MEALEY'S LITIGATION REPORT
Insurance Bad Faith

Does Policy Reformation Create A Retroactive Bad-Faith Claim?

by
Laura A. Turbe-Capaz, Esq.

Butler Pappas Weihmuller Katz Craig LLP
Tampa, Florida

A commentary article reprinted from the December 23, 2010 issue of Mealey's Litigation Report: Insurance Bad Faith

LexisNexis®

Commentary

Does Policy Reformation Create A Retroactive Bad-Faith Claim?

By
Laura A. Turbe-Capaz

[Editor's Note: Laura A. Turbe-Capaz is a senior associate in the Tampa office of Butler Pappas Weihmuller Katz Craig LLP, which also has offices in Chicago, Charlotte, Mobile, Tallahassee, and Miami. She is an experienced trial attorney in the firm's Extra-Contractual, Third-Party Coverage, and Liability Departments.

Introduction

After an automobile accident, a situation may arise where it is discovered that the insurance policy does not accurately reflect the intention of the parties at the time when the policy was issued. When this happens, a claim for reformation of the insurance policy is often presented. The most common grounds for seeking reformation include mutual mistake, fraud, or mistake of the agent. If a claim results in an actual reformation of the contract, an issue that an insurer may consider is whether the policy reformation would provide retroactive insurance coverage and a possible retroactive basis for a bad-faith claim.

This particular issue has not been addressed in many jurisdictions. The majority of courts in California and Colorado appear to adhere to the view that policy reformation does not create a retroactive claim for insurer bad faith. On the other hand, there is authority from Wisconsin which found an insurer liable for bad faith for certain actions that occurred prior to reformation of the insurance policy. The Florida courts have yet to address this exact issue; however, if and when the issue is presented, a strong argument exists against a claim for retroactive insurer bad faith.

California: *R & B Auto Center, Inc. v. Farmers Group, Inc.*

In *R & B Auto Center, Inc. v. Farmers Group, Inc.*,[1] the insured was a car dealership that was licensed to sell only used vehicles, and it had specifically sought products deficiency liability coverage or coverage for losses suffered as a result of the lemon laws. However, as issued, the explicit terms of the policy only covered the sale of new cars, even though the declarations page indicated that the insured business sold used cars.[2] When R & B was subsequently sued for "selling a lemon," the insurer denied coverage and refused a defense on the ground that the insurance policy only covered the sale of new vehicles. Later, the insured sued the insurer and others on allegations of negligent and intentional misrepresentation, breach of contract, reformation, bad faith, breach of fiduciary duty, and unfair competition.[3]

With respect to the claims for bad faith and reformation of the insurance contract, R & B attempted to "piggyback" a bad-faith cause of action onto the reformation cause of action.[4] R & B argued that "an insurance contract can be reformed to provide not only retroactive insurance coverage, but also a retroactive basis for a bad faith claim."[5] In support of its argument, R & B stated that, despite the fact that coverage did not exist at the time the insurer processed the claim, the insurer should be liable for bad faith if, in the future, the insurance contract is reformed to provide coverage for used car sales.[6]

The appellate court disagreed based upon the reasoning that, before an insurer may be found to have acted in bad faith for its denial or delayed payment of insurance

benefits, it must be shown that the insurer acted unreasonably or without proper cause.[7] Further, the reasonableness of an insurer's actions or decisions is evaluated at the time that such are made. When an insurer is presented with a claim and there is no potential for coverage under the policy, the insurer has no duty to defend and may reasonably deny the claim. Accordingly, the court asserted that, "[s]ince it is reasonable to deny the claim at the time, if the policy is later reformed to provide retroactive coverage, the insurer may not be held liable for bad faith for failing to have the foresight to know that the policy would be reformed."[8] Applying such principles to the facts of the case, the court stated that, when R & B submitted its lemon law claim for a used car sale, the policy only provided lemon law coverage for new car sales; thus, at the time of the insurer's claim evaluation, it was reasonable for the insurer to deny it.[9] Moreover, if the policy was later reformed to provide lemon law coverage for used car sales, the court held the insurer could not be deemed to have acted in bad faith retroactively. The court explained that it would be inequitable to use a judgment of reformation to provide a retroactive basis for a bad-faith claim in such a situation.[10]

