Commentary

Frivolous Claim: The Need For Bad Faith Legislation

By
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> **Insurance Company** \ in-shůr-ən(t)s kəmp-(ə-)nē \ n. \ 1: Popular Piñata For Populist Politicians

Over the past few years a slew of state legislatures have introduced bills that address the conduct of insurance companies in the handling of claims. Such legislative proposals are usually referred to, in some form or another, as efforts to enact "bad faith" laws. These legislative attempts have been successful in a few states, unsuccessful in others and, in still a few more, the process remains on-going.[1]

In general, such bad faith bills are designed to allow insurance customers to recover various types of damages from their insurance companies if the insurer unjustifiably fails to pay a claim. It sounds simple enough. A person pays premium to its insurance company, perhaps for several years, in exchange for protection against certain types of losses, such as to his or her automobile or home. Then, when it comes time to make a claim, the insurance company fails to pay — but for reasons that are determined to have been inappropriate. In this situation, the bills afford recompense to the aggrieved insurance purchaser for damages sustained on account of the insurer's claim handling shortcoming. In addition to the rationale for such laws being simple, so too, no doubt, is the logic behind legislators' introduction of them. Insurance companies, as a whole, are a soft target. There is unlikely to be a public outcry against such proposed legislation. Additionally, there are a lot more voters who buy insurance than sell it.

An effort to enact a law, of any type, must mean that there is an existing deficiency that needs to be filled. But is that the case with bad faith laws? If an insurance company mishandles a claim — that is a wrong. And it should be righted. But the enactment of a law to do so suggests that, without such legislative action, no remedy would have existed. Yet, mechanisms are already in place to compensate insurance customers whose insurance companies failed to pay a claim without proper justification. Furthermore, only an infinitesimal percentage of insurance claims are mishandled. But despite the lack of a need for bad faith laws, they have the ability to alter the landscape for *all* insurance claims. By adopting legislation that impacts claims across the board, for the benefit of so few, legislators are doing more harm than good.

Part I of this Commentary examines the concept of bad faith in general: what it is, why it was adopted, how it operates and why it is one of the most complex areas of insurance law — even without any new statutes to have to consider.

Part II looks at the arguments that are often made for and against the passage of bad faith laws. This is followed by an examination of bad faith laws that have recently been enacted in two states — despite the existence of remedies for insurer misconduct already in place. First there is Minnesota — a state that would be described by some as having no existing bad faith law prior to the enactment of its statute. By contrast, the other state under consideration — Washington — had no shortage of bad faith laws, but, nonetheless, its legislature went ahead with further enactments.

Part III explains why bad faith legislation does more harm than good.

Part I — A Primer On Bad Faith

Most insurance coverage issues involve just that — whether a particular claim is *covered* under the terms and conditions of a certain insurance policy. The process involves a comparison between the facts and insurance policy — and perhaps resort to case law for guidance on how to interpret a policy provision. But sometimes there is an additional aspect to the otherwise "Is it covered" question. In certain instances the insurance company's conduct in handling the insured's claim, or the process by which the insurer arrived at a determination that a claim is not covered, is alleged by the insured to have been inappropriate. Insureds allege that their insurers' conduct caused them damages, leading to a separate claim for their recovery. This additional aspect of the claims process is usually referred to under the general heading called "bad faith." Bad faith damages are sometimes called "extra-contractual" damages, because they are awarded in addition to any owed under the insurance policy, *i.e.*, contract.

Bad faith — or breach of the duty of good faith, as it is also sometimes called — is one of, if not the most, complex aspects of insurance law. The question whether a particular claim is covered can be a straightforward one — comparing facts (sometimes relatively undisputed) to policy language and perhaps case law. And more often than not there are only two possible answers: yes or no. Even when courts nationally are split over their treatment of a coverage issue — and they frequently are — the fracture is generally only into two, or, at most, three, schools of thought.

But bad faith questions often involve significantly less cut and dry answers than can come from comparing facts to an insurance policy and case law. The standards for establishing bad faith involve terms that are not easily defined, such as willful, malicious, reckless, unreasonable and unfairly, and such standards can vary tremendously from state to state. Even bad faith standards that appear, on their face, to be the same, may in fact be subject to nuances that make them actually quite different.

And that's just half the story. Often-times one of the most important issues surrounding bad faith is determining the insurance company's mindset in handling the insured's claim or arriving at its coverage determination. This is a fact intensive inquiry. Not to mention that the need for the insured to get inside the insurance company's head, so to speak, brings a significant subjective element into play. That subjective determinations are never ones to lend themselves to cut and dry answers, *in any legal context*, is also an important source of the complexity of bad faith.

Any discussion of bad faith must begin with an explanation of the types — first-party and third-party, with third-party being of two varieties.

One type of third-party bad faith arises in the context of an insured being sued by a third-party and the insured's liability insurer takes over its defense. *Braesch v. Union Ins. Co.*, 464 N.W.2d 769, 773 (Neb. 1991). In this situation, "[a] conflict of interest is inherent in the insurer's control of settlement when . . . there is potential exposure in excess of the policy limits. A settlement demand within the policy limits highlights that conflict, inasmuch as it will be in the insured's interest for that demand to be met. Such a settlement is not necessarily in the insurer's best interest, however, for by going to trial the insurer might be able to avoid liability altogether, or obtain a judgment for an amount less than the demand." *Myers v. Ambassador Ins. Co.*, 508 A.2d 689, 691 (Vt. 1986).

