

Bad Faith And Unfair Claim Handling Practice Issues

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I. Introduction

An important issue that arises for issuers of fidelity bonds, commercial crime policies, financial institution bonds, and other employee dishonesty coverage policies is whether they can be held liable for the bad faith performance of their duties to insureds and what actions constitute bad faith performance. An implied duty of good faith and fair dealing has long been recognized in contract law.¹ In fact, one of the earliest recognitions appears in an 1878 treatise entitled *Bishop on Contracts*.² The treatise stated that “when parties enter into a contract, the law presumes each of them to be acting in good faith toward the other; and it binds each to the other, to whatever good faith requires.”³ The implied duty of good faith has increasingly been applied and recognized in first-party insurance cases and has led to a cause of action in tort. Bad faith in the insurance context is defined as “any frivolous or unfounded refusal to pay proceeds of policy; it is not necessary that such refusal be fraudulent.”⁴ This article will examine the various aspects of bad faith claims, claims handling statutes, and issues of which insurers and their attorneys should be aware.

II. Beginnings of Bad Faith in the Insurance Context

The *Restatement (Second) of Contracts* provides a starting point for the study of bad faith causes of action.⁵ Section 205 states that every contract imposes upon each party a duty of good faith and fair dealing in performance and enforcement of a contract.⁶ The Uniform Commercial Code defines good faith as “honesty in fact in the conduct or transaction concerned.”⁷ In the case of a merchant, the UCC defines “good faith” as “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.”⁸ The Comment to the *Restatement (Second) of Contracts* states that the phrase “good faith” is used in a variety of contexts.⁹ However, the phrase emphasizes

¹ RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

² Robert H. Jerry, II, *The Wrong Side of the Mountain: A Comment on Bad Faith's Unnatural History*, 72 TEX. L. REV. 1317 (1994).

³ *Id.* (citing JOEL P. BISHOP, BISHOP ON CONTRACTS § 106 (1878)).

⁴ BLACK'S LAW DICTIONARY 139 (6th ed. 1990).

⁵ RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

⁶ *Id.*

⁷ *Id.*; UCC § 1-201(19) (2001).

⁸ UCC § 2-103(1)(b) (2001).

⁹ RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. A (1981).

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“faithfulness to an agreed common purpose and consistency with the justified expectations of the other party.”¹⁰

In the 1950s and 60s, the duty of good faith and fair dealing found its way from contract law into insurance law. Courts began to impose a duty of good faith and fair dealing on insurers in dealing with their insureds.¹¹ Specifically, courts began to examine whether the implied duty of good faith and fair dealing could lead to a cause of action in tort for an insured against an insurer. In a series of cases, California (not surprisingly) led the way in recognizing that an insured could bring a tort action against an insurer for the insurer’s breach of the duty of good faith.¹²

Causes of action for bad faith originated with third-party insurance, or liability insurance. In *Brown v. Guarantee Insurance Co.*, the California Court of Appeals stated that “if an insurer undertakes to defend the insured and enters into settlement negotiations, then the insurer owes a duty of good faith to the insured.”¹³ In *Comunale v. Traders & General Insurance Co.*, the California Supreme Court stated that the insurer “breached an implied covenant of good faith and fair dealing when the insurer did not consider the insured’s interest and compromised the position of the insured by entering into a settlement within the policy limits.”¹⁴ The court in *Comunale* still considered the implied duty of good faith to arise from the insurance contract and did not describe the action as the tort of bad faith. However, good faith became the standard by which courts measured the conduct of insurers. For example, if an insurer did not consider the interests of the insured in seeking settlement or delayed investigation of the claim or payment of the claim, the insurer would be liable for bad faith performance of the insurance contract.

The third in the series of California cases explicitly acknowledged that an insured could bring an action in tort against the insurer. In *Crisci v. Security Insurance Co.*, the California Supreme Court held that breaching the covenant of good faith and fair dealing in the settlement context constituted a tort.¹⁵ In *Crisci*, the insured refused to enter into settlement with the plaintiff that was within the policy limits. After the refusal to settle, the case was litigated, and the court entered a judgment against the insured that exceeded the policy limits. In upholding the insured’s action for bad faith, the court stated that liability is imposed against an insurer who “unwarrantedly refuses an offered settlement where the most reasonable manner of disposing of the claim is by accepting the settlement . . . not for a bad faith breach of the contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.”¹⁶ The decision in *Crisci* affirmed the decision in *Comunale* that the

¹⁰ *Id.*

¹¹ *Brown v. Guarantee Ins. Co.*, 319 P.2d 69 (Cal. Ct. App. 1957).

¹² ROBERT JERRY, II, UNDERSTANDING INSURANCE LAW (2d ed. 1996); Marc S. Mayerson, “First Party” Insurance Bad Faith Claims: Mooring Procedure to Substance, 38 TORT & INS. PRAC. L.J. 861 (2003).

¹³ JERRY, *supra* note 12.

¹⁴ 328 P.2d 198 (Cal. 1958).

¹⁵ 426 P.2d 173 (Cal. 1967).

¹⁶ *Id.* at 176-77.

duty to settle lies within tort and contract law. The court in *Crisci* awarded the insured remedies for mental suffering, thus establishing that tort remedies are available for breach of a duty to settle.¹⁷ This holding in *Crisci* allowed insureds to seek a broader range of damages, including those for mental anguish and possibly punitive damages.

