

BAD FAITH IN THE ABSENCE OF UNREASONABLENESS: SAY IT ISN'T SO.

by
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We insurance-defense counsel have all heard of bad faith in the absence of a breach of an express contractual provision (like paying a claim), a la *Rawlings* and *Deese*. But have you heard of bad faith liability without any unreasonable conduct? And did you know that Arizona law seemingly has allowed it since 1973? At least that is what plaintiff's counsel may tell you if, in your third-party insurance practice, you get a case where the insurance-carrier client *reasonably* (but wrongly) denied coverage and then refused to consider a settlement offer within policy limits.

I. Reasonableness May Not Suffice When It Comes To Refusing To Consider Settlement Offers

That is what happened in *State Farm Automobile Insurance Company v. Civil Service Employees Insurance Company*. State Farm denied coverage of a third-party claim against its insured. It then refused to defend the insured or to entertain any offers to settle the third-party claim. State Farm's coverage position was wrong but reasonable, "an honest though erroneous belief that under the facts and law coverage did not [exist]." We usually counsel carriers that "reasonableness under the circumstances" shields against bad faith, the only downside being payment of covered contractual benefits. According to *Civil Service*, however, no such shield exists when it comes to a carrier's duty to give "equal consideration" to settlement offers.

The mere fact that an insurer has erroneously concluded that there is no coverage and therefore in good faith refuses to defend, cannot excuse subsequent breaches by the insurer of other provisions of the contract, including the implied obligations pertaining to settlement.

In other words, State Farm's good-faith coverage defense did not shield it from liability for the full amount of the excess judgment its insured stipulated to with the third-party claimant. State Farm's good faith belief of no coverage did "not necessarily prevent a finding that the insurer was guilty of 'bad faith' (*i.e.*, breach of its duty) in failing to adequately consider the interests of its insured." State Farm nevertheless had to give "equal consideration" to a settlement offer – to seriously consider paying benefits that State Farm reasonably thought were not payable under the policy. Its failure to do so opened the door for extra-contractual damages – the full amount of the stipulated judgment.

II. Is Civil Service Still Good Law? Should it Be?

Obviously, there are questions about *Civil Service*. Maybe the most obvious is that it is more than 30 years old, and Arizona bad faith law has developed significantly since 1973. For example, a recent Arizona district court opinion holds that, in the first-party insurance setting, a good-faith coverage dispute may shield a carrier from any extra-contractual liability for failing to investigate its insured's claim. In fact, arguably a carrier need not even investigate such a claim because the carrier has no duty to investigate a claim that the carrier believes in good faith is not covered under the plain language of the policy:

[I]f the insurance company took the position that, accepting the facts as the insured had presented them as true, the injury to the insured would be outside the scope of the policy, then there would be no additional investigation or evaluation for the insurance company to undertake. Therefore, as long as the insurance company's interpretation of the policy was reasonable, there would be no additional bad faith inquiry.

Logically, this reasoning would seem to apply equally in the third-party context. If a good-faith coverage defense may eliminate the duty to investigate a first-party claim, shouldn't a good-faith coverage defense possibly eliminate the duty to give equal consideration to a third party's settlement offer? From a cost-benefit standpoint, it might well make business sense for a carrier to seriously consider settling even uncovered claims (e.g., to avoid the litigation expense associated with the coverage battle). But should a carrier really be duty-bound to consider paying money to settle a claim that the carrier believes in good faith is not covered?

Civil Service seems to say yes. It reasons that to "hold otherwise would result in penalizing the more prudent insurer who initially correctly recognizes the duty to defend, but subsequently wrongfully refuses a settlement offer. . . Certainly an insurer who not only rejected a reasonable offer of settlement but also wrongfully refused to defend should be in no better position than if it had assumed the defense and then declined to settle."

III. Isn't Bad Faith More Than A Breach of Contract? Maybe Not.

But this reasoning seems more consistent with a simple breach-of-contract causation analysis than a bad-faith causation analysis. *Civil Service* seems to reason that *but for* the carrier's wrongful (albeit reasonable) breach of the insurance contract (the no-coverage position that led to the breach of the express duty to indemnify), the carrier would have accepted the settlement offer and prevented the excess judgment against its insured. Based on that simple causation analysis, the excess judgment was a foreseeable consequence of the no-coverage position that led to the refusal to settle. As one commentator trying to explain *Civil Service* puts it:

[I]n other words, when one party to a contract breaches a contract, that party is responsible for the foreseeable consequential damages from that breach, whether the breach was inadvertent, negligent or intentional. Accordingly, when an insurer wrongfully denies coverage, even if its belief in the absence of coverage was merely negligent, the insurer should be held liable for the foreseeable consequential damages from its denial of coverage, including the fact that there is no settlement in a situation in which a reasonable insurer affording coverage would have settled the case.

