

# **THE CASE FOR BAD FAITH DAMAGES IN ENGLISH INSURANCE LAW**

## **WHY INSURERS SHOULD STOP HATING AND START LOVING BAD FAITH REMEDIES**

**By**

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Every year, millions of insurance claims are resolved amicably, without dispute about the scope of coverage, and without any charges of bad faith with respect to either party. However, some substandard insurers have adopted policies of delaying payments, establishing needless procedures for an insured to prove a loss, or have cavalierly placed an insured's assets at risk without any reasonable basis for doing so. The economic disparity between insurers and most insureds makes it difficult or impossible for many insureds to enforce their rights under the insurance contract. Additionally, an insurer's unreasonable failure to honor the obligations under its policy can have a devastating impact on the insured's finances, and even their health. As a result, American courts have, for several decades, recognized that normal remedies for breach of contract are not sufficient to fully compensate insureds when insurers act in bad faith and unreasonably delay or deny claims.

Bad faith law in the United States is not uniform. Courts in some states award damages for bad faith by recognizing an independent tort, while others characterize bad faith as a simple breach of the implied covenant of good faith and fair dealing inherent in every contract. Some courts impose heavy burdens on bad faith plaintiffs to establish that the insurer's actions were both objectively unreasonable and that the insurer knew that there was no reasonable basis for its actions, while others have adopted a standard closer to negligence. The types of damages awarded vary from the requirement that the insurer comply with the policy terms and pay the insured's attorney's fees to allowing damages for emotional distress and punitive damages.

As English law has not previously recognized a right to recover bad faith damages in insurance cases, it has the opportunity to profit from the American experience and adopt the best parts of American bad faith law while rejecting its excesses. By doing so it can ensure that insurers that act responsibly toward their insureds are not at a competitive disadvantage with insurers whose policies encourage delayed claim payments and bad faith denials of claims, while also ensuring that the insurers do not abuse their economic power to the detriment of the public.

### **1. The Nature of the Insurance Contract**

Insureds purchase insurance to manage their financial risk resulting from numerous perils, including tort liability, property damage, catastrophic health care costs, and interruption of business. Insureds rely on the financial strength of the insurer, which

is generally significantly greater than their own, to avoid the devastating impact of serious loss. In some cases this can involve payment of enormous medical bills, and, in the case of health insurance, can determine whether an insured is able to receive medical treatment that could prolong or save their lives. In other cases it can involve the ability to rebuild a house destroyed by fire. It can determine whether a physician is able to continue practice or will have to declare bankruptcy after a catastrophic verdict. If an insurer unreasonably delays payments contracted for under the policy, refuses to settle a serious liability claim or denies the claim altogether, it defeats the very basis of obtaining the coverage in the first place and can impose severe financial hardship on insureds.

American courts have recognized that while insurance contracts are private contracts, they also have a purpose of protecting the public. Indeed, certain forms of coverage, such as auto and trucking liability coverage, are deemed so important to the public welfare that state legislatures have enacted statutes requiring coverage.

Courts also recognize that there is, in most cases, a substantial economic disparity between insureds and insurers, which would enable unscrupulous insurers to take advantage of insureds to get them to take less than the full amount of their loss to settle a claim, just to avoid the costs involved in enforcing their rights or to avoid the damage that could befall them if they fail to collect something under their policies. The purpose of bad faith damages is to “safeguard an insured in an inferior bargaining position who contracts for calamity protection, not commercial advantage.” *Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal.4<sup>th</sup> 390, 400, 97 Cal.Rptr.2d 151, 159 (Cal. 2000).

## **2. Bad Faith Standards**

### **a. First Party Bad Faith – Elements**

- Covenant of fair dealing. Every contract contains an implied covenant that “neither party will do anything which will injure the right of the other to receive the benefits of the agreement.” *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958); *Dairyland Ins. Co. v. Herman*, 124 N.M. 624, 628, 954 P.2d 56, 60 (N.M. 1997).
- Insurer’s duty of good faith is limited by the obligations the insurer assumes under the policy. *Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal.4<sup>th</sup> 390, 400, 97 Cal.Rptr.2d 151, 159 (Cal. 2000).
- To establish tort action for bad faith, most states require the insured to show (1) the absence of a reasonable basis for denying the benefits of the policy; and (2) the insurer’s knowledge or reckless disregard of the lack of a reasonable basis for denying the claim. *E.g.*, *Wittmer v. Jones*, 864 S.W.2d 885, 890 (Ky. 1993); *Anderson v. Continental Ins. Co.*, 85 Wis.2d 675, 691, 271 N.W.2d

368, 376 (Wis. 1978); *Williams v. Allstate Indemnity Co.*, 266 Neb. 794, 799, 669 N.W.2d 455, 460 (2003).