III. Tort of Bad Faith

Once the tort of bad faith was recognized in third-party insurance cases, insureds began asserting the cause of action in first-party insurance cases. Many jurisdictions now recognize the tort of bad faith in first-party insurance settings.¹⁸ Most jurisdictions have not been called on to decide whether the tort of bad faith applies to fidelity policies and financial institution bonds. Instead, most cases involve surety bonds or first-party insurance liability policies.

As in the third-party setting, California led the way with its decision to extend the tort of bad faith to first-party insurance settings in *Gruenberg v. Aetna Insurance Co.*¹⁹ In *Gruenberg*, the California Supreme Court affirmed California precedent in *Crisci* and *Comunale*. The court differentiated between third-party cases and first-party cases and stated that the duty of the insurer is the same, but first-party cases present a different aspect of that duty.²⁰ First-party insurance cases are those in which the insured person brings a claim under the insurance policy. Third-party insurance cases are those in which the insured person injures another person and that third person brings a claim under the insurance policy. The court further stated that “a common legal principle underlies the decision in *Crisci*, *Comunale* and *Gruenberg*; namely that in every insurance contract there is an implied covenant of good faith and fair dealing.”²¹ “The duty to so act is imminent in the contract whether the company is attending to the claims of a third person against the insured or the claims of the insured itself.”²² This is a broad statement of the insurer’s extra contractual obligations.

IV. Distinctions between the Tort of Bad Faith and Statutory Bad Faith

Some states have adopted statutes that provide the insured with additional damages in a bad faith action. Tennessee courts have rejected a common law action for the tort of bad faith.²³ Instead, the Tennessee legislature has enacted a statute that allows an insured to recover actual damages if the insured suffers a loss and the insurer refuses to pay the claim within sixty days after a demand is made.²⁴ In addition to recovery of the amount of loss and interest, the insured may also recover an amount not exceeding

¹⁷ *Id.* at 178-79.

¹⁸ See Appendix A.

¹⁹ 510 P.2d 1032 (Cal. 1973).

²⁰ *Id.* at 1037.

²¹ *Id.* at 1038.

²² *Id.*

²³ *MFA Mut. Ins. Co. v. Flint*, 574 S.W.2d 718 (Tenn. 1978).

²⁴ TENN. CODE ANN. § 56-7-105 (2002).

twenty-five percent of the loss.²⁵ Under the Tennessee statute, the insured may only recover actual damages and not tortuous damages, such as punitive or mental anguish.²⁶

Similar to Tennessee, the Georgia legislature has recognized a statutory cause of action for a breach of the implied duty of good faith and fair dealing.²⁷ The Georgia Code allows the insured to recover the amount of the loss, plus an amount not to exceed fifty percent of the loss or \$5,000, whichever is greater.²⁸ In addition, the insured may also recover attorneys' fees.²⁹

The Arkansas legislature has also enacted a statute that allows for recovery of extra-contractual damages by the insured if the insurer fails to pay the claim within the time specified in the policy.³⁰ Under Arkansas law, in addition to the amount of the claim, the insured may recover twelve percent of the loss plus attorneys' fees.³¹ Similar to Arkansas, Michigan has enacted a statute that allows the insured to recover as additional damages twelve percent interest on the amount of loss in addition to the amount of the loss.³² The twelve percent interest begins to apply sixty days from the date the insurer receives the proof of loss.³³

While statutory provisions may limit the amount of damages the insured recovers in a bad faith action, the statutes may also expand recovery for the insured because some states' statutes allow recovery of attorneys' fees that typically may not be recovered in a tort action.³⁴ For example, in Idaho, if the insurer does not pay the claim within thirty days from the receipt of the proof of loss, the insured may recover attorneys' fees incurred from prosecuting a bad faith action.³⁵

Unlike the statutes discussed above, other states that recognize common law bad faith action allow the insured to recover tort remedies, such as punitive damages, emotional distress, or mental anguish.³⁶ Tennessee and Georgia allow the insured to recover actual damages that arise from the insurer's breach of the insurance contract. Those states that recognize bad faith as a common law tort action allow recovery for incidental and non-contractual damages to the insured caused by the insurer's breach of the insurance contract.

²⁵ *Id.*

²⁶ *Id.*

²⁷ GA. CODE ANN. § 33-4-6 (2002).

²⁸ *Id.*

²⁹ *Id.*

³⁰ ARK. CODE ANN. § 23-79-208 (Michie 2002).

³¹ *Id.*

³² MICH. COMP. LAWS § 500.2006 (2002).

³³ *Id.*

³⁴ N.C. GEN. STAT. § 6-21.1 (2002); TENN. CODE ANN. § 56-7-105 (2002); IDAHO CODE § 41-1839 (2002); VA. CODE ANN. § 38.2-209 (2002); PA. CONS. STAT. ANN. § 8371(2002); S.C. CODE ANN. § 38-59-40 (2002); OR. REV. STAT. § 742.061 (2002).

³⁵ IDAHO CODE § 41-1839 (2002).

³⁶ *Rawlings v. Apodaca*, 726 P.2d 565 (Ariz. 1986); *Dodge*, 778 P.2d at 1240; *K-W Indus.*, 754 P.2d at 502; *Suver*, 462 N.E.2d at 415; *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1042 (Cal. 1973).