If that is the law, then its *contract* law, not bad faith law.

Unlike the duty to indemnify, the duty to settle (or give "equal consideration" to settlement offers) is an implied duty. Even a cursory look at Arizona's jury instructions on the implied duty of good faith and fair dealing highlights that proving breach of such an implied duty requires proving not only that the carrier acted unreasonably and knew or should have known it was acting that way, but also that such bad faith conduct actually caused the sought after damages. Isn't bad faith law more than a mere breach of contract? More than just being wrong? Even *Morris* stated that "absent bad faith conduct," the carrier that reserves its rights based on a wrong coverage defense "will never be at risk for more than its . . . policy limit[s]."

IV. The Better Approach Versus The Better Advice.

A better approach that is more consistent with bad faith law would be to hold that a carrier which, based on a reasonable but wrong no-coverage position, refuses to settle within policy limits may be liable only up to the carrier's policy limits. To hold that carrier liable for anything more than policy limits would run afoul of basic bad faith law because the carrier has done nothing in bad faith. To collect more than policy limits, the insured should have to prove that the carrier actually acted in bad faith; for example, that it did not have a good-faith coverage position. Otherwise, let's not call it bad faith, but breach of contract.

Caution dictates, however, that in the third-party insurance setting the better advice is to tell carriers to make sure that they affirmatively give "equal consideration" to *all* offers to settle within policy limits, even if the carrier believes in good faith that there is no coverage under the policy. Under existing Arizona law, a carrier who does otherwise acts at its "own peril."

FOOTNOTES CAN BE FOUND ON PAGES 13 AND 14

applying it,” said Wilrich. “I’ve asked some of the best among the best to come and share with our classes.”

The student profiles at PhoenixLaw differ from students at ASU or UA. Although our student body is split fairly evenly between women and men, which is true of most law schools, the comparison ends there.

The average age of students at PhoenixLaw is 33, and most are working professionals with spouses and children. Their occupations include paralegals, nurses, engineers, psychologists and law enforcement officials, to name just a few. They bring significant work and life experience to the classroom, and their maturity and dedication to receiving a legal education is evident. Approximately three-quarters of the students attend PhoenixLaw on a part-time basis, primarily in the evenings after work.

PhoenixLaw is committed to being student-centered, and offers help to them in various ways, from philosophical to practical.

“Law school should be rigorous and challenging, but it doesn’t have to be a painful experience,” said Dean Shields. “We want our students to succeed, not suffer.”

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FOOTNOTES

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Rawlings v. Apodaca, 726 P.2d 565, 573 (Ariz. 1986) (“Thus, although Farmers breached its express covenants, the evidence supports the conclusion that for its own profit Farmers breached its duty to play fairly with its insureds and to give their legitimate interests equal consideration.”).

Deese v. State Farm Mut. Auto. Ins. Co., 838 P.2d 1265, 1269 (Ariz. 1992) (quoting *Rawlings*).

Third-party coverage comes into play when an insurance carrier contracts to compensate its insured for liability to third parties. First-party coverage involves liability policies which directly benefit the insured. For a discussion of the differences between third-party and first-party bad faith claims, see *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 792 P.2d 719 (Ariz. 1990).

509 P.2d 725 (Ariz. 1973).

Id. at 733.

Deese, 838 P.2d at 1268 (“the proper inquiry into whether an insurer has acted in bad faith rests on a determination of reasonableness under the circumstances”).

In the third-party setting, an insurance carrier has at least three duties: the duty to indemnify, the duty to defend and the duty to give equal consideration to settlement offers. The first two duties are express; the third is implied. See, generally, Steven Plitt, Arizona Liability Insurance Law Ch. 2 (1998).

Civil Service, 509 P.2d at 733.

Such a stipulated judgment is usually part of a *Damron*- or *Morris*-type agreement, in which the insured assigns to the third-party claimant all of the insured’s rights and claims, including a bad faith cause of action, against the carrier. See *Damron v. Sledge*, 460 P.2d 997 (Ariz. 1969); *USA v. Morris*, 741 P.2d 246 (Ariz. 1987).

Id. at 733.

