2016 CLM Annual Conference
April 6-8, 2016
Orlando, FL

The New Trend in Bad Faith Litigation?

Insurers have seen a rising number of first party lawsuits from non-insureds due to post-loss assignment of contractual rights to strangers to the insurance contract. As a result, insurers are faced with a series of new problems in attempting to address claims presented. Who has the right to make the claim? Is the assignment valid and enforceable? Is the insured, the party the carrier contracted with, aware of the assignment and the actions of those who are allegedly acting in their interest. The issue may present insurers with potential exposure to inflated indemnity claims, attorney's fees and extra-contractual damages as a result of assignments to which they did not consent. In Florida, for example, insurers have been besieged by direct actions from third-party vendors for exorbitant repair or remediation costs following a post-loss assignment. In the wake of Hurricane Katrina and superstorm Sandy, insurers faced potential indemnity for assignments taken by HUD or "Road Home" programs. Pennsylvania courts have recently authorized post-loss assignment of bad faith claims to tort plaintiffs. This presentation will explore the reasons behind this emerging trend, the effectiveness of the anti-assignment clause in the insuring agreement, and strategies for insurers to deal with such claims.

The Insurance Contract

One of the first things every law student learns is the definition of a contract: "An agreement between two or more persons which creates an obligation to do or not to do a particular thing." Or, as defined in Restatement, Second, Contracts § 3: "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." The import of the contract is a relationship between the parties; the mutuality of obligations flow from the contract document based upon the agreed terms. In every insurance contract there is an implied obligation of good faith and fair dealing between the parties that neither the insurance company nor the insured will do anything to injure the right of the other party to receive the benefits of the agreement. Consistent with the general principles of indemnity, the goal of the insurance contract is to place the insured back into the position he or she would have been had no loss occurred. It is not to bestow a windfall or place the insured in a greater position due to the loss. For that reason, insurance contracts require the insured to have an insurable interest in the subject matter of the policy.

The insurance relationship is governed by the terms of the contract. The requirement of an insurable interest allows the insurer to properly underwrite and evaluate the risks that it chooses to take in the insuring relationship. Just as the insurer has contractual obligations to pay claims

pursuant to the contract, the insured has concomitant obligations under the contract. For example, in a property policy the insured may be required to make a timely claim, exhibit the property as necessary, and mitigate the loss.

Anti-Assignment Clauses

Due to the mutuality of obligation, insurance policies generally have anti-assignment clauses which prohibit the assignment of a policy, or an interest in the policy, without the insurer's consent. These clauses often come into play in determining the validity or enforceability of attempted assignment of the claims under an insurance policy. In determining whether such assignments are valid, the courts usually draw a distinction between assignments made pre-loss, that is prior to a covered loss, and assignments made post-loss, or after the occurrence resulting in the claim. Many courts have now held that anti-assignment clauses bar pre-loss assignments but are not enforceable against post-loss assignments of a claim for benefits under the policy. The rationale is that requiring an insurer to provide coverage to a stranger to the policy prior to the occurrence would put the insurer in the position of covering a party to whom it had not contracted and could not have properly underwritten the risk associated by that potential insured, thereby materially increasing the risk. Because post-loss assignments are generally thought to involve obligations that are fixed by the occurrence, the risk factors are often considered to be irrelevant with regard to the covered loss and instead treated as a mere transfer of as chose in action.

That rationale makes sense when the amount of the loss is fixed and what is being assigned is a liquidated sum. However, when a loss has occurred but the claim is not liquidated, a problem arises. To allow proper adjustment of the claim – and in conformance with the general principle of indemnity -- an insured must comply with various obligations under a policy in to adequately present and substantiate the claim. This often requires substantial cooperation from the insured that a third-party cannot provide or may not be obligated to provide. For example, the insured may be required to provide access to the damaged property, provide documents related to the loss, answer questions about the loss, submit to a formal examination under oath, and cooperate with the insurer's investigation of the claim. These duties are arguably not transferable to a third party upon assignment. *See, e.g., Engleman v. Royal Ins. Co.*, 51 P.2d 417, 417-19 (Nev. 1935) (compliance with proof of loss requirement was not assignable); *Calif. Fair Plan Ass'n v. Superior Court*, 8 Cal. Rptr. 3d 746, 752-53 (Cal. Ct. App. 2004) (compliance with examination under oath requirement was not transferable to assignee); *Ausch v. St. Paul Fire & Marine Ins. Co.*, 511 N.Y.S.2d 919, 923 (N.Y. App. Div. 1987) (same); *Globecon Group, LLC v. Hartford Fire Ins. Co.*, 434 F.3d 165, 172, 175 (2d Cir. 2006). Moreover, amelioration of the contractual bar to assignment runs counter to the traditional strong public policy in favor of the freedom to contract and the corollary principle that a party to a contract to deal with only the party with whom it contracted. These are meaningful rights. As courts have recognized in the health care context, for example, such clauses are valuable tools in persuading providers to keep costs down.