V. Nature of Conduct Required to Constitute Bad Faith

Once the tort of bad faith was recognized by many jurisdictions, the important issue in each state became what conduct constitutes bad faith. The elements of bad faith vary among the jurisdictions and few states have identical requirements. In the insurance context, mere negligence on the part of the insurer is not sufficient to constitute bad faith.³⁷ Some state courts have recognized that negligence combined with another act may be enough in some contexts to constitute bad faith. Negligence along with something else on the part of the insurer may constitute gross negligence or reckless disregard.³⁸

A New York court has stated that “bad faith requires an extraordinary showing of disingenuous or dishonest failure to carry out a contract.”³⁹ While an Arkansas court described bad faith as “affirmative misconduct, without good faith defense, in a malicious, dishonest, or oppressive attempt to avoid liability,”⁴⁰ another court has concluded that bad faith requires showing the absence of a “reasonably legitimate or arguable reason for the insurers refusal to pay a claim.”⁴¹

Yet another court required the insured to show “absence of a reasonable basis for denying benefits of the policy and the insurer must have knowledge or reckless disregard of the lack of a reasonable basis for denying a claim.”⁴² Arizona has held that the insurer must intentionally deny the claim, fail to process the claim, or fail to pay a claim without a reasonable basis for such action.⁴³ Arizona courts have also required the insured to prove that the insurer acted unreasonably and either knew or was conscious of the fact that its conduct was unreasonable.⁴⁴

Kentucky developed a test to determine whether the insurer acted in bad faith. The Kentucky Supreme Court held that there are three elements that must be present in order for the insured to establish a private cause of action of tortious misconduct that justifies a claim for bad faith.⁴⁵ The three elements are as follows: (1) the insurer must be obligated to pay the claim under the terms of the policy; (2) the insurer must lack a reasonable basis in law or fact for denying the claim; and (3) it must be shown that the insurer either knew there was no reasonable basis for denying the claim or acted with reckless disregard for whether such a basis existed.⁴⁶

³⁷ *Anderson v. Cont'l Ins. Co.*, 271 N.W.2d 368 (Wis. 1978).

³⁸ *Aetna Cas. & Sur. Co. v. Day*, 487 So. 2d 830 (Miss. 1986); *Jessen v. Nat'l Excess Ins. Co.*, 776 P.2d 1244 (N.M. 1989).

³⁹ *Gordon v. Nationwide Mut. Ins. Co.*, 285 N.E.2d 849, 854 (N.Y. 1972).

⁴⁰ *First Main Ins. Co. v. Booth*, 876 S.W.2d 255 (Ark. 1994).

⁴¹ *Ins. Co. of N. Am. v. Citizens Bank of Thomasville*, 491 So.2d 880 (Ala. 1986).

⁴² *Anderson*, 271 N.W.2d at 376-77.

⁴³ *Dodge*, 778 P.2d at 1243.

⁴⁴ *Twin City Fire Ins. Co v. Burke*, 63 P.3d 282, 286 (Ariz. 2003) (quoting *Zilisch v. State Farm Mut. Auto Ins. Co.*, 995 P.2d 276, 280 (Ariz. 2000)).

⁴⁵ *Wittmer v. State Farm Mut. Auto. Ins. Co.*, 864 S.W.2d 885, 890 (Ky. 1993).

⁴⁶ *Id.*

In *First National Bank of Louisville v. Lustig*, a seminal case for bad faith in the fidelity context, the Fifth Circuit Court of Appeals applied the elements enunciated in *Wittmer v. State Farm Mutual Automobile Insurance Co.*⁴⁷ to review a bad faith judgment entered against Aetna Casualty and Surety Company and Federal Insurance Company.⁴⁸ The Fifth Circuit focused its analysis on the second element, whether the “insurer had no reasonable basis for denying coverage for the claim.”⁴⁹ The court concluded “if a genuine issue exists as to either questions of law or fact, a claim is considered fairly debatable and the bad faith action must be dismissed.”⁵⁰ A claim is “fairly debatable if (1) the issue is one of first impression in the state in which the suit is filed and other jurisdictions support the insurer’s position and (2) if a dispute over relevant facts related to coverage exists.”⁵¹

In *Lustig*, the claim on which the insured sought coverage was “fairly debatable” because Kentucky courts had not defined “manifest intent” and other jurisdictions supported the view of Federal and Aetna.⁵² Furthermore, a question of fact existed as to whether the policy had been terminated before the claim was brought.⁵³

One jurisdiction that has attempted to explain bad faith in great detail is Michigan. The Michigan Supreme Court stated that the insured must show conduct that is “arbitrary, reckless, indifferent, or intentional disregard for the interest of the person who is owed a duty.”⁵⁴ In the same decision, the Michigan court listed factors that could be considered in determining the presence of bad faith.⁵⁵ The factors included whether the insured was informed of developments that affected the insured’s interest, whether the insured was informed of settlement offers, whether settlement offers or settlement negotiations were initiated when the circumstances called for such, whether reasonable settlement offers were rejected, and whether an appeal was taken when reasonable grounds for an appeal existed.⁵⁶

Considering insurance law is governed by state law, the federal courts require the same showing of bad faith as the state in which the court sits. The Sixth Circuit, applying Kentucky law, held that a party acts in bad faith if it acts “vexatiously, wantonly or for oppressive reasons.”⁵⁷ The Second Circuit Court of Appeals has held that “to impose sanctions, a court must find that (1) the challenged claim was without a colorable basis and (2) the claim was brought in bad faith, or motivated by improper purposes such as harassment or delay.”⁵⁸

⁴⁷ *Id.*

⁴⁸ *First Nat’l Bank of Louisville v. Lustig*, 96 F.3d 1554 (5th Cir. 1996).