Stephen S. Ashley, *Bad Faith Actions Liability & Damages* § 4:13 (1984) (noting that applying the duty to settle in this context “most certainly . . . compels insurers to pay uncovered claims”)

But a quick cite check reveals that it is good law and has been cited by more recent cases. See

Rogan v. Auto-Owners Ins. Co., 832 P.2d 212, 218 (Ariz. App. 1991) (citing *Civil Service* for the proposition that an “erroneous denial of coverage and consequent refusal to give consideration to a settlement offer exposes insurer to liability in excess of policy limits”); *Parsons v. Continental National Am. Group*, 550 P.2d 94, 100 (Ariz. 1976) (citing *Civil Service* for the proposition that “In the instant case the further fact that the carrier believed there was no coverage under the policy and so refused to give any consideration to the proposed settlements did not absolve them from liability for the entire judgment entered against the insured.”); See also 14 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance* § 203:26 (3d ed. 2005) (citing *Civil Service*); 3 David L. Leitner et al., *Law and Prac. of Ins. Coverage Litig.* § 29:26 and n.16 (2000) (“If an insurer fails to settle the underlying claim because it has denied coverage and refused to defend the insured, the insurer

may be liable for the policy limits and for the amount of any excess judgment beyond those limits regardless of whether the insurer acted in bad faith," citing *Civil Service*.) (emphasis added).

Young v. Allstate Ins. Co., 296 F. Supp. 2d 1111, 1120 (D. Ariz. 2003), citing *Knoell v. Metropolitan Life Ins. Co.*, 163 F. Supp. 2d 1072, 1076 (D. Ariz. 2001).

RAJI (Civil) 4th Bad Faith 2 (First Party) ("Adequacy of Investigation").

Bad Faith Actions Liability & Damages § 4:13 (noting the inconsistency "between allowing the insurer to deny a claim in a first-party case because of reasonable doubts about coverage but not allowing the insurer to do so in third-party cases").

Civil Service, 509 P.2d at 733 (internal quotations omitted).

Indeed, one commentator cites *Civil Service* for the proposition that a carrier "should be strictly liable for all damages caused by its conduct, regardless of whether its interpretation was objectively reasonable." Amy G. Langerman & Richard W. Langerman, *Arizona Insurance Bad Faith And The Doctrine of Strict Liability*, 22 ARIZ. ST. L. J. 349, 361 and n.99 (1990).

See Rogan, 832 P.2d at 217-218 ("The basis for limiting an excess judgment to the policy limits when there is no settlement offer is based on the following reasoning. When an insurer refuses to defend or denies coverage alone the insurance contract is breached, but there is no causal connection between the breach and the excess judgment. Given competent counsel to represent the insured, the judgment would be the same as if the defense had been conducted by the insurer's counsel. [Citation omitted.] But, when there is a refusal to settle within the limits of the insurance contract, then there is a causal connection between the act of the insurer and injury to the insured, i.e. the excess judgment. Had the insurer accepted the reasonable settlement offer, it would have lessened the liability exposure to the insured.") (emphasis added).

1 Allan D. Windt, *Insurance Claims and Disputes* § 5:5 (4th ed. 2001).

Trus Joist Corp. v. Safeco Ins. Co., 735 P.2d 125, 134 (Ariz. App. 1986).

The duty-to-settle jury instructions require that, before a carrier can be held liable for failing to give "equal consideration" to a settlement offer, the jury must first find that the carrier failed to do so in bad faith. RAJI (Civil) 4th Bad Faith 8 instructs on the duty to give "equal consideration" to settlement offers. Bad Faith 8's "USE NOTE" directs the court to also give RAJI (Civil) 4th Bad Faith 9, which requires that to prevail the third-party plaintiff must "prove that [the carrier] breached the duty of good faith and fair dealing" before the plaintiff "is entitled to the full amount of the judgment that was entered against the insured." *See also* RAJI (Civil) 4th Bad Faith 2 (First Party) ("Causation").

Rawlings, 726 P.2d at 573 ("Failure to perform the express covenant to pay the claim is not the sine qua non for an action for breach of the implied covenant of good faith and fair dealing. . . Not every breach of an express covenant in an insurance contract is a breach of the covenant of good faith and fair dealing.").

Miel v. State Farm Mut. Auto. Ins. Co., 912 P.2d 1333, 1340 (Ariz. App. 1995) ("If the company breaches its duty, its insured or the assignee may recover compensatory damages for breach of contract, or damages in tort if the insurer's actions rise to the level of bad faith. . . Thus no cause of action for mere negligence exists in a case like this one.").

741 P.2d at 251. *See also* RAJI (Civil) 4th Bad Faith 13 n1 (Morris Cases) ("Burden of Proof") ("The issue of whether an insurance company is liable for any amount in excess of the policy limits requires an analysis of the law of third-party bad faith. Cases involving claims of extracontractual liability will require additional instructions. *See* Bad Faith Instructions 8-12.").

This is the view of a "respectable minority" of jurisdictions. Stephen S. Ashley, *Bad Faith Actions Liability & Damages* § 4:13 (1984) (noting that Arizona is not part of that minority).

And what about punitive damages? In the insurance setting, a bad faith claim is the spring board to a punitive damages claim. If a carrier with a good faith coverage defense can be held in bad faith for refusing to consider a settlement offer, could the same conduct form the basis for punitive damages?