmative defense but then declined to follow California's lead.[90] The court held that an insured's failure to give notice of facts relating to insurance coverage could not be translated into an actionable tort or a defense of comparative fault.[91] The court noted that the insurer's duty to defend under the insurance contract is measured by the facts known and knowable at the time of the insured's request.[92] This question of whether the insurer breached its duty to the insured was sufficient to answer the question of whether the insurer must now reimburse the insured for the past defense costs.[93]

VI. The Economic Loss Rule May Bar Some Forms Of Reverse Bad Faith

In some states the economic loss rule could potentially bar an insurer from seeking tort damages for the loss caused by an insured's bad faith. In *Royal Surplus Lines Insurance v. Coachman Industries, Inc.*, the Eleventh Circuit applied Florida law to find that the economic loss rule precludes an insurer's claim for damages resulting from an insured's breach of the good faith duty implied in the insurance contract.[94] In *Coachman*, the lawsuit arose out of an accident involving the insured's product.[95] A mobile home designed by the insured dropped a gas tank on the interstate resulting in the death of the driver and injuries to his wife.[96] Despite the catastrophic damages, the insurer did not foresee significant exposure because it did not believe the accident was caused by the insured's negligence.[97] It turned out that the insured had withheld critical information[98] from the insurer which showed it could have prevented the accident.[99] The insured did not inform the insurer of this information until after an opportunity to settle for two million dollars had expired.[100] The insurer eventually settled for just under $10,000,000 but did not reserve its right to deny coverage under the insurance contract.[101]

The insurer sued the insured for breach of contract and breach of the implied covenant of good faith arising out of the contract.[102] The trial court denied both actions and the insurer appealed.[103] On appeal the Eleventh Circuit affirmed the trial court's ruling.[104] The Eleventh Circuit found that the breach of contract claim failed because the carrier had waived its right to deny coverage by paying the settlement.[105] Secondly, the court found that the insurer's tort claim for breach of the good-faith duty also failed under the economic loss rule.[106] The court found that Florida law prohibited recovery for an economic loss where the facts alleged are identical to a claim for breach of contract.[107] Because the insurer had not alleged separate facts for the breach of fiduciary duty claim, the court affirmed the trial court's dismissal of this claim.[108] The court did not address whether the economic loss rule applied to an insured's bad-faith claim.

VII. Certain Courts Have Recognized Claim For Reverse Bad Faith In Dicta

A United States District Court in Pennsylvania found that an insured owes a duty of good faith and fair dealing to an insurer.[109] However, the court limited the insurer's recovery to "contractual common law damages."[110] Under Pennsylvania law the insured was also limited to contractual damages for a common law claim of bad faith.[111] In Pennsylvania an insured may obtain punitive damages for an insurer's bad faith as a result of 42 Pa. Cons. Stat. § 8371 (1994).[112] Before passage of § 8371, an insured could only recover contractual damages in a bad-faith claim.[113] A claimant could also

recover damages as an assignee of an insured for the insurer's failure to settle a third-party liability claim.[114]

The Massachusetts Appeals Court has also recognized, if only in dicta, that "courts [must] be vigilant to ensure that plaintiffs not engage in 'reverse bad faith' conduct."[115] This finding was somewhat tempered by a federal court's finding only four months later that no cause of action existed for reverse bad faith in Massachusetts.[116] However, a recent trial court decision in Massachusetts said that a defendant's defense of "reverse bad faith" was not inappropriate.[117] The court did not rule on the claim because it had already ruled that the insurer had not acted in bad faith.[118]

VIII. One State Legislature Has Created Cause Of Action Similar To Reverse Bad Faith

In Tennessee an insurer may seek recovery of 25% of an insured's claim if the insured does not recover and the insurer can show that the insured did not bring the action in good faith. Tennessee Code § 56-7-106 states:

> In the event it is made to appear to the court or jury trying the cause that the action of the policyholder in bringing the suit was not in good faith, and recovery under the policy is not had, the policyholder shall be liable to the insurance company, corporation, firm, or person in a sum not exceeding twenty-five percent (25%) of the amount of the loss claimed under the policy; provided, that the liability, within limits prescribed, shall, in the discretion of the court or jury trying the cause, be measured by the additional expense, loss, or injury inflicted upon the defendant by reason of the suit.