The Florida Quagmire

Recent case law developments in Florida highlight the problem with post-loss assignments. In Florida, third party providers have started taking an assignment of benefits ("AOB") from

insureds to putatively allow the provider to bill the insurer directly. The AOB allows the third party vendor to direct bill the insurance company and attempt to collect without the insurer first paying the insured.

The Florida Court of Appeals, Fourth District, in the recent case of *One Call Property Services v. Security First Ins. Co.*, 165 So. 3d 749 (Fla. 4th DCA 2015), held that an insured's assignment of a breach of contract action to a third party was valid notwithstanding the policy's anti-assignment clause. In *One Call*, the insured assigned its property restoration/emergency services company the benefits of its insurance policy following a water loss. The assignment read as follows:

> I, the Owner, hereby assign any and all insurance rights, benefits, and proceeds under any applicable insurance policies to One Call. I make this assignment in consideration of One Call's agreement to perform services and supply materials and otherwise perform its obligations under this contract, including One Call not requiring full payment at the time of service. I intend to transfer all insurance rights to One Call, including any causes of action which exist or may exist in the future.

Security First refused to reimburse One Call "adequately" for the services it provided. One Call sued Security First in a first party action for breach of contract to recover the full amount of its charges. Security First moved to dismiss the breach of contract lawsuit on the basis of the non-assignment provision and that, when the non-assignment provision was read in conjunction with the loss payment provision of the policy, the policy precluded One Call, as assignee for the insured, from bringing the lawsuit to determine the amount of the loss and what was due under the policy. The trial court granted the motion to dismiss.

On appeal, the Court of Appeals reversed, finding that a claim on an insurance policy was an assignable chose in action. Therefore, an insurance policy could be assigned as any other chose in action even in light ofthe insurance policy contained a provision forbidding assignment.

This result is consistent with many states, so why is this decision such an issue? First, the court in *One Call* rejected Security First's argument that the insured had assigned unaccrued rights under the policy, holding that the loss payment provision "falls far short of creating a contractual bar to assignment." Therein lies the problem. The insured had assigned a ***potential*** right to recover benefits but had not yet preformed its obligations under the policy. Security First asserted that the time the assignment was executed, the insured had nothing to assign because at that time there were no benefits due and owing to the insured under the policy's loss payment clause. The loss payment provision of the policy specified that Security First was not obligated to pay any loss damages until 20 days after receiving a proof of loss, 60 days after receiving a written proof of loss and there was an entry of a final judgment or written executed mediation settlement, or within 90 days after receiving final notice of an initial claim "reopened claim" or "supplemental claim" from the insured.

Rejecting Security First's position, the Court held that a standard loss payment provision in an insurance policy did not preclude an assignment of a post-loss claim, even when the payment

was not yet due, concluding that loss payment clauses merely address the timing of the payment and expressly contemplate that a lawsuit could occur before payment is due. The Court declined to interpret Security First's loss payment clause as affecting the validity of a post-loss assignment. In reaching this conclusion, the Florida Court of Appeals held that an assignable right to benefits accrues on the date of the loss, even though payment is not yet due under the loss payment clause. Furthermore, according to the Court, even assuming that the insured's right to benefits did not accrue until payment was due under the loss payment provision, there was no reason why the insured could not assign an unaccrued right to benefits under the policy, so long as the assignment took place after the loss.

Unfortunately, the court paid little attention to the inherent problem in this holding: compliance with the insured's obligations under the policy. The court rejected a contention that the insured has a "duty to adjust," then simply concluded that a third-party assignee may recover benefits on a covered loss "as long as the insured complies with policy conditions." The court failed to explain what happens if the insured does not comply.

The court acknowledged that the issue of anti-assignment boils down to two competing public policy considerations. First, whether the assignment of benefits allows contractors to unilaterally set the value of a claim and demand payment for fraudulent or inflated invoices; and second, whether the assignment of benefits would allow homeowners to hire contractors for emergency repairs immediately after a loss, particularly in situations where homeowners cannot afford to pay the contractors up front. The court determined that it was not in a position to evaluate either of these public policy arguments because the record in the trial court was insufficient. However, the court did note that if studies showed that assignments invited fraud or abuse, then the Florida Legislature was in the best position to investigate and undertake comprehensive reform and not the court.