"It is this control of the litigation by the insurer coupled with differing levels of exposure to economic loss which gives rise to the 'fiduciary' nature of the insurer's duty." *Id.* If an insurance company fails to settle a claim, when there was an opportunity to do so within the policy limits, and such a settlement was reasonable, the insurer subjects the insured to the risk of a judgment in excess of the policy limits — for which the insured would be liable but the insurer would not. To put it another way, "[b]y taking such an unreasonable risk, the insurer would be gambling with the insured's money to the latter's prejudice." *Shuster v. South Broward Hosp. Dist. Physicians' Prof. Liability Ins. Trust*, 570 So. 2d 1362, 1367 (Fla. Ct. App. 1990).

The typical consequence for an insurer that, in bad faith, fails to settle a claim, when there was an opportunity to do so within policy limits, is liability for the full amount of the judgment — even the amount in excess of the policy limit. This is sometimes referred to as the "judgment rule" and the majority of states have adopted it. *See Economy Fire & Cas. Co. v. Collins*, 643 N.E.2d 382, 385 (Ind. App. Ct. 1994) (rejecting the alternative "pre-payment rule" — which holds an insurer liable for a judgment in excess of policy limits only if part or all of the judgment has been paid by the insured — and instead adopting the "judgment rule" because it eliminates the insurer's ability to hide behind the financial status of its insured and it recognizes that the entry of judgment itself against an insured constitutes actual damage — such as impairing the insured's credit and damaging the insured's reputation).

The other category of third-party bad faith — although not nearly as common as third-party bad faith in the failure to settle within limits context — involves a claim by an injured party brought directly against the tortfeasor's insurer. The most well-known source of third-party bad faith is the Supreme Court of California's adoption of it in *Royal Globe Ins. Co. v. Superior Court*, 23 Cal.3d 880 (Cal. 1979). The court held that the Unfair Practices Act of the state's Insurance Code afforded a private party, *including a third party claimant*, the right to sue an insurer for violation of the Act — addressing various unfair claims settlement practices. *Id.* at 891. The court further held that "it is inconceivable that the Legislature intended that such a litigant would be required to show that the insurer committed the acts prohibited by that provision 'with such frequency as to indicate a general business practice.'" *Id.*

However, just nine years later *Royal Globe* was overruled by *Moradi-Shalal v. Fireman's Fund Ins. Companies*, 46 Cal.3d 287 (Cal. 1988). The *Moradi-Shalal* Court concluded that "developments occurring subsequent to our *Royal Globe* decision convince us that it was incorrectly decided, and that it has generated and will continue to produce inequitable results, costly multiple litigation, and unnecessary confusion unless we overrule it." *Moradi-Shalal* at 297 (also noting that courts in eight states had expressly acknowledged, but declined to follow, *Royal Globe*; courts in nine states had implicitly rejected its holding; and only two states other than California recognized a statutory cause of action for private litigants — with the courts in those states rejecting *Royal Globe's* conclusion that a single violation of their Unfair Practices Act is a sufficient basis for a suit for damages).

While *Moradi-Shalal* is a lengthy decision, and the court gave many reasons for its decision to overrule *Royal Globe,* a principal driver of the court's decision was recognition of the adverse consequences that third-party bad faith would have on the general public:

> Confirming Justice Richardson's prediction in his *Royal Globe* dissent, several commentators have observed that the rule in that case promotes multiple litigation, because its holding contemplates, indeed encourages, two lawsuits by the injured claimant: an initial suit against the insured, followed by a second suit against the insurer for bad faith refusal to settle. As a corollary, *Royal Globe* may tend to encourage unwarranted settlement demands by claimants, and to coerce inflated settlements by insurers seeking to

> avoid the cost of a second lawsuit and exposure to a bad faith action.
>
> Thus, one author observed, "One result of this decision is that every time a demand is now made to settle a lawsuit, an additional demand is likely to be forthcoming to coerce higher settlements. The demand now carries the threat that, unless settlement is immediate, a separate suit will be filed for violation of the Unfair Practices Act. The public ultimately will be affected by the additional drain on judicial resources. Moreover, the public will indeed suffer from escalating costs of insurance coverage, a certain result of inflated settlements and costly litigation."
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> Other commentators agree that *Royal Globe*, and its allowance of a direct action against the insurer, may result in escalating insurance costs to the general public resulting from insurers' increased expenditures to fund coerced settlements, excessive jury awards and increased attorney fees. As stated by one writer, "The increased settlement costs required to settle the actual lawsuit and the potential one that hovers over most litigation involving an insured defendant will obviously result in higher premiums. In addition, those insurers that have the courage to refuse settlement where they do not feel it is warranted will necessarily be the subject of additional litigation because they will not in all instances have guessed correctly regarding the value of the case. When they have guessed incorrectly, *Royal Globe* encourages lawsuits against them."

Moradi-Shalal at 301-02 (citations omitted).

In contrast to coverage for insureds for injuries caused to third-parties, first-party bad faith involves claims by insureds for policy benefits for their *own* damages. *Universal Life Ins. Co. v. v. Giles*, 950 S.W.2d 48, 60 (Tex. 1997). First-party bad faith gets most of the attention — from both courts and in the legislation that has been proposed. When the term "bad faith," without any other qualification, is used, it is likely that the person using such term, in the generic sense, is speaking of first-party bad faith.