Therefore, where an insurer can prove that the insured staged a loss in order to bring a claim, the insurer is permitted to recover its expenses from the insured up to 25% of the loss. This law does not address potential scenarios in which an insured has acted in bad faith in negotiating a settlement, but appears to be limited to circumstances where an insured brings an action against the insured for a loss that is not legitimate. The statute would not apply to actions by claimants to set up a bad-faith suit.

IX. How A Florida Court's Expansion Of The Implied Covenant Of Good Faith Could Revitalize Reverse Bad Faith

Florida courts have recently explored an expansion of the implied covenant of good faith inherent in all contracts.[119] Florida courts recognize the implied covenant as a gap filling default rule,"[120] which comes into play "when a question is not resolved by the terms of the contract."[121] Plaintiffs have attempted to use the implied covenant of good faith to bring first-party bad-faith claims under the common law.[122] Florida's Supreme Court is currently addressing whether such claims are subject to dictates of Florida's insurance bad-faith statute, § 624.155, Fla. Stat.[123]

A ruling by the Florida Supreme Court that an insured can bring a cause of action for breach of the implied warranty of good faith and fair dealing distinct from the bad-faith statute could potentially open the door for reverse bad-faith claims. Though a Florida court has already confirmed that there was no affirmative defense for comparative bad faith,[124] expanding the insured's rights under the implied covenant of good faith could permit a future court to grant that same right to the insurer based upon the well established law that the implied covenant of good faith and fair dealing is a two-way street, running to both the insurer and the insured.[125]

X. Conclusion

State courts have declined to create a cause of action for reverse bad faith despite frequent requests by legal commentators.[126] However, state legislatures can act where the courts have failed. A statutory cause of action for reverse bad faith would help reduce "set-ups" and baseless bad-faith claims by insureds. The insureds' risk of exposure in such situations would likely deter such abuse of "bad faith" litigation and help restore proper perspective to the world of "bad faith" litigation.

Endnotes

1. Victor E. Schwartz & Christopher E. Appel, *Common-Sense Construction of Unfair Claims Settlement Statutes: Restoring the Good Faith in Bad Faith*, 58 Am. U. L. Rev. 1477, 1478-1479 (2009) (discussing fact that all states offer some form of bad-faith relief for insureds either at common law or by statute).

2. TENN. CODE ANN. § 56-7-106 (2011) (allows the insurer to recover 25% of the amount claimed by an insured if the jury finds that the insured did not bring the suit in good faith and in doing so caused the insurer to suffer damages and unnecessary expense).

3. Gwynne A. Young & Johanna W. Clark, *The Good Faith, Bad Faith, and Ugly Set-up of Insurance Claims Settlement*, The Florida Bar Journal, February 2011, at 9.

4. John Dobbyn, *Is Good Faith in Insurance Contracts a Two-Way Street?*, 62 N.D. L. Rev. 355, 355-357 (1986) (discussing how courts have granted insureds the same level of protection that is afforded to infants and incompetents).

5. Brassil v. Maryland Cas. Co., 210 N.Y. 235, 242 (N.Y. Ct. App. 1914).

6. Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 200 (Cal. 1958).

7. *Id.*

8. Diamond Heights Homeowners Ass'n. v. National American Ins. Co., 277 Cal. Rptr. 906 (Cal. Ct. App. 1991).

9. North American Van Lines, Inc. v. Lexington Ins. Co., 678 So. 2d 1325 (Fla. 4th DCA 1996).

10. Brown v. Guarantee Ins. Co., 319 P.2d 69 (Cal. 1958).

11. Auerbach v. Maryland Cas. Co., 236 N.Y. 247 (N.Y. 1923).

12. Brown, 319 P.2d at 72.

13. *Id.*

14. Hilker v. Western Auto. Ins. Co., 231 N.W. 257 (Wis. 1930).

15. *Id.*

16. John F. Dobbyn, *Is Good Faith in Insurance Contracts a Two-Way Street?*, 62 N.D. L. Rev. 355, 367- 370 (1986) (explaining the reason an insured with a deductible or SIR would be inclined to disfavor settlement to the detriment of the insurer where the proposed settlement amount is near the insured's deductible).

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.*

24. Douglas R. Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?*, 77 Marq. L. Rev. 41, 61-65 (1993) (discussing the scenario in which an insured could obtain coverage in excess of the policy limits by baiting the insurer into not settling within the policy limits by withholding information showing the insured to be at fault).

