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"What is The Meaning of "Bad Faith"

Although the term "bad faith" is frequently bandied about in the insurance world, the meaning of the term is quite amorphous. Because of this, it is critical to understand the legal context that gives rise to the obligation of an insurer to act with "good faith" towards its insured, and the concomitant bodies of law that define when an insurer acts in "bad faith." Understanding these principles will help insurers avoid the conduct that can give rise to bad faith exposure.

Every contract has an implied covenant of good faith and fair dealing, and insurance policies are no different. "Bad faith" exists when an insurer breaches this duty by not dealing fairly with its insureds. Because the remedies under the insurance contract may not compensate an insured fully when its insurer acts in bad faith, tort remedies resulting from the common law or statute may put an insurer at risk for damages that are in addition to those available under its insurance contract (i.e., extra-contractual damages).

The covenant of good faith and fair dealing applies differently depending on the type of insurance contract involved, and this impacts the types of bad faith claims to which an insurer may be exposed by any particular claim. With respect to third party liability policies, the most significant type of bad faith claim is that arising from a breach of the duty to settle. First party claims can result in bad faith when the insurer does not conduct an adequate investigation or delays in adjudicating a claim. In addition to these common law claims, various state statutes define bad faith in particular ways and can thus impact bad faith exposure in either the first or third party scenario. Each of these is discussed in turn below.

I. Third Party Liability Policies and Bad Faith Refusal to Settle

Third party liability policies provide defense and indemnity when an insured faces a lawsuit from a third party. Generally, the insurer controls the defense of third party claims and, as a result, a good faith duty to settle arises. A breach of the duty to settle may occur when the insurer, controlling the litigation, decides not to settle an underlying claim, the insured goes to trial, and the trial results in a judgment in excess of the policy limits. In such circumstances, the available damages may include: (1) the full amount of any judgment in excess of policy limits; (2) other consequential damages proximately caused by the insurer's breach; (3) emotional distress; (4) attorneys' fees incurred to establish coverage; and (5) in cases of serious misconduct, punitive damages.

The standards for finding a breach of the duty to settle can vary significantly depending on the jurisdiction. For example, in some jurisdictions, an insurer is strictly liable anytime it does not settle an underlying claim and an excess verdict results. Other states hold an insurer liable for the excess verdict if the insurer acted negligently, and still others require the insured to demonstrate that the insurer acted intentionally or recklessly to make the insurer liable for an excess verdict. These standards are most frequently articulated in multi-factor tests that courts and juries apply to determine if the insurer has acted in bad faith.

For example, Illinois juries are instructed to consider the following factors in evaluating a bad faith refusal to settle claim: (1) the reasonable probability of an adverse liability finding; (2) the reasonable probability of a verdict in excess of the policy limits; (3) the advice of defense counsel; (4) the advice of the insurer's adjusters; (5) the insurer's willingness to negotiate; (6) the adequacy of insurer's investigation; and (7) the insurer's communication with the insured regarding settlement demands. Arizona law requires consideration of similar factors, but describes them differently: (1) the strength of the injured claimant's case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to a settlement; (3) failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; (4) the insurer's rejection of advice of its own attorney or agent; (5) failure of the insurer to inform the insured of a compromise offer; (6) the amount of financial risk to which each party is exposed in the event of a refusal to settle; (7) the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and (8) any other factors tending to establish or negate bad faith on the part of the insurer. Washington formulates the factors in this matter: (1) strength of the injured claimant's case on the issue of liability and damages; (2) the adequacy of the insurer's investigation and evaluation; (3) the adequacy of the insured's policy limits and the consequent risk to which each party is exposed in the event of a refusal to settle; (4) willingness or refusal to negotiate and the resulting "climate for settlement;" (5) any other action by the insurer demonstrating a greater concern for the insurer's monetary interest than for the financial risk attendant to the insured's situation.

One currently unsettled issue in bad faith law is whether the insurer has an affirmative duty to initiate settlement even in the absence of a policy limits demand. Courts finding no such duty reason that imposing a duty to initiate settlement discussions would place an insurer at a negotiating disadvantage. For example, Illinois generally holds that an insurer has no duty to initiate settlement, although courts recognize a limited exception where liability is clear and damages will "greatly exceed" policy limits. However, other states hold that an insurer must initiate settlement when the claimant shows some interest in settlement and there is evidence that a within limits settlement can be reached. In such circumstances, the insurer may not simply wait for a policy limits demand before considering whether it has a duty to try to settle the underlying claim.