Unsuccessful in the trial court, Security First also looked to the Florida office of insurance regulation for relief. Security First requested that the regulators approve policy form changes that would explicitly prohibit post-loss assignment of benefits. The office of regulation refused and that decision was affirmed in *Security First Insurance Company v. State of Florida, Office of Insurance Regulations* 177 So. 3d 627 (Fla. 1st DCA 2015). In its regulatory filings, Security First argued that AOBs were leading to higher premiums for insurance customers. Security First argued that vendors and contractors, particularly water remediation companies called in after natural disasters, took advantage of insureds by taking assignment of benefit when the insured was vulnerable then inflating the cost to do the work. Studies showed that vendor bills with AOBs were nearly thirty percent (30%) higher than comparative estimates from vendors without an AOB. Some vendors then added an additional twenty percent (20%) for overhead and profit, even though general contractors were not required to oversee the work. Vendors used these inflated invoices to attempt to extract higher settlements because they had been assigned the rights to collect, which would potentially trigger, under Florida statute, the right to attorney's fees, and thus significantly increase litigation costs over the vendor's invoices. Security First also argued that the insured's may have suffered other property damages from the loss, but did not realize that the AOB was broad enough to assign all of the rights available under the homeowner's policy and the right to pursue any legal action. In some states, the assignment of all rights deprives the insured of any legal interest.

Security First complained that it and other insurers were being forced to adjust losses in litigate with entities with whom they did not contract and that the assignees had completely different profit-driven motives than the insured's motives to promptly repair and restore damaged property at a reasonable cost. Moreover, Security First argued that the assignees, while ostensibly "stepping in the shoes" of the insurer, had no obligation to comply with the contractual terms agreed to by the original parties, which materially affected the risk the insurers assumed when issuing the policy. Security First provided testimony that a network of insurance consumers and attorneys had conducted seminars for vendors and contractors showing them how to increase profit margins by thirty percent (30%) by obtaining assignment of benefits. Security First's position highlights the problems inherent in the AOB issue, including increased litigation and claim expense.

Recent cases from other jurisdictions have allowed the assignment of policy benefits:
CPR Restoration and Cleaning Services, LLC v. Franklin Mutual Insurance Co., 2012 WL 2345391 (NJ.App.Div. June 21, 2012). Witherspoon hired CPR to clean up damage to the home caused by a fire. Witherspoon assigned CPR's rights under the policy but the policy had a no assignment clause. Franklin Mutual settled with Witherspoon, but did not pay CPR, so CPR sued both Franklin Mutual and Witherspoon. On appeal, the appellate division determined that the assignment was of a right to receive payment under the policy, rather than the policy itself, and therefore the assignment of rights under the policy did not materially change the insurer's duties. Further, the Court held that for an anti-assignment clause to void an assignment, it must specifically state that "non-conforming assignments (i) shall be "void" or "invalid," or (ii) "that the assignee shall acquire no rights or the non-assigning party shall not recognize any such assignment." Without this language, the assignment was valid.

In *City Center West LP v. American Modern Home Insurance Co.*, 741 F.3d 1338 (10th Cir. 2014), the Tenth Circuit Court of Appeals refused to vacate the assignment of claims under a policy. The Court drew a distinction between assignment of the policy itself and the assignment of a claim, finding only that the former was prohibited. The insurance company argued that the term "policy" in the anti-assignment clause includes any rights that flow from the contract, including claims under the policy. However, the Court of Appeals followed the majority rule and concluded that the anti-assignment clause was limited only to pre-loss assignments.

Governmental Assignments

Anti-assignment clauses were at issue in *In re Katrina Canal Breaches* litigation arising from a lawsuit brought by the State of Louisiana as the assignee of claims under numerous insurance policies as part of Louisiana's "Road Home Program." The Road Home Program was set up by Louisiana post-Katrina to distribute federal funds to homeowners suffering damages. In return for receiving grants up to $150,000, the homeowners were required to execute a limited subrogation/assignment agreement which provided as follows:

> I/we hereby assign to the State of Louisiana . . . to the extent of the grant proceeds awarded or to be awarded to me under the [Road Home] Program, all of my/our claims and future rights to reimbursement and all

> payments hereinafter received are to be received by me/us: (a) under any policy of casualty or property damage insurance or flood insurance on the residence, excluding contents ("residence") described in my/our application for homeowner's assistance under the program ("policies"): (b) from FEMA, Small Business Administration, and any other federal agency, arising out of physical damage to the residence caused by Hurricane Katrina and/or Hurricane Rita."