⁴⁹ *Id.* at 1564 (quoting *Wittmer*, 864 S.W.2d at 890.)

⁵⁰ *Id.* at 1565.

⁵¹ *Id.*

⁵² *Id.* at 1567.

⁵³ *Id.*

⁵⁴ *Commercial Union Ins. Co. v. Liberty Mut. Ins. Co.*, 393 N.W.2d 161, 164 (Mich. 1986).

⁵⁵ *Id.*

⁵⁶ *Id.*

⁵⁷ *Big Yank Corp. v. Liberty Mut. Fire Ins. Co.*, 125 F.3d 308, 313 (6th Cir. 1997).

⁵⁸ *Milltex Indus. Corp. v. Jacquard Lace Co.*, 55 F.3d 34, 38 (2d Cir. 1995).

Because each jurisdiction has varying requirements, elements, and tests for what constitutes the tort of bad faith, choice of law rules become very important. The jurisdiction in which the insurance contract was issued will generally be the law that will apply to the determination of bad faith.⁵⁹ This is typically the state where the insured is located.⁶⁰

VI. Unfair Claims Practices Act

Along with the right to bring an action for bad faith, insureds may bring an action for an insurer's violation of the state's Unfair Claim Practices Act. The National Association of Insurance Commissioners, along with the states, drafted a model act to address unfair trade practices by insurance companies. The Unfair Trade Practices Act was amended in 1971 to provide fourteen claims activities.⁶¹ If an insurance company violates any of the fourteen claims, the action may be considered unfair claims practices. The following conduct are prohibited by the Act:

- (1) misrepresentation of relevant facts or insurance policy provisions regarding coverage;
- (2) failure to acknowledge promptly and to act reasonably upon claims communications;
- (3) failure to adopt and to implement reasonable standards for the prompt investigation of claims communications;
- (4) refusal to pay claims without conducting a reasonable investigation based upon all available information;
- (5) failing to affirm or to deny coverage within a reasonable time after proof of loss statements have been submitted;
- (6) failure to affirm or to deny coverage within a reasonable period of time after completion of the investigation;
- (7) compelling insureds to initiate litigation to recover under its insurance policy by offering substantially less than the amount(s) ultimately recovered by the insureds;
- (8) failure to settle claims promptly where liability under one provision of the policy has become reasonably clear in order to influence settlements under other coverage provisions;

⁵⁹ *Interco, Inc. v. Mission Ins. Co.*, 808 F.2d 682 (8th Cir. 1987).

⁶⁰ *Id.*

⁶¹ Unfair Trade Practices Act § 3 (1971).

- (9) failure to provide a prompt and reasonable explanation of the contractual and legal basis for coverage, denial or offer of a compromise settlement.⁶²

Most states have now adopted the Model Act or their own version of the Model Act.⁶³

While the Model Act provides strict guidelines for insurance carriers as well as fidelity bond carriers, one state, Missouri, excludes fidelity insurers from its unfair claims practices act.⁶⁴

In 1990, the National Association of Insurance Companies drafted the Unfair Settlement Practices Act, which is separate and distinct from the Unfair Claims Practices Act. The 1990 Act expands the list of activities that constitute unfair trade practices by adding the following:

- (1) failure to provide the insured with the forms necessary to submit claims within 15 calendar days of a request along with reasonable explanations regarding their use; and
- (2) failure to effectuate prompt, fair and equitable claim settlement once liability has become reasonable clear.⁶⁵

The only states to adopt a version of the 1990 Model Act are Georgia, Missouri, and Nebraska.⁶⁶

VII. Bad Faith and Unfair Claims Practices Act

Insureds who bring claims against fidelity insurers may assert causes of action for both bad faith and violations of the state's Unfair Claims Practices Act. The two causes of action are separate and distinct. As noted above, most states recognize a common law action of bad faith and most states have an Unfair Claims Practices Act.

An insurer may be liable for violation of the Unfair Claim Practices Act if it fails to acknowledge or deny coverage after a certain period of time after completion of investigation or a proof of loss is submitted. However, the Unfair Claims Practices Act does not require evidence of the mental state of the insurer. An action for bad faith requires the insured to prove the insurer acted recklessly or intentionally in handling the insured's claim.

Bad faith does not focus on the reasonableness of the conduct but involves an absence of reason in handling the claim.⁶⁷ Also, an action for bad faith does not focus on

⁶² *Id.* § 9 (1971).

⁶³ *See* Appendix A.

⁶⁴ MO. REV. STAT. § 375.1000 (2003);

⁶⁵ Unfair Claims Settlement Act § 4.

⁶⁶ Charles D. Thomas & Dirk E. Ehlers, *Bad Faith: Trends in Statutory and Common Law Framework and Review of Recent Cases*, IV FID. L.J. 19 (1998).

the manner in which the insurer processes a claim.⁶⁸ Different from an action for bad faith, an action for unfair claims practices focuses on the manner in which the insurer handled the claim and approached investigation and settlement.