In most states, the mere fact of an excess verdict does not necessarily make an insurer liable for a bad faith refusal to settle claim. For example, some states provide that if an insurer can demonstrate that its refusal to settle was the product of a good faith mistake of judgment, then the insurer will not be liable for bad faith. Thus, insurers will often defend against a bad faith claim by relying heavily upon defense counsel's analysis that the claim did not implicate the policy limits. In addition, the timing of a settlement demand can provide an insurer with a defense to a bad faith refusal to settle claim. If the demand comes too early, then the insurer can argue that the facts of the claim were insufficiently developed to permit the insurer to evaluate the potential exposure. In addition, some states permit insurers to refuse to settle claims if there are unsettled questions of coverage. Finally, in situations where there are multiple claims against the same insurer policies, some states permit settlement on first come basis while others prohibit the insurer from settling one claim for one insured over objection of another insured. As the law of third party bad faith refusal to settle demonstrates, virtually the entirety of the insurer's handling of the underlying claim and the underlying defense will be examined under a microscope to determine if a bad faith refusal to settle claim exists.

II. First Party "Bad Faith"

Many states recognize a common law bad faith claim against a first party insurer for failing to investigate, for failing to process a claim appropriately, or for delaying or denying payment without justification. Like third-party bad faith claims, different state's law provides different factors to consider in determining whether the insured engaged in bad faith. For example, Alabama applies a four part test to a first party bad faith failure to pay that considers: (1) whether the insurer breached the insurance contract; (2) whether the insurer intentionally refused to pay; (3) whether the insurer had no reasonable basis not to pay; and (4) whether the insurer knew it had no reasonable basis not to pay. Colorado will find first party bad faith if: (1) the insurer's conduct was unreasonable under the circumstances; and (2) the insurer knowingly or recklessly disregarded the claim.

In the event an insurer engages in bad faith in connection with a first party claim, the potential remedies include an award of the policy limits, an award of consequential damages (for example, if the insurer's delay meant that the insured could not reopen its business and lost profits as a result), emotional distress damages, attorneys' fees, and punitive damages.

III. Statutory Claims

Many states have statutes governing insurer conduct that can apply to both first party and third party claims. In particular, many states have passed the uniform claims settlement practices acts, which provide standards for handling claims. However, the impact of the passage of the uniform act can vary significantly. For example, a few states permit a direct action by an insured against an insurer for breach of the uniform claims settlement practices act. Many other states provide that only the state insurance commissioner can assert a claim under the act. However, in the states that do not permit a direct action for breach of the statute, insurer conduct can be examined by reference to the requirements of the statute to determine if a common law bad faith claim has been established. Three states are discussed below to highlight these different approaches.

In Illinois, there is no common law bad faith claims other than refusal to settle, and no private right of action under the uniform act. Instead, Illinois enacted Section 155 of the Illinois Insurance Code which finds sanctions appropriate where a company's conduct or delay in resolving a claim is "vexatious and unreasonable." Section 155 preempts all other bad faith claims in Illinois except a bad faith refusal to settle. Importantly, damages under Section 155 are capped at attorneys' fees, costs, and an amount not to exceed any of the following amounts: (a) $60,000, (b) 60% of judgment against the insured or (c) the amount in excess of the settlement amount offered by the insured. In addition, insurers are permitted to argue that their conduct was appropriate because there was a "bona fide" dispute about coverage or liability.

Colorado has adopted the uniform act, but permits no private right of action under the uniform act. Instead, Colorado enacted a separate "prompt payment" statute that permits recovery if "the insurer delayed or denied authorizing payment of a covered benefit without a reasonable basis for that action." By contrast, Connecticut has both a common law claim for bad faith if insurer acted with a dishonest motive and also a statutory cause of action if the insurer engages in certain conduct, including misrepresenting pertinent facts or insurance policy provisions, failing to respond promptly to communications or to explain decisions, and failing to conduct an appropriate investigation.

As these examples highlight, the existence of statutory "bad faith" claims adds another element to potential bad faith exposure. Understanding how the statutory claims in a particular jurisdiction fit within potential common law bad faith causes of action is critical to understanding the behavior that may result in bad faith exposure.

IV. Conclusion

As discussed above, the term "bad faith" is an umbrella term that can involve a combination of claims – both common law and statutory. Although there are a number of different types of bad faith claims, they all share a common feature: bad faith commonly exists when the insurance company fails to give equal consideration to the interests of its insured. Keeping that central principle front of mind can help insurers avoid conduct that can result in potential bad faith exposure.