Many years later, the State of Louisiana brought suit against more than two hundred insurance companies involving more than 150,000 claims in an effort to recover funds dispensed under the program. The insurers removed to federal court under CAFA and argued that the assignments to the State of Louisiana were invalid under the anti-assignment clauses in the policies. On appeal, the Fifth Circuit certified a question to the Louisiana Supreme Court to determine if the anti-assignment clause barred the assignment of such contractual obligations. The Louisiana Supreme Court determined that Louisiana statutes allowed the enforcement of anti-assignment clauses to preclude post-loss assignments of claims under insurance policies. The Court also found that, while recognizing that the majority of courts through distinctions between pre- and post-loss assignments, it would not invalidate the assignments as a matter of public policy because of legislative enactment. However, after recognizing the general enforceability of anti-assignment clauses, the Court determined that those clauses must "clearly and unambiguously express that the non-assignment clause applies to post-loss agreements." In refusing to formulate a bright-line test, the Court instead remanded the case to the federal courts to determine whether the individual anti-assignment clauses in the various policies were sufficiently clear and explicit to be enforced.

One of the primary issues in the *In re Katrina Canal Breaches* was the public policy consideration of the "critical difference between a liquidated claim for policy proceeds, where all the insurer has to do is pay an undisputed amount of money, and an unliquidated claim for additional damage to the property, which has not yet been proven." The insurers successfully argued that the insured's obligations under the contract must be considered in evaluating whether post-loss assignments are valid. The insurers noted that the adjustment of a hurricane property damage claim often requires substantial cooperation from the insured and resolution of various coverage issues. For example, the insured must (i) provide access to the damaged property, (ii) provide documents requested by the insurer, (iii) submit to a formal examination under oath if requested, and (iv) cooperate with the insurer's investigation of the claim. Third party assignees, especially the State of Louisiana did not have the obligations and could not comply with these obligations, especially considering the large volume of claims at issue. The insurers noted that "the difference between a liquidated and unliquidated claim is magnified many times over in this case, where the State seeks to pursue more than 151,000 claims, even though it has no specific knowledge of the damage to the thousands of properties at issue, and cannot comply with the insureds' duties under the policies." Allowing the state's action would have forced the insurers to litigate, years after the fact, thousands of previously-closed homeowners' insurance claims, where the State had virtually no relevant loss information to which the insurers were contractually entitled.

The insurers noted many ways that allowing such post loss assignments would substantially alter their risk and prejudice their contractual rights:

- requiring defense of two separate lawsuits seeking to recover on the very same insurance claim -- one lawsuit filed by a policyholder and this lawsuit filed by the State -- which imposes substantial additional costs and can lead to inconsistent results.
- litigating against a third party (the State) with which they did not contract and never anticipated having to litigate against.
- Potential for the State to use its bargaining power to extract payments on claims that were fairly adjusted, where the insured never would have sued.
- litigating cases where the damage was repaired, or the home was torn down, prejudicing insurers' ability to adequately investigate new or supplemental claims, which would substantially increase administrative costs and legal fees.

What about extra-contractual claims, such as attorney fee statutes or bad faith?

Another issue with the assignment of benefits is that the assignment assigned of post-loss contractual "rights" may exceed the mere right to collect that the avoidance of the anti-assignment clause is intended to allow. Personal torts such as bad faith are generally held to not be assignable. However, the allowance of "post-loss" claim assignment could change that trend, particularly where bad faith is premised on statutory violations. For example, assignments of "all claims" may putatively implicate attorney fees statutes for prompt payment of claims. In Florida first party bad faith cases are statutory and not personal tort claims; therefore, they are potentially assignable. Where an AOB allows an assignment of "any and all rights and benefits under the policy" to another person, it arguably assigns along with it the potential bad faith claim. Other states are now recognizing that even personal bad faith claim can be assignable. For example, Pennsylvania courts have recently ruled that bad faith claims are assignable. In *Allstate Property and Casualty Insurance Co. v. Wolfe*, 105 A. 3d 1181 (Pa. 2014), the court upheld an injured tortfeasor's assignment of a statutory bad faith claim to an injured third party.

A key defense to extra-contractual damages in third-party assignments is to recognize what has been assigned. If case law allows a post-assignment of accrued benefits, then arguably only those benefits that have accrued and are fixed are assignable. In other words, if a bad faith claim does not accrue and arise until there has been a breach of contract, and the breach does not occur until benefits have been denied, then the bad faith claim is arguably not a post-loss claim subject to assignment. Likewise, when a bad faith claim is premised upon statutory obligations, which have conditions precedent, such as a notice of claim, a bad faith claim could not have accrued if the insured had not filed such notice of claim prior to the assignment to the third party vendor.