For the insured to bring a cause of action for violation of the Unfair Claims Practices Act, the insured must show that the insurer committed one of the enumerated violations. Unlike an action for bad faith, the Unfair Claims Practices Act requires a showing that the violation of the act by the insurer was committed “with such frequency as to indicate a general business practice.”⁶⁹ Thus, an action for violation of the Unfair Claims Practices Act must show that the insurer engaged in a pattern of conduct. If the activity only occurred one time, the insured may not have a successful cause of action under the Unfair Claims Practices Act. Unlike the unfair claims cause of action, the bad faith cause of action only requires proof that the insurer acted in bad faith in handling a single claim.

Finally, the bad faith action arises in common law and gives rise to tort damages, such as compensatory, emotional distress, and punitive. An unfair claims action arises under the statute and gives rise only to statutory damages.

VIII. Damages

A. PUNITIVE DAMAGES

One issue that is greatly contested among jurisdictions is when and whether bad faith conduct justifies an award of punitive damages. Punitive awards are usually justified when conduct is outrageous or egregiously tortuous.⁷⁰ Mere negligence does not support an award of punitive damages. Moreover, merely showing that the insurer acted in bad faith is not enough to support an award of punitive damages.⁷¹ Furthermore, if the insured can only establish that the insurer refused to pay the amount of the bond, an award of punitive damages is not warranted.⁷²

As the different jurisdictions have varying requirements for proving bad faith, the evidence necessary to support an award of punitive damages also varies. In Ohio, the insured must show that the insurer acted with actual malice, fraud, or oppression.⁷³ In Kentucky the insured must show that the insurer acted with intentional misconduct or reckless disregard of the rights of an insured.⁷⁴ Still, the jury does not have to award punitive damages but has discretion as to whether it believes punitive damages are

⁶⁷ Pioneer Chlor Alkali Co., Inc. v. Nat'l Union Fire Ins. Co., 863 F. Supp. 1237 (D. Nev. 1994).

⁶⁸ *Id.*

⁶⁹ Country Club of Johnson County, Inc. v. U.S. Fid & Guar. Co., 563 S.E.2d 269, 277 (N.C. Ct. App. 2002).

⁷⁰ TXO Prod. Corp. v. Alliance Res. Corp., 509 U.S. 443 (1993).

⁷¹ Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 520 (Ind. 1993); Rocanova v. Equitable Life Assur. Soc'y, 634 N.E.2d 940 (N.Y. 1994).

⁷² *Suver*, 462 N.E. at 417.

⁷³ *Id.* See also Corwin Chrysler-Plymouth, Inc. v. Westchester Fire Ins. Co., 279 N.W.2d 638 (N.D. 1979).

⁷⁴ Curry v. Fireman's Fund Ins. Co., 784 S.W.2d 176 (Ky. 1989).

justified in each specific situation.⁷⁵ In California, to recover punitive damages, the insured must prove there has been oppression, fraud, or malice by the insurer.⁷⁶

As a general rule, punitive damages are not recoverable for breach of contract.⁷⁷ Therefore, proponents of the tort of bad faith in the insurance context recognize the advantage of tort remedies, including large punitive damage awards. A large punitive damages award was entered by a California jury in *Downey Savings & Loan Association v. Ohio Casualty Insurance Co.*⁷⁸ The jury awarded punitive damages in the amount of \$5 million after hearing testimony that Ohio Casualty failed to respond for four months to the notice provided by Downey of a loss. Then Ohio Casualty claimed it had not received notice until ten days before the response. Ohio Casualty conducted no interviews until seven months after notice by Downey, refused to acknowledge coverage, and conducted no interviews after receiving a third-party complaint filed against Downey.⁷⁹ Ohio Casualty appealed the bad faith award and the California court of appeals sustained the punitive damages.⁸⁰ In finding “substantial evidence” to support the punitive award, the court cited to the California statute that allows punitive damages if the plaintiff proves “oppression, fraud or malice.”⁸¹ Finally, the court noted that the insurer’s “obligations of good faith and fair dealing encompass qualities of decency and humanity inherent in the responsibility of a fiduciary.”⁸²

This year, the United States Chamber of Commerce conducted a survey of senior attorneys at companies with annual revenues over \$100 million and asked them to rank all 50 states on several areas, including the area of punitive damages.⁸³ The survey was conducted in January and February, 2003.⁸⁴ The top five states in the area of punitive damages are Delaware, Iowa, North Dakota, Virginia and New Hampshire.⁸⁵ The survey respondents believed the worst states in the area of punitive damages were Mississippi, West Virginia, Alabama, Texas, and California.⁸⁶ The study also asked respondents to cite what they felt was the most important issue for state legislators who wanted to focus on improving the litigation environment in their state. The leading issue named by state legislators was “placing a ceiling on damages.”⁸⁷

⁷⁵ *Id.*

⁷⁶ *Cates Constr. Inc. v. Talbot Partners*, 86 Cal. Rptr. 2d 855 (Cal. 1999).

⁷⁷ *Trammell v. Vaughan*, 59 S.W. 79 (Mo. 1900).

⁷⁸ 234 Cal. Rptr. 835 (Cal. Ct. App. 1987).

⁷⁹ *Id.*

⁸⁰ *Id.*

⁸¹ *Id.* at 849.

⁸² *Id.*

⁸³ The Harris Poll, 2003 U.S. Chamber of Commerce State Liability Systems Ranking Study, April 4, 2003.