While third-party bad faith dates back nearly a hundred years (*see Brassil v. Maryland Cas. Co.*, 104 N.E. 622 (N.Y. 1914), first-party bad faith is of more recent vintage — with many courts giving credit for its origin to the Supreme Court of California in *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973), where the court held:

> [I]n the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy. . . . That responsibility is not the requirement mandated by the terms of the policy itself — to defend, settle, or pay. It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.

Id. at 1037; *see also Nichols v. State Farm Mutual Auto. Ins. Co.*, 306 S.E.2d 616, 618 (S.C. 1983) ("The *Gruenberg* decision is premised on an implied covenant of good faith and fair dealing that neither party will do anything to impair the other's rights to receive benefits under the contract.").

Courts have used various rationales for adopting a cause of action in tort for first-party bad faith:

> An insurance policy is not obtained for commercial advantage; it is obtained as protection against calamity. In securing the reasonable expectations of the insured under the insurance policy there is usually an unequal bargaining position between the insured and the insurance company. . . . Often the insured is in an especially vulnerable economic position when such a casualty loss occurs. The whole purpose of insurance is defeated if an insurance company can refuse or fail, without justification, to pay a valid claim. We have determined that it is reasonable to

> conclude that there is a legal duty implied in an insurance contract that the insurance company must act in good faith in dealing with its insured on a claim, and a violation of that duty of good faith is a tort.

Nicholson, 777 P.2d at 1155 (Alaska 1989) (quoting *Noble v. National American Life Ins. Co.*, 624 P.2d 866, 867-68 (Ariz. 1981)); *see also Spencer v. Aetna Life & Cas. Ins. Co.*, 611 P.2d 149, 158 (Kan. 1980) (despite declining to adopt the bad faith tort, the court examined the rationales of many decisions that have, and concluded that all of the arguments pertain to the unequal bargaining position between the insurer and insured and the public interest nature of the insurance industry); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 167 (Tex. 1987) (noting that, without a cause of action for first-party bad faith, insurers could arbitrarily deny coverage and delay payment of a claim with the penalty being limited to interest on the amount owed).

Some states have chosen to address bad faith by statute. *See Rose ex rel. Rose v. St. Paul Fire and Marine Ins. Co.*, 599 S.E.2d 673, 679, n.6 (W. Va. 2004) ("At least sixteen states, including West Virginia, also use statutes to impose various duties upon insurance companies to use 'good faith' toward a claimant throughout the settlement of a claim. These statutes — which, like West Virginia's, are usually patterned after the National Association of Insurance Commissioners' "Model Unfair Trade Practices Act" or "Model Unfair Claims Settlement Practices Act" — have been construed by courts to allow a claimant to bring an action against an insurance company for damages caused by a violation of the statute.").

While many do, not all states recognize a cause of action for first-party bad faith. Some states have declined to adopt such cause of action on the basis that adequate alternative remedies already exist to address insurer's improper behavior. *See Marquis v. Farm Family Mut. Ins. Co.*, 628 A.2d 644, 652 (Me. 1993) ("[i]n view of the broad range of compensatory damages available in a contract action and in view of the statutorily provided remedies of interest on the judgment and attorney fees, we believe sufficient motivation presently exists to stifle an insurer's bad faith tendencies without the further imposition of the specter of punitive damages under an independent tort cause of action") (quotation omitted) (alteration in original). Other states have refused to recognize the tort on the basis that the relationship between the insurer and insured, in the first-party context, is not a fiduciary one. *See Best Place, Inc. v. Penn. Am. Ins. Co.*, 920 P.2d 334, 343 (Hawaii 1996) (adopting tort cause of action but citing decisions from several states that have refused to do so).

In general, the significance of a court's adoption of a cause of action for first-party bad faith is the opening of the door to an insured's recovery of damages in tort, rather than its recovery being limited to damages for breach of contract:

> [T]he requirement that contract damages be foreseeable at the time of contracting in some cases would bar recovery for damages proximately caused by the insurer's bad faith. The measurement of recoverable damages in tort is not limited to those foreseeable at the time of the tortious act; rather they include "[a] reasonable amount which will compensate plaintiff for *all* actual detriment proximately caused by the defendant's wrongful conduct."

White v. Unigard Mut. Ins. Co., 730 P.2d 1014, 1017-18 (Idaho 1986) (citations omitted and emphasis in original); *see also Tackett v. State Farm Fire & Cas. Ins. Co.*, 653 A.2d 254, 264 (Del. 1995) ("If the bad faith claim is viewed as an independent tort, the insured's recovery may include damages for emotional distress, as well as for economic loss. By contrast, if the bad faith claim is viewed as arising *ex contractu,* the damages generally are confined to the payment of money due, with interest for delay.").