- First prong of test is objective – would a reasonable insurance company have denied the claim under similar circumstances. *Anderson v. Continental Ins. Co.*, 85 Wis.2d 675, 692, 271 N.W.2d 368, 377 (Wis. 1978); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 860 (Wyo. 1990); *Ruwe v. Farmers Mutual United Ins. Co.*, 238 Neb. 67, 73, 469 N.W.2d 129, 134 (1991). Also phrased as whether the validity of the denied claim is “fairly debatable.” *Id.*
- Where coverage is “fairly debatable”, insurer has right to contest coverage. *Id.* In California this test is whether there is a “genuine dispute as to coverage.” *Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 992 (9th Cir. 2001).
- Whether claim is “fairly debatable” raises the question of whether the insurer has properly investigated the facts of the claim. *Anderson v. Continental Ins. Co.*, 85 Wis.2d 675, 692, 271 N.W.2d 368, 377 (Wis. 1978); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 860 (Wyo. 1990); *Ruwe v. Farmers Mutual United Ins. Co.*, 238 Neb. 67, 73, 469 N.W.2d 129, 134 (1991). However, some courts have held that if the insured relies on the failure to investigate the claim, the insured must show that the insurer intentionally failed to determine facts sufficient to show whether there was an arguable basis or fairly debatable basis for denying the claim. *King v. National Foundation Life Ins. Co.*, 541 So.2d 502 (Ala. 1989).
- Using the “fairly debatable” or “genuine dispute” doctrine, an insurer can obtain summary judgment dismissing a bad faith claim by showing that there was a reasonable basis for denying the claim. *Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 994 (9th Cir. 2001)
- Second part of test is whether insurer knew that it had no reasonable basis for denying the claim or recklessly disregarded it. This can be satisfied by showing that the insurer acted consciously or deliberately rather than negligently. *Colley v. Indiana Farmers Mutual Ins. Co.*, 691 N.E.2d 1251 (Ind.App. 1998)(“Poor judgment or negligence do not amount to bad faith; the additional element of conscious wrongdoing must also be present.”) *Ruwe v. Farmers Mutual United Ins. Co.*, 238 Neb. 67, 73, 469 N.W.2d 129, 134 (1991)(reckless disregard can be implied when there is reckless disregard or indifference to the facts or proof submitted by the insured.)

#### **b. First Party Bad Faith – Damages Available**

- Payment of the claim that was improperly denied.
- Attorneys' fees in bringing the suit. *Filasky v. Preferred Risk Mut. Ins. Co.*, 152 Ariz. 591, 734 P.2d 76, 83 (1987).
- Loss of business or credit reputation. *Assicurazioni Generali, S.p.A. v. Milsap*, 760 S.W.2d 314, 318 (Tex.App. 1988).
- Loss of earnings and property. *Filasky v. Preferred Risk Mut. Ins. Co.*, 734 P.2d 76, 83.
- Emotional distress stemming from other losses. *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313, 319 (R.I. 1980).
- Punitive damages. *Id.* However, many courts allow punitive damages only when the conduct is significantly worse than that which would constitute normal bad faith. *Filasky v. Preferred Risk Mut. Ins. Co.*, 152 Ariz. 591, 598, 734 P.2d 76, 83 (1987) (requires showing that “evil hand” that damaged the objectives of the insurance contract was “guided by an evil mind which either consciously sought to damage the insured or acted intentionally, knowing that its conduct was likely to cause unjustified, significant damage to the insured.”); *Tomaselli v. Transamerica Ins. Co.*, 25 Cal.App.4th 1269, 31 Cal.Rptr.2d 433 (1994) (punitive damages normally based on finding of malice, oppression or fraud – generally due to a continuous policy of non-payment of claims).