25. *Id.*

26. *Id.*

27. Patrick E. Shipstead & Scott S. Thomas, *Comparative and Reverse Bad Faith: Insured's Breach of Implied Covenant of Good Faith and Fair Dealing as Affirmative Defense or Counterclaim*, 23 Tort & Ins. L.J. 215, 230-231 (1987) (explaining that California courts have set the foundation for reverse bad faith by recognizing comparative bad faith).

28. 155 Cal. App. 2d 679, 319 P.2d 69 (Cal. Ct. App. 1958).

29. *Id.* at 70.

30. *Id.*

31. *Id.* at 684.

32. 139 Cal. Rptr. 91, 95 (Cal. Ct. App. 1977).

33. *Id.*

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. 218 Cal. Rptr. 817 (Cal. Ct. App. 1985).

39. *Id.* at 819.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id* at 821.

44. *Id.* at 822.

45. *Id.* at 833.

46. California Fair Plan Ass'n v. Politi, 270 Cal. 243 (Cal. Ct. App. 1990).

47. *Id.* at 162.

48. TENN. CODE ANN. § 56-7-106 (2011) allows the insurer to recover 25% of the amount claimed by an insured if the jury finds that the insured did not bring the suit in good faith and in doing so caused the insurer to suffer damages and unnecessary expense.

49. 605 N.E.2d 936 (Ohio 1992).

50. *Id.* at 939.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.*

55. *Id.*

56. *Id.* at 942.

57. *Id.* at 632-633.

58. *Id.* at 632.

59. *Id.*

60. *Id.* at 633.

61. Johnson v. Farm Bureau Mutual Ins. Co., 533 N.W.2d 203, 208 (Iowa 1995).

62. *Id.* at 205.

63. *Id.*

64. *Id.*

65. *Id.*

66. *Id.*

67. *Id.*

68. *Id.*

69. *Id.*

70. *Id.* at 207.

71. *Id.* at 208.

72. *Id.* at 208.

73. Iowa R. Civ. Pro., Rule 80(a).

74. Johnson, 533 N.W.2d at 208.

75. *Id.*

76. 928 P.2d 298 (Okla. 1996).

77. *Id.* at 301.

78. *Id.*

79. *Id.*

80. *Id.*

81. *Id.*

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* at 302.

86. *Id.*

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.* at 307-308.

91. *Id.* at 308.

92. *Id.* at 306.

93. *Id.*

94. 184 F. App'x 894, 2006 WL 1674261 (11th Cir. June 19, 2006).

95. *Id.*

96. *Id.* at 898.

97. *Id.*

98. *Id.* (The codefendant had written a letter to the insured before the accident explaining that the insured's modifications to relocate the gas tank had caused other accidents. The codefendant recommended that the insured inform all prior customers of the problem and offer to repair the problem for free).

99. *Id.*

100. *Id.*

101. *Id.* at 899.

102. *Id.* at 895-896.

103. *Id.* at 896.

104. *Id.* at 895.

105. *Id.*

106. *Id.*

107. *Id.* at 902.

108. *Id.*

109. Greater New York Mutual Ins. Co. v. North River Ins. Co., et al. North River Ins. Co., 872 F. Supp. 1403, 1408 (E.D. Pa. 1995).

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.* at 1406.

115. Parker v. D 'Avolio, 664 N.E.2d 858, 864, n.9 (Mass. App. Ct. 1996).

116. Schulz v. Liberty Mutual Ins. Co., 940 F. Supp. 27 (D. Mass. 1996).

117. Callahan v. Norfolk & Dedham Group, 2009 WL 3282941 (Mass. Super. Aug. 6, 2009).

118. *Id.*

119. County of Brevard v. Miorelli Eng'g, Inc., 703 So. 2d 1049, 1050 (Fla. 1997).

120. Speedway SuperAmerica, LLC v. Tropic Enterprises, Inc., 966 So. 2d 1 (Fla. 2d DCA 2007).

121. *Id.*

122. Citizens Property Ins. Co. v. Bertot, 14 So. 3d 1073, 1075 (Fla. 3d DCA 2009) (discussing the divergence in opinion between federal courts as to whether

claims enforcing the implied warranty of good faith and fair dealing are governed by § 624.155, Fla. Stat. or can be brought independent of the statutory requirements).

123. QBE Insurance Corp. v. Chalfonte Condominium Apartment Ass'n, Case No. SC09-441.

124. Nationwide Property & Cas. Ins. Co. v. King, 568 So. 2d 990 (Fla. 4th DCA 1990) (court would not create new affirmative defense of comparative bad faith).

125. *See supra* notes 35-37.

126. *See supra* notes 1-3. ■

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