Because first- and third-party bad faith address different risks for the insured, they are typically subject to different standards. In the third-party context, the insurer has the responsibility of defending the claim, usually has exclusive authority to accept or reject settlements and could subject the insured to liability in excess of the policy limits because of its refusal to settle within those limits. *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 792 P.2d 719, 723 (Ariz. 1990). In third-party situations, the insurance policy creates a fiduciary relationship — on account of the insured being wholly dependent upon the insurer to see that the insured's best interests are protected. *Beck v. Farmers Ins. Exchange*, 701 P.2d 795, 799 (Utah 1985). This same risk, however, is generally seen as lacking in the context of first-party claims, where "[t]he insurer is not in a position to expose the insured to a judgment in excess of the policy limits through its unreasonable refusal to settle a case, nor is it in a position to otherwise injure the insured by virtue of its exclusive control over the defense of the case." *Lawton v. Great Southwest Fire Ins. Co.*, 392 A.2d 576, 581 (N.H. 1978).

> Courts have been more reluctant to impose a tort duty on insurers to settle first-party claims. For one thing, an insurer's and an insured's interests are not aligned when the insured is claiming on his own behalf as they are or should be in third-party cases where insurer and insured face a common opponent. While insurers are obliged to pay valid claims promptly, they are entitled to challenge claims they believe may be invalid. Indeed, from a competitive viewpoint, an insurer must pay only valid claims and must deny invalid claims to keep premiums to customers at a minimum. In a third-party case, both the insurer and the insured have a common interest in challenging a third-party's claim. But in a first-party case, an insurer's interest in challenging the claim directly conflicts with the insured's interest in making the claim.

Giles, 950 S.W.2d at 60 (Tex. 1997) (citation omitted).

On account of the potential harm to the insured being greater in the third-party context, the applicable standards for establishing first- and third-party bad faith often differ. *See Clearwater v. State Farm Mut. Auto. Ins. Co.*, 792 P.2d 719, 722 (Ariz. 1990). And those differences can be substantial. For example, the Supreme Court of Colorado adopted a much higher standard for an insured to prove first-party versus third-party bad faith. *See Goodson v. Am. Standard Ins. Co. of Wis.*, 89 P.3d 409, 415 (Colo. 2004) (first-party claimant must prove that the insurer either knowingly or recklessly disregarded the validity of the insured's claim; for third-party bad faith, the insured need only show that a reasonable insurer under the circumstances would have paid or otherwise settled the third-party claim, *i.e.*, negligence standard).

Therefore, because of the different purposes between first-party and third-party bad faith, any comparison between the applicable standards for establishing each is apples to oranges. But even when only one type of bad faith is examined, *i.e.*, the comparison is apples to apples, the standards also vary widely between states. For example, in the third-party bad faith context, compare *Asermely v. Allstate Ins. Co.*, 728 A.2d 461, 464 (R.I. 1999) (adopting a standard that resembles strict liability for an insurer that fails to settle within policy limits) with *Helmbolt v. LeMars Mut. Ins. Co., Inc.*, 404 N.W.2d 55, 57 (S.D. 1987) (recognizing that there are an array of factors — at least seven — to consider in determining whether an insurer's refusal to settle was bad faith).

Decisions addressing bad faith often contain neat and tidy rules describing the standard that an insured must satisfy to establish its insurer's bad faith handling of a claim. Such rules are usually expressed by a litany of adjectives describing various forms of inappropriate behavior by an insurer. These standards make for convenient sound bites for courts. However, the question whether an insurer actually committed such conduct — given the highly factual nature of the inquiry — is often-times easier said than done. For this reason, knowing the bad faith standard is only the first step — an important, but small one — in attempting to establish that an insurer committed bad faith in its handling of an insured's claim.

Lastly, any discussion of bad faith is likely to turn to the potential damages recoverable. Like the standards to establish bad faith, the potentially recoverable damages are also subject to wide variation between states — with the question of the availability of punitive damages often coming into play.

Part II – Bad Faith: The Fallacy Of The Need For A Legislative Remedy

Despite all that already exists when it comes to bad faith — normous bodies of case law, statutes and regulations — over the past few years several state legislatures have seemed unsatisfied with the current state of affairs and concluded that it is appropriate to take action. The arguments that are often made for and against the passage of bad faith laws are not surprising and nor do they differ much regardless of the state being addressed.

The principal arguments put forth in favor of adopting bad faith laws sound like this — from a plaintiffs' law firm addressing Washington's bad faith statute:

> As personal injury attorneys, we often find ourselves involved in legal action against insurance companies. When that happens, it usually goes like this: Our client gets injured and then files a claim with either their insurance company or the insurance company of the person responsible for the injury. The insurance company sits on the paperwork and doesn't return phone calls, e-mails or letters, usually for a period of months. When the insurance company finally gets back in touch with the injury victim, it is either to inform them that the injury is not their problem for one reason or another, or they make a settlement offer that is so low that it will only cover some of the costs. This is about the time that our clients contact us.[2]

Then there's this, from the Vice-President of the Minnesota Association for Justice addressing its state's proposed bad faith legislation:

> In 2005, six-month-old Jonathan Johnson and his two-year-old brother, Jacob Johnson of Mora, Minn., died in a car accident with their mom and cousin. At that time, they were legally living with their father and grandfather three days a week. Their father, Charles Dack, and their mother were very young and not married.
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> Insurance policy limits were $100,000, but Dack's insurance company offered him $5,000 for each son. The offer was a blatant disregard for the value of each life lost. Yet due to Dack's youth, education and employment status, the company counted on him taking the money offered.
>
> The insurance company even defended its offer in court. After a very long legal battle a jury understood the value of life and found Dack's loss to be $1.57 million. The insurance company paid its $100,000 policy limit and was free to get away with the injustice of the battle it forced Dack to endure without having to pay the bill.
>
> This is all because Minnesota is one of the few states that does not have a "good-faith" law. As a result, Charles Dack could not collect the judgment amount the jury found appropriate.[3]