⁸⁴ *Id.*

⁸⁵ *Id.*

⁸⁶ *Id.*

⁸⁷ *Id.*

B. NEW DEVELOPMENTS RELATING TO PUNITIVE DAMAGES

A recent United States Supreme Court case, *State Farm Mutual Automobile Insurance Co. v. Campbell*,⁸⁸ applied the three guidelines for reviewing an award of punitive damages that was promulgated in *BMW of North America, Inc. v. Gore*.⁸⁹ The three guidelines are (1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases.⁹⁰ The Court stated that "the most important indicium of the reasonableness of a punitive damages award is the degree of reprehensibility of the defendant's conduct."⁹¹

In *Campbell*, the Utah Supreme Court reinstated a punitive damages award of \$145 million entered by the trial court against State Farm. State Farm refused to settle an insurance claim for an automobile wreck for the policy limit of \$50,000 and instead, allowed the case to go to trial. In going to trial, State Farm assured Curtis Campbell, the insured who caused the accident, that he had no liability for the accident and that he did not need separate counsel. When the jury returned a verdict of over \$150,000 finding that Mr. Campbell was 100% at fault, State Farm refused to appeal. Thus, the Campbells brought a bad faith action against State Farm.

The U.S. Supreme Court stated that "State Farm's handling of the case merits no praise."⁹² State Farm had disregarded the likelihood that Mr. Campbell was liable and that, if the case went to trial, a jury would probably grant an award that exceeded the policy limits.⁹³ However, the Court found that the \$145 million punitive damages award was far too excessive when compared to a \$1 million dollar compensatory award.⁹⁴ The Court believed that Utah used the case "as a platform to expose and punish the perceived deficiencies of State Farm's operations throughout the country."⁹⁵ The Court noted that "few awards exceeding a single-digit ratio between punitive and compensatory damages . . . will satisfy due process."⁹⁶ The Court noted that a ratio of 4 to 1 will likely satisfy due process standards, but a ratio of 145 to 1 will not.⁹⁷ Finally, providing guidance on the award of punitive damages, the Court stated that the "measure of punishment must be both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered."⁹⁸

⁸⁸ 2003 WL 1791206 (U.S. 2003).

⁸⁹ 517 U.S. 559 (1996).

⁹⁰ *Gore*, 517 U.S. at 575.

⁹¹ *Campbell*, 2003 WL 1791206, at *8.

⁹² *Id.*

⁹³ *Id.*

⁹⁴ *Id.*

⁹⁵ *Id.*

⁹⁶ *Id.* at *11.

⁹⁷ *Id.*

⁹⁸ *Id.* at *12.

C. THE UGLY

There are few reported cases in which fidelity insurers that have been found to have acted in bad faith and to be subject to high punitive damage awards. However, the law of most jurisdictions treats fidelity bond insurers the same as other first-party insurers for application of common law and statutory bad faith claims.⁹⁹ Still, courts have recognized that “financial institution bonds are inherently different from insurance policies.”¹⁰⁰ A fidelity bond is a negotiated contract and is not subject to the same analysis as regular insurance policies. However, as noted above, some bad faith statutes, including Arkansas and Tennessee, expressly apply to bonds.

These decisions have opened the door for large damage awards to be levied against fidelity insurers, with no apparent limit on the amount of punitive damages awarded. Some jurisdictions subject insurers, fidelity or not, to extra-contractual claims in excess of actual loss and even higher than the limit of liability under the insurance contract.¹⁰¹

In a first-party insurance case, the Supreme Court of Montana let stand a district court reduction of punitive damages from \$575,000 to \$300,000.¹⁰² Even though the contract damages were only \$12,679, the court agreed that \$300,000, a sum twenty-six times greater than the amount of the contract damages, was “large enough to get the company’s attention,” and appropriate.

In another first-party insurance case alleging bad faith refusal to pay a claim, the Court of Appeals for the Tenth Circuit, applying Oklahoma law, refused to set aside or decrease a punitive damage award of \$2 million. The underlying contractual damages in the case amounted only to \$1,500 and the consequential damages only to \$3,000.¹⁰³ Claiming that the jury had not been allowed to “run wild” with its discretion, the court found that the jury had applied appropriate standards and followed appropriate guidelines, thereby concluding that any amount of punitive damages the jury decided upon was reasonable.¹⁰⁴

Finally, the United States District Court for the Northern District of California, in a very recent case, determined that due to bad faith refusal to pay a claim, the defendant insurer was liable not only for \$320,849 in back payments and \$1,200,000 in future

⁹⁹ *Dodge v. Fid. & Dep. Co. of Md.*, 778 P.2d 1240, 1243 (Ariz. 1989); *Transamerica Premier Ins. Co. v. Brighton School Dist.* 27J, 940 P.2d 348, 352 (Colo. 1997). *See also* *Loyal Order of Moose Lodge 1392 v. Int’l Fidelity Ins. Co.*, 797 P.2d 622, 628 (Alaska 1990); *Int’l Fid. Ins. Co. v. Delmarva Sys. Corp.*, 2001 WL 541469, at *10 (Del. Super. Ct. May 9, 2001); *Suver v. Pers. Serv. Ins. Co.*, 462 N.E.2d 415, 417 (Ohio 1984).

¹⁰⁰ *FDIC v. Ins. Co. of N. Am.*, 105 F.3d 778, 786 (1st Cir. 1997).

