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Insurance Bad Faith:
Strategies for Avoiding or Pursuing Claims

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INSURANCE BAD FAITH:
STRATEGIES FOR AVOIDING OR PURSUING CLAIMS

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I. BAD FAITH IN GENERAL.

"Bad faith" is the legal concept to describe a breach of the covenant of good faith and fair dealing that is implied by law in every contract. Breach of this covenant involves more than simply the breach of specific contractual duties or mistaken judgment. It signifies certain unreasonable conduct in relation to an insurance company's duties owed under a policy of insurance.

Because insurance involves both "first party" and "third party" coverages, bad faith claims exist with respect to both first party and third party insurance policies. First party coverage concerns a policyholder's claim for direct benefits under an insurance policy. Examples include homeowner's insurance, life insurance, health insurance, disability insurance, and automobile insurance. In that case, a claim for "bad faith" consists of the policyholder claiming breach of the implied covenant of good faith and fair dealing when the insurance company refuses, without proper cause, to compensate the policyholder for a loss covered by the policy or by unreasonably delaying payments due under it.

Third party coverage concerns a policyholder's claim that an insurance company has breached the implied covenant of good faith and fair dealing by mishandling a claim made by a third party against the policyholder. Examples include general liability policies or director and officer insurance policies, in which the policyholder claims the insurance company failed unreasonably to defend the policyholder against a third-party claim or that it refused to settle a claim reasonably within policy limits.

The gist of a "bad faith" claim, in either case, arises as a matter of law from the insurance policy, apart from the terms of the policy itself, namely, that the insurance company must refrain from doing anything that will injure the right of the policyholder to receive the benefits of the insurance contract, the terms and conditions of which define the duties and performance to which

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the policyholder is entitled. The implied covenant is that neither party will do anything which will injure the right of the other to receive the benefits of the agreement. In addition, each contracting party must do everything that the contract presupposes that the party will do to accomplish its purpose.

The rationale for these implied duties is that people buy insurance to obtain peace of mind and security in the event of a loss or claim, and that they expect to be paid promptly in the event of such a loss. Because insurance companies sell insurance policies on this basis, insurance companies are not permitted to exalt their interests over the interests of the policyholder in obtaining the protection for which they bargained. For this reason, the insurance company must give at least as much consideration to the interests of the policyholder as it does to its own.

Unreasonableness is determined on a case-by-case basis and typically involves showing that the insurance company failed or refused to discharge its contractual duties, in consideration of the contractual purposes and the reasonably justified expectations of the parties. This failure or refusal to discharge duties must be prompted not by an honest mistake, bad judgment, or negligence, but by a conscious and deliberate act that unfairly frustrates the agreed common purposes, and disappoints the reasonable expectations of the other party thereby depriving that party of the benefits of the agreement.

Because the claim has its origin in the existence of an agreement, only persons in privity with the insurance company have standing to assert a claim for bad faith in most jurisdictions. Persons other than insureds/policyholders generally cannot sue for damages resulting from an insurance company's withholding policy benefits unless they are in privity of contract with the insurance company.

II. BAD FAITH – FIRST PARTY CASES.

Under First Party insurance policies, an insurance company promises to indemnify its policyholder for covered losses. The implied covenant of good faith and fair dealing in those policies is that the insurance company will make a thorough and prompt investigation of the insured's claim for benefits and that it will not unreasonably delay or withhold payment of benefits. An insurance company thus breaches this covenant when it (a) fails to investigate a claim reasonably or (b) unreasonably delays or withholds payment of benefits.

A. Failure To Investigate A Claim Reasonably.

An insurance company's duty to investigate a claim obligates it to investigate a claim *thoroughly*. In most jurisdictions, this means the insurance company must fully inquire into all possible bases that might support the policyholder's claim. Following are questions to ask that assist in determining whether an insurance company has made an adequate investigation, specifically, did the insurance company –

- Gather facts accurately?
- Focus on the right issues?

- Investigate promptly, especially when facts are fresh?
- Intimidate any witnesses or solicit false information?
- Use properly trained personnel?
- Reflect balance or bias?
- Fairly evaluate the findings?
- Handle the claim consistent with industry practice?
- Violate any state statutes or administrative regulations?
- Rely on unverified information?
- Adequately document its findings?
- Reach a decision before the investigation was concluded?
- Reach a decision based on the whole factual record, and not just isolated facts or events?
- Refuse to re-consider when presented with additional evidence?
- Refer the claim to a committee that merely rubber-stamped the decision?

The insurance company's duty to investigate includes the duty to interview witnesses with significant information. The insurance company's duty extends to whatever facts or theories that might support coverage under the policy, even if the policyholder has not advanced all facts or theories. Moreover, the insurance company cannot sit back and wait for the policyholder to provide it with all information. If information is reasonably available to the insurance company, then the insurance company has a duty to initiate its own investigation and obtain that information.

An insurance company may have a duty to consult with an expert if its own representatives are not sufficiently knowledgeable about the subject matter of a claim. At the same time, reliance on an expert will not necessarily insulate an insurance company from a bad faith claim. If the insurance company dishonestly selected its expert, or if the expert itself acted unreasonably or failed to conduct a thorough investigation into the claim, a bad faith claim may still lie against the insurance company. A policyholder can establish this if it can prove that a reasonable investigation would have uncovered evidence to establish coverage or a potential for coverage. More egregious examples include an expert ignoring evidence submitted by the policyholder, especially if it contradicts the evidence on which the expert relied, or if the expert is found to have lied in a deposition or to the policyholder. Following are questions to consider in determining whether an insurance company reasonably relied on an expert's report to determine coverage:

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

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

B. Unreasonable Delays Or Withholding Of Payment.

To establish a claim in a First Party case that an insurance company has unreasonably delayed payment of a claim, it must be shown that the insurance company's delay was "unreasonable" or "without proper cause." In most jurisdictions, if the insurance company has made full and prompt payment, no bad faith claim can exist, no matter how egregious its conduct may have been.

Improper withholding of policy benefits may include a denial of benefits due, discontinuing ongoing benefit payments, or paying less than the amount due, Moreover, it may not withhold payments on all claims when only some are in dispute. The rationale is that such delay impermissibly pressures the policyholder into compromising the disputed claims for the sake of obtaining the undisputed claims.

An insurance company may not deny a claim based on a standard it knows to be impermissible or is based on an interpretation contrary to established law. Nor may it engage in abusive or coercive tactics to avoid payment of the claim or to pressure the policyholder into accepting less than the amount owed. Even arrogance or hostility by a claims representative can constitute evidence of bad faith conduct, as can groundless accusations against the policyholder or groundless threats to rescind the policy.

The duty to act in good faith does not stop when coverage litigation commences. While the insurance company has a right to sue or defend itself in litigation regarding its coverage rights, evidence of its litigation tactics may constitute continuing evidence of its breach of the implied covenant of good faith and fair dealing. Moreover, an exceedingly low settlement offer may also be evidence of that breach.

III. BAD FAITH – THIRD PARTY CASES.

Under Third Party insurance policies, an insurance company promises to defend and indemnity its policyholder against covered claims. The implied covenant of good faith and fair dealing in those policies is that the insurance company will provide a defense if a potential for liability exists and that it will attempt to effect a reasonable settlement of third party claims within policy limits. An insurance company thus breaches this covenant when it (a) fails to provide a defense against a third party claim when it is reasonably required to do so; or (b) fails to settle a third party claim timely or reasonably within policy limits.