The principal arguments by insurers, their trade associations and tort reform advocates, in support for the rejection of bad faith laws, are equally unsurprising. These groups argue that adequate remedies to respond to insurer misconduct already exist and such statutes will lead to increased lawsuits, which will result in higher premiums for everyone. *See* American Legislative Exchange Council, "Memorandum in Support of Resolution Opposing Unfair and Unbalanced Insurance 'Bad Faith' Legislation," 2009 (citing the following reasons why legislative attempts to expand bad faith laws represent bad public policy: State insurance regulators can and do fairly protect consumers; [B]ills seek to expand insurer liability far beyond what is reasonable; [B]ills can distort the claims process, hindering insurers' ability to detect and fight fraud; and [B]ills are likely to result in increased litigation, payment of meritless claims and unreasonably high damage awards and settlement values which increase costs that ultimately are passed on to consumers.").

Another argument for the rejection of bad faith laws is the operation of the free market. Insurance companies are often referred to collectively as the "insurance industry," as if these thousands of companies are all part of one big family. And while insurance companies do have many shared objectives, they are still competitors at heart — and often-times fierce ones at that. The ease by which insureds can switch insurers, and the constant bombardment to advertising that they should do just that, serves as an incentive for insurers to treat their customers in a manner that they will want to remain their customers. Reporting positive results of customer satisfaction surveys seems to be an important part of insurance company marketing. Also along these lines, it doesn't help for insureds and potential insureds to see an insurer's name in the headline of a news story describing a claim scenario gone horribly wrong.

Minnesota: The Land Of 10,000 Laws

In April 2008 Minnesota Governor Tim Pawlenty signed his state's bad faith bill into law — effective August 1, 2008. On its face, some might say that the Gopher State was in need of a bad faith law. After all, Minnesota courts have held that the state does not recognize a cause of action for bad-faith breach of an insurance contract absent an independent tort. *Sather v. State Farm Fire Cas. Ins. Co.*, No. C3-01-1268, 2002 WL 378111, at *5 (Minn. Ct. App. Mar. 12, 2002) (citing *Haagenson v. Nat'l Farmers Union Prop. & Cas.*, 277 N.W.2d 648, 652 (Minn. 1979)). "A malicious or bad-faith motive in breaching a contract does not convert a contract action into a tort action." *Haagenson*, 277 N.W.2d at 652.

So, enter the Minnesota legislature and its 2008 enactment of M.S.A. § 604.18. In general, this statute provides that an insured may be awarded one-half of the amount of its claim recovery that is in excess of the amount offered by the insurer at least ten days prior to trial (up to $250,000), if the insurer knew of a lack of a reasonable basis for denying benefits of an insurance policy or acted in reckless disregard of the lack of a reasonable basis for denying such benefits. Further, the insured may also be awarded its reasonable attorney's fees, not to exceed $100,000, to prove such violation.

While this new law has been applauded by some as a necessary response to a perceived void in protection for Minnesota policyholders, at the hands of alleged miscreant insurers, upon closer review the statute sets out to solve a problem that did not exist in cases that presumably led to its enactment.

An examination of some of the specifics at issue in the Minnesota decisions, that have declined to recognize a bad faith cause of action for breach of an insurance contract, reveals that they would not have satisfied the statute's "lack of a reasonable basis" requirement in any event. For example, in *Haagenson*, *supra*, damages were sought from an insurer for intentional infliction of emotional distress and punitive damages on account of an insurer's non-payment of no-fault benefits under an automobile liability policy. *Id.* at 652. While the Minnesota high court held that, as a matter of law, such damages were not recoverable for bad faith breach of contract, the court also observed that it did "not appear from the circumstances of the accident that the responsible officials of defendant insurance company had no reason whatsoever to contest plaintiffs' claim under the insurance contracts." *Id.* This certainly does not sound like a situation in which the insurer would have violated Minnesota's bad faith statute because it knew of a lack of a reasonable basis for denying benefits under an insurance policy.

What's more, the policyholder in *Haagenson* was hardly without a remedy for delayed payment of the automobile claim. Pursuant to Minnesota statute, M.S.A. § 65B.54, subd. 1, the court permitted interest on the overdue sum in the amount of 10% per annum. Thirty years later this statute is still on the books in Minnesota and now provides for interest on the overdue sum in the amount of 15% per annum. *See* M.S.A. § 65B.54, subd. 2. Compared to the amount that insurers are earning on their money these days, 15% seems ample incentive for them to avoid untimely payments.

Likewise, in *Sather*, *supra*, the Court of Appeals of Minnesota cited *Haagenson* for the proposition that Minnesota does not recognize a cause of action for bad-faith breach of an insurance contract absent an independent tort. *Sather* at *5. But, again, just as in *Haagenson*, the facts at issue would not have satisfied the new Minnesota statute's "lack of a reasonable basis" standard anyway. *Sather* involved a claim for storm damage under a homeowner's policy. *Id.* at *1. While the *Sather* Court was quick to point out that refusal to pay a claim, even if done in bad faith, is not an independent tort, the court also observed that the insurer denied payment only for disputed claims, each payment made by the insurer was specified as non-final and the policyholders did not submit any covered claims that were not paid. *Id.* at *6. Again, even if the new Minnesota bad faith statute had been in effect at the time of the Sather family's claim, the insurer's claim decisions were certainly not undertaken with knowledge of a lack of a reasonable basis for denying benefits under an insurance policy.