¹⁰¹ *Capstick v. Allstate Ins. Co.*, 998 F.2d 810 (10th Cir. 1993) (awarding \$2 million in punitive damages in a case granting just \$1,500 on the contract claim and \$3,000 in consequential damages). *Dees v. Am. Fire Ins. Co.*, 861 P.2d 141 (Mont. 1993) (awarding \$300,000 in punitive damages on a case awarding just \$12,679 on the contract claim).

¹⁰² *Dees*, 861 P.2d at 141.

¹⁰³ *Capstick*, 998 F.2d at 810.

¹⁰⁴ *Id.* at 818.

benefits, but also for \$5 million in punitive damages.¹⁰⁵ Ruling that the jury had been properly instructed on elements of malice, oppression, and fraud, the court said that the evidence was sufficient to support the jury's punitive damages award.¹⁰⁶

D. THE GOOD

Several cases are reported in which the fidelity insurer was not found liable for high damage awards. In *FDIC v. Aetna Casualty & Surety Co.*,¹⁰⁷ the FDIC brought an action for coverage for loan loss under a bankers blanket bond. Aetna did not interview any loan officers but did review thousands of documents.¹⁰⁸ Subsequently, Aetna denied coverage to the FDIC.¹⁰⁹ The FDIC then amended its complaint to allege bad faith against Aetna.¹¹⁰ The court looked to Tennessee law to determine whether punitive damages should be awarded to the FDIC and found that Aetna did not act with the requisite conduct required for an award of punitive damages.¹¹¹ The court noted that the FDIC based its allegations of bad faith upon Aetna's investigatory tactics which, according to the court, "were normal and commonly accepted strategical pretrial discovery decisions."¹¹²

In *Stop & Shop Companies, Inc. v. Federal Insurance Co.*,¹¹³ Stop & Shop sought coverage under a commercial crime policy for losses that arose when its tax service provider embezzled money. Federal denied coverage because the loss was not a "direct loss" and was excluded because it was caused by the criminal act of an "authorized representative" of the insured.¹¹⁴ Stop & Shop filed suit alleging bad faith denial of coverage.¹¹⁵ The court found that Federal did not act in bad faith and was not liable for bad faith damages to Stop & Shop.¹¹⁶ The court noted that it was reasonable for Federal to deny coverage in light of the complexity of the issue and the court's prior decision on a different, but analogous policy.¹¹⁷

Another case in which the court found that the insurer did not act in bad faith is *First Dakota National Bank v. St. Paul Fire & Marine Insurance Co.*¹¹⁸ First Dakota purchased American State Bank, a failed bank, and sought coverage under American's fidelity bonds for loss caused by an employee of American.¹¹⁹ St. Paul denied coverage based on the untimeliness of notice and a proof of loss, lack of manifest intent by the

¹⁰⁵ *Hangarter v. Paul Revere Life Ins. Co.*, 236 F. Supp. 2d 1069 (N.D. Cal. 2002).

¹⁰⁶ *Id.* at 1110.

¹⁰⁷ 903 F.2d 1073 (6th Cir. 1990).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* at 1079.

¹¹² *Id.*

¹¹³ 946 F. Supp. 99 (D. Mass. 1996), *rev'd on other grounds*, 136 F.3d 71 (1st Cir. 1998).

¹¹⁴ *Id.* at 101.

¹¹⁵ *Id.*

¹¹⁶ *Id.* at 110.

¹¹⁷ *Id.*

¹¹⁸ 2 F.3d 801 (8th Cir. 1993).

¹¹⁹ *Id.*

employee, and the bank's ratification of the conduct.¹²⁰ Under South Dakota law, attorneys' fees may be awarded for bad faith conduct if the insurer acted "vexatiously or without reasonable cause."¹²¹ The court found that First Dakota was not entitled to attorneys' fees because St. Paul did not act "vexatiously or unreasonable in refusing coverage under the fidelity bond."¹²²

E. LIMITS ON THE AMOUNT OF DAMAGES

One state statute that deserves mention is Tenn. Code Ann. § 56-7-105. First, the Tennessee statute expressly applies to fidelity bonds. Second, the Tennessee statute places a cap on the amount of damages recoverable in a bad faith action. In addition to any loss incurred by the insured, the insurer can be held liable for damages, but not in an amount to exceed 25 percent of the loss. To recover bad faith penalties under Tenn. Code Ann. § 56-7-105, the claimant must prove the following: (1) the policy of insurance must, by its terms, have become due and payable; (2) a formal demand for payment must have been made; (3) the insured must have waited 60 days after making demand before filing suit (unless there was a refusal to pay prior to the expiration of the 60 days); and (4) the refusal to pay must not have been in good faith.¹²³

Tennessee courts have held that the statute does not require a penalty to be in the amount of 25 percent.¹²⁴ Instead, the plaintiff must prove that it suffered "additional expense, loss or injury because of the insurer's failure to pay."¹²⁵

The Georgia Code also places a limit on the amount of damages recoverable by the insured. The insured may recover the amount of the loss, plus an amount not to exceed fifty percent of the loss or \$5,000, whichever is greater.¹²⁶ In addition, the insured may also recover attorneys' fees.¹²⁷

The Arkansas Code limits the insured to recovery of the amount of the claim, and in addition, twelve percent of the loss plus attorneys' fees.¹²⁸ Michigan limits the amount of additional damages the insured may recover to twelve percent interest on the amount of loss in addition to the amount of the loss.¹²⁹ The twelve percent interest begins to apply sixty days from the date the insurer receives the proof of loss.¹³⁰

¹²⁰ *Id.* at 805.