#### **c. Third Party Bad Faith – Failure to Settle**

- Under most liability policies, the insurer has the right to defend the claim and also has the right to settle the claim. The insured is precluded from settling the claim, except at its own expense. The basis for imposing a duty to settle is the insurer's exclusive control over settlement negotiations and defense of the litigation. *Haddick v. Valor Insurance*, 198 Ill.2d 409, 414, 763 N.E.2d 299, 303 (2001).
- An insurer has little incentive to settle for policy limits or for an amount near the policy limits, because the risk of an excess verdict is borne by the insured or the insured's excess carriers. *Haddick v. Valor Insurance*, 198 Ill.2d 409, 415, 763 N.E.2d 299, 303 (2001).
- Courts in the United States have uniformly adopted the position that an insurer which fails to settle a case within its policy limits through fraud, bad faith or (in some states) negligence, is liable for

the full amount of any excess judgment entered against the insured. *Adduci v. Vigilant Ins. Co.*, 98 Ill.App.3d 472, 475, 424 N.E.2d 645, 648 (1981); *McCall v. Allstate Ins. Co.*, 251 Ga. 869, 870, 310 S.E.2d 513, 514 (1984); *Johnson v. Tennessee Farmers Mutual Ins. Co.*, 2005 WL 549195 (Tenn.App. March 9, 2005).

- Duty to settle arises when there is:
  - A claim against the insured (suit is not required).
  - Reasonable **probability** of excess verdict.
  - Reasonable **probability** of liability finding against insured.
  - Demand for settlement within policy limits.

*Haddick v. Valor Insurance*, 198 Ill.2d 409, 763 N.E.2d 299 (2001). If there is no probability of an excess verdict or of a liability finding against the insured, or if there is no potential for settling the claim within policy limits, there is no duty to settle.

- Insurer is not required to place insured's interests ahead of its own in determining whether to settle. It is required to give the insured's interests equal weight to its own interests in considering settlement. One way to view this is whether a reasonable insurer with no limits would have declined to settle the claim. *Safeway Ins. Co. v. Guerrero*, 210 Ariz. 5, 106 P.3d 1020, 1024 (2005); *Sloan v. State Farm Mut. Auto. Ins. Co.*, 135 N.M. 106, 114, 85 P.3d 230, 238 (2004); *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1172, 769 N.E.2d 100, 106 (2002).
- Factors courts consider in determining whether the insurer has given equal weight to the insured's interests include:
  - Whether the insurer has adequately investigated the claim to determine its value. *Sloan v. State Farm Mut. Auto. Ins. Co.*, 135 N.M. 106, 114, 85 P.3d 230, 238 (2004); *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1174, 769 N.E.2d 100, 107 (2002).
  - Advice of insurer's adjusters and defense counsel concerning likelihood of success, likely verdict value and recommendations regarding settlement. *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1172-73, 769 N.E.2d 100, 106 (2002). Failure to follow advice of defense counsel and adjusters indicates bad faith. *Id.*;

- Refusal to negotiate is one indication of bad faith. *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1173, 769 N.E.2d 100, 106 (2002); *Cotton States Mut. Ins. Co. v. Brightman*, 256 Ga.App. 451, 454, 568 S.E.2d 498, 500-501 (2002); *Hawkins v. Dennis*, 258 Kan. 329, 344, 905 P.2d 678, 689 (1995).
- Failure to keep insured informed of negotiations. *Lafauci v. Jenkins*, 844 So.2d 19 (La.App. 2003); *Redcross v. Aetna Cas. & Surety Co.*, 260 A.D.2d 908, 688 N.Y.S.2d 817 (1999); *Truck Ins. Exchange v. Bishara*, 128 Idaho 550, 916 P.2d 1275.
- Substantial prospect of adverse verdict and potential that it will exceed policy limits. *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1174, 769 N.E.2d 100, 107 (2002).

#### **d. Damages for Failure to Settle.**

- Compensatory damages are the amount of the judgment that exceeds the policy limits. *Wolkowitz v. Redland Ins. Co.*, 112 Cal.App.4th 154, 162, 5 Cal.Rptr.3d 95, 103 (2003); *Medical Mut. Liability Ins. Soc. of Maryland v. Evans*, 330 Md. 1, 25, 622 A.2d 103, 114 (1993).
- Some courts have allowed claims for loss of consortium due to the emotional distress caused to a spouse when an insurer fails to settle in bad faith. *Robin v. Allstate Ins. Co.*, 844 So.2d 41, 47 (La.App. 2003).
- Courts have also allowed the insured to recover damages for loss of credit rating, business reputation and emotional distress, where the insurer knew or should have known that they would be incurred as the result of the insured's bad faith failure to settle. *Birth Center v. St. Paul Cos.*, 567 Pa. 386, 407, 787 A.2d 376, 389 (2001);
- Courts have allowed the insured to recover the value of a business destroyed as the result of the failure to settle. *Aetna Life & Casualty Co. v. Little*, 384 So.2d 213, 216 (Fla.App. 1980)
- Courts have also allowed punitive damages where there is evidence that the insurer acted with intent to injure the insured or acted in reckless disregard of the insured's interests. *Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal.4<sup>th</sup> 390, 410, 97 Cal.Rptr.2d 151, 166 (Cal. 2000); *Campbell v. State Farm Mut. Auto. Ins. Co.*, 98 P.2d 409, 416 (Utah 2004); *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1178, 769 N.E.2d 100, 111 (2002).