Colorado: *Brennan v. Farmers Alliance Mutual Insurance Company*

The Colorado Court of Appeals addressed the viability of a bad-faith claim following the judicial reformation of an insurance policy in *Brennan v. Farmers Alliance Mutual Insurance Company*.[11] Under Colorado's No-Fault Act, personal injury protection (PIP) insurers are required to offer named insureds extended PIP coverage, such as extended PIP benefits for injured pedestrians, in exchange for a higher premium.[12] When an insurer fails to do so, extended protection for pedestrians would be read into extended coverage under the policy.[13] The insurer in *Brennan* denied an injured pedestrian's claim for additional PIP benefits under the vehicle driver's policy on the basis the policy did not provide extended PIP coverage for pedestrians. However, it was later determined to be undisputed that the insurer had never offered extended coverage for pedestrians to the insureds; therefore, the trial court judicially reformed the contract to reflect such coverage.[14]

On appeal, the district court determined that the trial court did not abuse its discretion when it concluded that the insurer was not guilty of bad faith in failing to pay additional benefits *before* the insurance policy was judicially reformed.[15] The court held that, until a contract is reformed, the insurer has no obligation to conform to a reformed policy.[16] Furthermore, prior to reformation of the insurance contract, there could be no bad-faith breach of contract for failing to pay additional PIP benefits because, by the plain terms of the policy in existence at the time and up until the contract was actually reformed, there was no coverage for additional PIP benefits.[17]

In a similar action for extended PIP benefits, in which an injured pedestrian sought reformation of an insurance policy and alleged claims for breach of contract and bad-faith failure to pay extended PIP benefits, the Tenth Circuit Court of Appeals followed the *Brennan* decision. In *Clark v. State Farm Mutual Automobile Insurance Company*,[18] the Tenth Circuit furthered its analysis and noted the importance of the district court determining the effective date of the policy reformation as such date would affect the viability of the contract, tort, and statutory claims.[19] When determining the effective date, the district court should consider the following factors: (1) the degree to which reformation from a particular effective date would upset past practices on which the parties may have relied; (2) how reformation from a particular effective date would further or retard the purpose of the rule in *Brennan*; and (3) the degree of injustice or hardship that reformation from a particular date would cause the parties.[20] The Tenth Circuit noted that the contract, tort, and statutory claims would remain viable only if the district court determined that the reformation occurred on a date preceding the order of reformation. However, if reformation is determined to be effective as of the date on which the reformation order is entered, the insurer would not have had a pre-existing duty.[21]

On remand, the district court determined that reformation of the insurance policy at issue would only apply *prospectively* and thus, the effective date of the reformed policy would be the date of the court's reformation order.[22] In reaching its decision, the district court noted that a retroactive reformation date would create an inequitable result for the insurer and cause the insurer to be liable for coverage that it could not reasonably foresee during a time that it did not even know of such exposure.[23] "After all, 'in insurance law, until an insurance contract is reformed, the insurer has no obligation to conform to such "reformed" policy.' "[24]

On appellate review, the Tenth Circuit found the district court's determination to be reasonable and noted that the selected reformation date was in accord with the court's acknowledgment that "[t]he fact that the insured may be entitled to obtain reformation of the policy does not impose any obligation upon the insurer to conform to such 'reformed' policy before a court has made such reformation."[25] The Tenth Circuit especially noted that the district court appropriately recognized the magnitude of the insurer's potential liability exposure if every plaintiff were able to proceed with breach of contract and tort claims under an earlier reformation date.[26]

Wisconsin: *Trinity Evangelical Lutheran Church v. Tower Insurance Company*

In *Trinity Evangelical Lutheran Church v. Tower Insurance Company*,[27] the Wisconsin Supreme Court examined whether the insurer could be found in bad faith for its actions in denying coverage to its insured *prior to* a stipulated reformation of the insurance policy. In *Trinity*, the insurer denied coverage to an insured school for injury claims presented as a result of an automobile accident involving a teacher for the insured school, who was in the course of employment and using her own vehicle at the time of the accident.[28] The basis for the coverage denial was the fact that the automobile insurance policy did not provide hired and non-owned automobile coverage. The insured maintained that it had discussed with the insurer the need for such coverage, but the policy application mistakenly failed to request such coverage; thus, the insured requested that the contract be reformed and the coverage backdated.[29] Initially, the insurer denied such request, but after it became clear that the insured had asked for hired and non-owned automobile coverage to be included in the policy, the insurer stipulated to the request to reform the policy to include non-owned and hired coverage at the time of the accident.