Lastly, in general, if an offer to settle a claim by an insurer, for an at-fault insured, is unfairly low, and subsequently proven so by a verdict against the tortfeasor-insured that exceeds the limits of his or her insurance policy, Minnesota law prevents the tortfeasor from having exposure for personal liability for the amount of the judgment in excess of the insurance policy limits. *See Short v. Dairyland Ins. Co.*, 334 N.W.2d 384, 388 (Minn. 1983) ("The insurer's duty of good faith is breached in situations in which the insured is clearly liable and the insurer refuses to settle within the policy limits and the decision not to settle within the policy limits is not made in good faith and is not based upon reasonable grounds to believe that the amount demanded is excessive."). While third-party bad faith is expressly excluded from M.S.A. § 604.18, Minnesota common law contains no such limitation. To the contrary, third-party bad faith, for failure to settle, exists in Minnesota and, not to mention, with a low threshold of proof.

Washington: How Do You Like Them Apples

Unlike Minnesota, Washington's common law does recognize a cause of action for bad-faith breach of an insurance contract. *See Smith v. Safeco Ins. Co.*, 78 P.3d 1274, 1276-77 (Wash. 2003) ("[A]n insurer has a duty of good faith to its policyholder and violation of that duty may give rise to a tort action for bad faith. To succeed on a bad faith claim, the policyholder must show the insurer's breach of the insurance contract was unreasonable, frivolous, or unfounded.") (citations omitted); *see also St. Paul Fire & Marine Ins. Co. v. Onvia, Inc.*, 196 P.3d 664, 668 (Wash. 2008) (same). Washington permits an award of damages for bad faith in the same manner as any other tort: those "damages proximately caused by any breach of duty." *Smith* at 1277.

What's more, under Washington law, an insured may maintain an action against its insurer for violation of the Consumer Protection Act (Wash. Rev. Code Ann. § 19.86.010). In general, Washington's Consumer Protection Act allows for a recovery of damages — even for a single violation of a claims handling regulation. *Industrial Indem. Co. of the Northwest, Inc. v. Kallevig*, 792 P.2d 520, 530 (Wash. 1990).

Indeed, a CPA violation has been found regardless of whether the insurer was ultimately correct in determining coverage did not exist. *Coventry Assocs. v. Am. States Ins. Co.*, 961 P.2d 933, 937 (Wash. 1998). The insured in *Coventry* was entitled to recover the amounts it incurred as a result of the bad faith investigation — the cost of hiring its own experts and investigators to determine if the insurer should have covered the claim as well as general tort damages. *Id.* at 940.

But despite such common law and statutory protections already in place for insureds, in 2007 Washington enacted the Insurance Fair Conduct Act (IFCA), which authorizes a cause of action by a first party claimant who is unreasonably denied a claim for coverage. *See* Wash. Admin. Code § 48.30.015. The aggrieved party shall be entitled to recover the actual damages sustained, the costs of the action, including reasonable attorneys' fees and litigation costs. § 48.30.015(1). The court may also award treble damages. § 48.30.015(2). Further, such damages are available if the insurer violates Wash. Admin. Code §§ 284-30-330, 284-30-350, 284-30-360, 284-30-370 and 284-30-380. § 48.30.015(5). In general, these code provisions set forth, in detail, a litany of claims handling practices, such as prompt acknowledgment of communications, prompt investigation of claims, prompt settlements and misrepresentation of policy provisions. All of the damages authorized by the IFCA can be awarded in addition to those available under Washington common law and its Consumer Protection Act.

Putting aside all of the specifics of these various statutory provisions, and there are many, at the heart of Washington's IFCA is an award of significant damages, including treble damages, from an insurer that "unreasonably denied a claim" or committed a single violation of a claims handling requirement. Washington's *unreasonable denial of a claim* threshold for establishing bad faith is lower than the burden required by many states and stands in contrast to the rationale used by numerous courts for declining to set their own first-party bad faith bars so low. *See Lawton v. Great Southwest Fire Ins. Co.*, 392 A.2d 576, 581 (N.H. 1978) (addressing first-party bad faith) ("The insurer is not in a position to expose the insured to a judgment in excess of the policy limits through its unreasonable refusal to settle a case, nor is it in a position to otherwise injure the insured by virtue of its exclusive control over the defense of the case.").

While much has been made of the "unreasonably denied a claim" standard adopted in Washington's IFCA, this standard already existed in the state's common law. *See Smith, supra* ("To succeed on a bad faith claim, the policyholder must show the insurer's breach of the insurance contract was unreasonable, frivolous, or unfounded."). Indeed, not long ago the Washington Supreme Court (5-4) held that an insurer's failure to defend, based upon a questionable interpretation of law — notwithstanding that the relevant issue was one of first impression and a close call — was unreasonable and the insurer acted in bad faith as a matter of law. *American Best Food, Inc. v. ALEA London, Inc.*, 229 P.3d 693, 700-01 (Wash. 2010).