### **3. Basis for allowing extra-contractual damages.**

- a. Insurance is more than a commercial contract for money. It is purchased to manage risk and obtain peace of mind that risk of serious financial hardship is limited. *Machan v. Unum Life Ins. Co. of America*, 2005 WL 1414354 (Utah June 17, 2005); *Best Place, Inc. v. Penn Am. Ins. Co.*, 82 Hawaii 120, 920 P.2d 334, 342 (Haw.1996); *Miller v. Fluharty*, 201 W.Va. 685, 500 S.E.2d 310, 319 (W.Va.1997). Bad faith actions by insurers defeat the purpose of this contract.
- b. Insurers advertise that their products will protect the insured against the risks of serious loss. *Rawlings v. Apodaca*, 151 Ariz. 149, 155, n.3, 725 P.2d 565, 571, n.3 (1986) (“Advertising programs portraying customers as being 'in good hands' or dealing with a 'good neighbor' emphasize a special type of relationship between the insured and the insurer – one in which trust, confidence and peace of mind have some part.”)
- c. While the insurer has contract remedies available to force the insurer to pay the amount owed, the need to invoke those remedies in large measure defeats the purpose of obtaining insurance. *Rawlings v. Apodaca*, 151 Ariz. 149, 154, 725 P.2d 565, 570 (1986)
- d. The disparity in economic power between the insurer and most insureds, coupled with the fact that the insurer sets the terms and conditions of coverage, determines whether to grant or deny claims, and undertakes the right to defend and settle third party claims, means the insurer takes on an “almost adjudicatory responsibility.” *Rawlings v. Apodaca*, 151 Ariz. 149, 155, 725 P.2d 565, 570 (1986)
- e. Aside from punitive damages, the damages awarded are all foreseeable consequences of unreasonable actions by insurance companies that will defeat the purpose of insurance. Decisions by insurers to deny coverage or to risk the insured’s assets, when taken without a good faith basis, expose the insureds to unreasonable risks.

### **4. Insurers Need Not Fear Bad Faith If They Act Reasonably.**

- a. Bad faith laws, when properly understood and applied, impose extra contractual remedies only on insurers that act with knowledge that they have no reasonable basis for their actions or that act in reckless disregard of the fact that they have no reasonable basis for their actions.
- b. Under the law in most jurisdictions, an insurer cannot be held liable for bad faith when there is no coverage under the policy. The insurer’s duties under the policy are all spelled out in its own policy and are voluntarily assumed by the insurer.

- c. Insurance companies with well thought out procedures and well staffed and adequately trained claims departments will be adequately protected from bad faith suits. Bad faith suits are most typically successful where the insurer has adopted policies which are designed to shortchange the insured or where a claims handler abuses his or her authority.
- d. The “fairly debatable” provides an objective measure for insurance companies, so that they will not be liable for bad faith if they have a reasonable basis for their decision. Courts have recognized the right of an insurer to have an honest dispute with an insured, and the right of an insurer to refuse to settle a claim where it has a good faith belief, based on adequate investigation, that the claim is defensible.
- e. A study of claims payments has determined that there is a slight upward shift (.3%) of the total value of claims paid in states with a bad faith remedy. Brown, M., Pryor, E. and Puelz, B., “The Effect of Bad-Faith Laws on First-Party Insurance Claims Decisions”, 33 J. LEGAL STUDIES 355, 384 (2004). Significantly, there is a greater increase in loss settlement amounts for claimants not represented by an attorney. *Id.*, 386. This finding may suggest that insurers are likely to treat an insured fairly when they are represented by an insurer with or without the threat of bad faith laws, but the threat of bad faith laws makes it more likely that an insurer will treat even the unrepresented insured fairly.
- f. Third party bad faith claims also protect excess insurers, which have greater leverage with primary carriers that may wish to risk a catastrophic verdict to obtain a small savings to their limits.