The insurer in *Trinity* also discharged the insured's liability in the underlying accident suit.[30] Despite this, the Wisconsin Supreme Court determined that the insurer had acted in bad faith when it *initially* denied coverage to the insured school. First, the court determined that the insurer should have understood its obligation to provide the requested coverage to an insured where there was a possible mutual mistake.[31] And, second, the insurer, knowing of the possible mutual mistake when it denied coverage, failed to "take honest, intelligent action or consideration based upon knowledge of the facts and circumstances."[32] Accordingly, the court determined that the only reasonable inference was that, under the circumstances, the insurer had acted in bad faith.[33]

Notably, in its appellate reply brief, the insurer presented the argument that an insurer is entitled to rely upon the insurance policy, as written, until the contract has been reformed.[34] However, neither the appellate court decision nor the supreme court's decision addressed this argument.

Florida: Undeveloped Territory

The purpose of reforming an insurance policy is not to create a new policy, but to bring the written policy in conformity with the intentions of the parties or to make the policy conform to a state statute. In Florida, courts have the equitable power to reform a written contract where it appears that there is clear and convincing evidence that, by fraud, inequitable conduct, or mutual mistake, the policy fails to express or conform to the parties' intentions.[35] Mistake appears to be the most common basis for a claim for reformation of an automobile liability policy. Under Florida law, a "mistake" giving rise to a claim for reformation of an insurance policy must be mutual to both contracting parties.[36] A one-sided or unilateral mistake may present a sufficient ground for rescission of the contract, but not reformation because, when there is no meeting of the minds, there is no contract to be rectified.

A court which determines a party's entitlement to policy reformation must also determine the effective date of such reformation. As explained in *Clark*, the determination of the effective date of reformation will affect the viability of a party's subsequent claim for breach of contract and/or bad faith.[37] The Tenth Circuit stated:

> The viability of . . . breach of contract, breach of the duty of good faith and fair dealing, and willful and wanton breach of contract claims depends on the effective date of reformation. These contract, tort, and statutory claims, however, will remain viable only if the district court in the exercise of its equitable power determines that reformation should occur as of a date preceding its order of reformation. Only under these circumstances would there be an extant contract, tort, or statutory duty

> to be breached. Conversely, if reformation is ordered to correspond to the date of entry of the order of reformation, there would be no pre-existing duty to pay extended PIP benefits.[38]

For purposes of determining the effective date of reformation, the *Clark* court provided several factors for a court to consider when exercising its equitable discretion. The most notable of the factors is the consideration of the degree of injustice or hardship that a retroactive reformation would cause the parties, namely the insurer.[39]

In most cases, retroactive application of a reformed insurance policy would create an inequitable result for the insurer. Such application would likely create retroactive coverage for a claim for which the plain language of the policy, as originally written, did not extend coverage or specifically excluded coverage. In addition, to allow an insured access to retroactive coverage may arguably open the door to a possible retroactive bad-faith claim. The inequitable result as to the insurer would be evident in a situation where the insurer had reasonably and in good faith denied coverage based upon the explicit terms of the pre-reformation insurance contract in effect at the time of the insurer's evaluation. To later find that an insurer's prior actions were "incorrect" based upon its *reasonable* reliance on the explicit policy language, as originally written, and its failure to anticipate a subsequent judgment of reformation is inappropriate and imposes a substantial hardship upon insurers. Furthermore, retroactive reformation would go against the general proposition that, until a contract of insurance is reformed, the insurer is justified in relying upon the policy as written and, thus, is not liable for failing to adhere to the terms of a prior oral contract which may differ from the written policy.[40]

Conclusion

Accordingly, should courts in Florida (or other jurisdictions) be faced with a bad-faith action in the context of a policy reformation cause of action, it would be inequitable for these courts to adhere to the reasoning and rationale that a bad-faith cause of action may be created on a retroactive basis. Reformation of a policy should be applied prospectively, from the date of the court's reformation order. Such a determination would adhere to the general reasoning that, despite an insured's entitlement to reformation of the policy, the insurer has no obligation to "conform" to such reformed policy prior to the actual reformation of the policy.