Part III — Bad Faith Legislation: More Harm Than Good

In support of the necessity for bad faith laws, advocates of such legislation are quick to cite (potentially unverifiable) anecdotes of insurance claims gone awry, and, admittedly, some claims handling scenarios that are chronicled in judicial decisions where insurers would no doubt like to have a do-over. But despite such unfortunate claims handling incidents, a simple fact remains: compared to the millions of claims handled annually by insurance companies, bad faith is rare. According to the American Insurance Association, approximately 1 in 5,000 claims result in insureds suing their insurers.[4] It is just not bad faith because the claims process comes across as a hassle to an insured or does not go as smoothly as he or she would like. In other words, bad faith is much easier to allege than it is to prove. So if that's the case, policyholder advocates will no doubt ask why the insurance industry works so hard to defeat such legislative proposals.

The simple answer is that such statutes unnecessarily drive up the cost of claims payments and litigation costs for insurers. Consequently, if the cost of doing business for insurers goes up, so too will the cost of insurance for the public as a whole. According to the actuarial firm Milliman, Inc., as reported by the Property Casualty Insurers Association of America, a study of five states that enacted first-party bad faith laws revealed that the average premium increase ranged from 3.5 to 7 percent.[5] *See also* American Legislative Exchange Council, "Resolution Opposing Unfair and Unbalanced Insurance 'Bad Faith' Legislation," August 2009 ("[U]warranted expansion of insurer liability for bad faith claims practices is likely to result in both larger damage payments and higher settlement values. [T]he resulting increase in the volume of litigation, the payment of meritless claims, and unreasonably high damage awards and settlement values can be expected to produce costs that will inevitably be passed on to insureds and other consumers of insurance services.") (citation omitted).

Statutes that allow for the recovery of enhanced damages and/or attorney's fees can be a magnet for, well, attorneys. There may be nothing that turns a mole hill into a mountain more than litigation with the prospect of an award of attorney's fees for the prevailing party. In such cases, it is not unusual for the plaintiff's attorney, on account of the claim for the recovery of its fees, to become the real party in interest. *See Banuelos v. TSA Washington, Inc.*, 141 P.3d 652 (Wash. Ct. App. 2006) (upholding the following recovery against a car dealer for its violation of a statute (as well as the Consumer Protection Act) that required the return of a buyer's $1,000 down payment within three days: $4.27 (13 days loss of use of $1,000 based on 12% annual interest; $12.81 in treble damages; and $90,125 in attorney's fees); *see also Palamara v. Kings Family Restaurants*, No. 07-317, 2008 WL 1818453 (W.D. Pa. Apr. 22, 2008) (approving the following class action settlement against a restaurant for violating the Fair and Accurate Credit Transactions Act (not truncating the expiration dates from credit card receipts): each class member to receive a coupon for (1) a free appetizer and a free mini-sundae, with a retail value of up to $4.68; (2) a free homemade bowl of soup and a free slice of apple or pumpkin pie, with a retail value of up to $4.78; (3) a free cup of soup and a free appetizer, with a retail value of up to $4.38; or (4) a free dinner salad and a free single scoop of Kings Premium Ice Cream, with a retail value of up to $4.38; and restaurant agreed to donate 500 gift certificates for kids soft drinks, with a retail value of $0.99 per drink, to First Tee, a non-profit organization which offers underprivileged children the opportunity to play golf) (And, apparently declining to be paid in ice cream, class counsel was awarded attorney's fees of $75,000). Of course, there is no shortage of other examples of class action settlements where the class members get a coupon — to buy more of the offending company's product or service — and plaintiff's counsel gets a gazillion dollars.

But despite the seemingly obvious attraction that may come from a statute that contains an attorney's fees provision, attorneys are still business people. There are only so many hours in a day so of course they need to use this limited resource in a manner that maximizes their chances to earn fees (especially if the bulk of their practice is contingent-fee based). That being so, simply because a statute contains an attorney's fees provision does not eliminate the need for the attorney to have a meritorious case. In other words, the plaintiff's attorney still needs to win — or be able to force a settlement because it has proven that it *can* win — before the attorney's fees provision has any import. That plaintiffs' attorneys operate rationally, and only act in their best economic interest, should be the gatekeeper of the court house.

With that in mind, now consider a statute that contains a minimum threshold for proving insurer bad faith (*i.e.*, a low barrier to entry for bringing such case) and a provision that allows for an award of attorney's fees to a prevailing insured. Also consider that bad faith determinations can be very fact intensive, involving such issues as: what did the insurer do and what was the insurer thinking when it did it. For this reason, unlike many coverage disputes, that involve legal issues, and can be resolved relatively quickly, by way of summary judgment, bad faith suits are not likely to fall into this category. To the contrary, bad faith cases often require a trial, with a fact finder, to resolve the disputed (and often hotly so) questions of what the insurer did and why. Translation — bad faith suits are expensive, likely involving a lot of discovery, experts and other components of litigation that drive up the cost.

This confluence of factors — a low bar to clear to establish bad faith, the plaintiff's chance to get its case before a jury (where permissible) and the plaintiff's attorney's ability to saddle the insurer with not only its own attorney's fees but also the insured's — is the perfect storm for the filing of bad faith suits. In this situation, the insured's counsel can present a scenario to the insurer in which settlement is an attractive option.