Endnotes

1. 44 Cal. Rptr. 3d 426 (Cal. App. 4th 2006).
2. *Id.* at 431.
3. *Id.*
4. *Id.* at 448.
5. *Id.*
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at 449.
10. *Id.* at 448-449.
11. 961 P.2d 550 (Colo. Ct. App. 1998).
12. *Id.* at 554.
13. *Id.*
14. *Id.*
15. *Id.* at 556.
16. *Id.* (citing 2 LEE R. RUSS & THOMAS F. SEGALLA, COUCH ON INSURANCE § 26:3 (3d ed. 1995)).
17. *Id.*
18. 319 F.3d 1234 (10th Cir. 2003).
19. *Id.* at 1242.
20. *Id.* at 1243.
21. *Id.* at 1244.

22. Clark v. State Farm Mut. Auto. Ins. Co., 292 F. Supp. 2d 1252, 1267-68 (D. Colo. 2003).

23. *Id.*

24. *Id.* (citing Brennan, 961 P.2d at 556).

25. Clark v. State Farm Mut. Auto. Ins. Co., 433 F.3d 703, 713 (10th Cir. 2005).

26. *Id.*

27. 661 N.W.2d 789 (Wis. 2002).

28. *Id.* at 793.

29. *Id.*

30. *Id.* at 794.

31. *Id.* at 797. The insurer, Tower Insurance Company, was a party-defendant in Trible v. Tower Ins. Co., 168 N.W.2d 148 (Wis. 1969), a case involving a nearly identical situation. The Trible case is Wisconsin's seminal case addressing the insurer's obligation to reform an insurance contract upon the discovery of a mutual mistake in the issuance of a policy. Trible involved an insurance agent's error in requesting coverage, and the court determined that the agency's mistake was attributable to the insurance company. A "mutual mistake" was created upon insurer's later discovery of that the insured had requested the at-issue coverage. The Trible court concluded that reformation of the erroneous policy was appropriate.

32. 661 N.W.2d at 797.

33. *Id.*

34. Reply Brief for Appellant, Trinity Evangelical Lutheran Church v. Tower Ins. Co., No. 01-1201, 2001 WL 34358735 (Wis. Ct. App. Sept. 4, 2001).

35. Providence Square Ass'n, Inc. v. Biancardi, 507 So. 2d 1366, 1369 (Fla. 1987); Pitofsky v. Liberty Mut. Ins. Co., 386 So. 2d 1235 (Fla. 3d DCA 1980).

36. Tobin v. Michigan Mut. Ins. Co., 948 So. 2d 692 (Fla. 2006); Universal Underwriters Ins. Co. v. Abe's Wrecker Service, Inc., 564 F. Supp. 2d 1350 (M.D. Fla. 2008).

37. 319 F.3d at 1243.

38. *Id.* at 1244 (citing COUCH ON INSURANCE § 26:3 for the following statement: "The fact that the insured may be entitled to obtain a reformation of the policy does not impose any obligation upon the insurer to conform to such "reformed" policy before a court has made such reformation.").

39. As the Tenth Circuit recognized in Clark, if every plaintiff could proceed with a breach of contract or tort claim based upon an earlier reformation date, the liability exposure to the insurers would be outrageous.

40. COUCH ON INSURANCE, *supra* note 16, § 26:3. ■

MEALEY'S LITIGATION REPORT: INSURANCE BAD FAITH
edited by Mark Rogers
The Report is produced twice monthly by

LexisNexis®

1018 West Ninth Avenue, 3rd Floor, King of Prussia Pa 19406, USA
Telephone: (610) 768-7800 1-800-MEALEYS (1-800-632-5397)
Fax: (610) 962-4991
Email: mealeyinfo@lexisnexis.com Web site: http://www.lexisnexis.com/mealeys
ISSN 1526-0267