Never mind that the bad faith allegations may be entirely defensible. For the insurer, the decision becomes about stopping two lawyers' meters from running and eliminating the always-present risk of an adverse verdict. No matter how strong their defenses, insurers are always at a risk for losing cases that they should win, especially ones involving their conduct. There is a general bias toward them, any rules concerning policy interpretation are construed against them and their Goliath-like perception, taking on a David-like policyholder, doesn't help. By likely being able to bypass summary judgment and get to trial, the plaintiff's attorney can, and will, constantly remind the insurer that juries (and even judges) are unpredictable and a runaway verdict is never off the table. Being forced into this corner leads not only to settlements by insurers, but possibly for amounts that may be more than the case is worth if it were tried to verdict. All of this of course drives up the cost of doing business for insurers, and, consequently, the cost of insurance for the public as a whole.

But if the bad faith standard were higher, requiring intentional or reckless, or even more culpable conduct, as it is in many states, fewer such suits would be filed. It would put into place a barrier to entry for unfounded bad faith suits — plaintiffs' attorney's inability to afford to take a case, on a contingent fee basis, unless the chance of prevailing is strong. As a dissenting Washington Supreme Court Justice in *American Best* put it, bad faith should be reserved for "more culpable conduct." *American Best* at 703 (Owens, J. dissenting).

Conclusion

Each year thousands of hard-working and well-intended individuals adjust millions of insurance claims. Of course some of those are not going to be handled as well as insurers would like. But every industry has instances of less than ideal conduct that is not representative of the industry as a whole. But instead of recognizing these situations for what they are, some in the plaintiffs' bar use them to paint the entire insurance industry — all 2.4% of U.S. gross domestic product in 2007 and $1.1 trillion in premium in 2008[6] — as being in need of repair.

Such plaintiffs' attorneys would be well-served to heed the age-old advice about what not to do with a stone when inside a glass house. After all, legal malpractice statistics reveal that claims against personal injury lawyers are right there at the top of the list of most common types. But that hardly makes all plaintiffs' attorneys incompetent or criminals. Of course not. Just as with insurance claims, the number of personal injury claims is enormous. It is inevitable that some are going to be handled poorly — even to the point of sending some lawyers to jail. But a few bad apples in the plaintiffs' bar does not spoil the bunch.

By pushing for bad faith laws, especially when remedies already exist, legislators are allowing an infinitesimal percentage of mishandled insurance claims to create a framework that adversely impacts all claims and all insurance buyers. In this way, legislators are doing more harm than good.

Endnotes

1. **Bad faith bills were introduced in the following states but failed to be enacted into law: Colorado** (SB09-103): On 3/30/09 the House Committee on Health and Human Services postponed the bill indefinitely; **Connecticut** (SB-763): On 1/28/09 the bill was referred to the Joint Committee on Insurance and Real Estate, where it died; **Florida** (S-962): On 5/2/09 the Senate indefinitely postponed and withdrew the bill from consideration. The bill died in the Committee on Banking and Insurance; **Georgia (**HB-450): On 2/19/09 the bill was committed to the House Second Readers, where it died; **Iowa** (SSB-1137): On 4/10/09 the bill was referred to the Judiciary, where it died; **Maine** (LD-1305): On 5/7/09, pursuant to Joint Rule 310.3, the bill was placed in legislative files where it died; **Montana** (HB-345): On 4/28/09 the bill died in the standing committee; **Nevada** (AB-224): On 5/16/09, pursuant to Joint Standing Rule No. 14.3.3, no further action was allowed on the bill; bill died; **New Mexico** (HB-157): Bill was postponed indefinitely and therefore died; **Oregon** (HB-2791): On 3/2/09 the bill was referred to the Judiciary, where no further action was taken; bill died; **Rhode Island** (H-5196): On 3/10/09 the House Corporations Committee recommended the bill be held for further study; the bill then died. **Bad faith bills were introduced in the following states and their status remains pending: New Jersey** (S-132): On 1/8/08 the bill was referred to the Senate Commerce Committee, where it is still active; **New York** (A-3698): On 1/6/10 the bill was referred to the Insurance Committee, where it is still active; **Pennsylvania** (SB-746): On 12/17/09 the bill was re-committed to the Judiciary, where it is still active; **Washington D.C.** (B18-103): On 1/29/09 the bill was referred to the Public Services and Consumer Affairs Committee, where it is still active. A public hearing was held on 6/25/09. **Bad faith legislation was enacted in the following states: Colorado** (HB08-1407): C.R.S.A. § 10-3-1114, 1115, 1116, 105, 106.5 (2008); **Maryland** (SB 389): Md. Code Ann. Insurance § 27-1001 (2007); **Minnesota** (SF 2822): Minn. Stat. § 604.18 (2008); **Washington** (SB 5726): Wash. Rev. Code § 48.30.015 (2007).

2. *http://www.doverlawfirm.com/library/keep-an-eye-on-washington-state1.cfm*.

3. *http://www.minnesotapersonalinjury.com/CM/Articles/good-faith-law.asp*.

4. *http://www.aiadc.org/aiadotnet/docHandler.aspx?DocID=326043*.

5. *http://www.pciaa.net/legtrack/web/naiipublications.nsf/49139d351a50a366862575fb00555bcb/862569e9006cf170862575fd00665171/$FILE/MI-BadFaith-WP.pdf*.

6. *http://www.iii.org/media/facts/statsbyissue/industry/*. ■