¹²¹ *Id.* at 811.

¹²² *Id.*

¹²³ *McColgan v. Auto-Owners Ins. Co.*, 2002 WL 31322538, at *3 (Tenn. Ct. App. Oct. 11, 2002).

¹²⁴ *Id.*

¹²⁵ *Id.* at *5.

¹²⁶ GA. CODE ANN. § 33-4-6 (2002).

¹²⁷ *Id.*

¹²⁸ ARK. CODE ANN. § 23-79-208 (Michie 2002).

¹²⁹ MICH. COMP. LAWS § 500.2006 (2002).

¹³⁰ *Id.*

F. PREJUDGMENT INTEREST

Fidelity insurers should be aware that courts may include in the insured's recovery of damages prejudgment interest. In *Bank of Huntingdon v. Smothers*,¹³¹ the Tennessee Court of Appeals interpreted a fidelity bond that insured against loss, but not loss of potential income.¹³² The court held that the bank could only recover "that which it lost, not the income it hoped to receive from the lost amount, such as interest."¹³³ However, the court did award prejudgment interest to the insured on the "amount honestly due under the bond."¹³⁴

IX. Defenses

A. ADVICE OF COUNSEL

One defense that coverage counsel for insurance companies should be aware of is the "advice of counsel" defense. Although there is very little authority relating to the advice of counsel defense in the fidelity law context, the defense is important to parties who issue fidelity insurance and to those who defend fidelity bond providers. If a fidelity insurer intends to rely on the advice of counsel defense, the following analysis will be useful in asserting the defense.

Insurers are expected to conduct reasonable investigation into claims made by the insureds.¹³⁵ However, the insured, who is the plaintiff to the suit, should be able to check to see whether the insurer actually did rely on the advice of counsel.¹³⁶ Also, the insurer must have been truthful with its attorney and given an accurate depiction of events.¹³⁷ If the insurer does not provide its attorney with all of the details and circumstances, then the attorney's advice may not be relevant to the defense.¹³⁸

Many insurers retain counsel to assist in analyzing, investigating, and evaluating the claims submitted by insureds. Attorneys often examine the language of the bond or policy and apply the specific provisions to the insured's claim to determine whether coverage exists for the insured. The insurer often relies heavily on the opinion of its attorney in rendering decisions to its insured. Thus, when an insurer is sued for bad faith handling of a claim by the insured, the insurer often seeks to defend on the basis that the insurer was acting on the advice of counsel. In another context, if the insurer delays in investigating and handling the insured's claim and the insured brings a bad faith action on

¹³¹ 626 S.W.2d 267 (Tenn. Ct. App. 1981).

¹³² *Id.*

¹³³ *Id.* at 271.

¹³⁴ *Id.*

¹³⁵ Michael Sean Quinn, *Insurance Bad Faith and the Attorney-Client Privilege*, 32 THE BRIEF 36 (Spring 2003).

¹³⁶ *Id.*

¹³⁷ *Id.*

¹³⁸ *Id.*

the basis of the delay, the insurer may defend on the grounds that its attorney did not act promptly in investigating the matter and was the actual party to cause the delay.¹³⁹

The advantage of the advice of counsel defense is that a court may find that the insurer did not act in bad faith because the insurer acted at the advice of its counsel. The disadvantage is that the attorney-client privilege between the insurer and its attorney may be waived.

Insurers who seek to use the “advice of counsel” defense must prove the following elements:

- (1) The insurer disclosed to its attorney all information necessary to make the coverage determination;
- (2) The attorney was acting as the insurer’s attorney in providing the advice;
- (3) The insurer relied on the attorney’s advice in good faith; and
- (4) The insurer did, in fact, act on the advice.¹⁴⁰

Jurisdictions that have recognized the advice of counsel defense have stated that any advice given by counsel is merely one factor that the court should examine in determining whether the insured acted in bad faith.¹⁴¹ Therefore, a bad faith action will not be dismissed on summary judgment based on the assertion that the insured took the advice of its counsel.

The advice of counsel defense may work to benefit the insurer. The advice may give weight to whether the insurer actually acted in good faith.¹⁴² For example, if the insurer reasonably relies on the good faith evaluation of its attorney, this reliance is evidence of the insurer’s good faith.

Another issue that arises if the insurer invokes the advice of counsel defense is the extent to which the insurer is willing to divulge all information in its file. Discovery would be conducted on all of the correspondence between the attorney and the insurer with respect to the bond at issue. Thus, the insurer’s file may contain documents that

¹³⁹ Gary M. Case, *The Advice of Defense Counsel in Surety and Fidelity Litigation: The Good, The Bad & The Ugly* (unpublished paper presented to the Twelfth Annual Northeast Sur. & Fid. Claims Conf. 2001).

¹⁴⁰ *Szumigala v. Nationwide Mut. Ins. Co.*, 853 F.2d 274 (5th Cir. 1988); *Aetna Cas. & Sur. Co. v. Superior Court*, 153 Cal. App. 3d 467 (Ct. App. 1984); *Hamilton County Bank v. Hinkle Creek Friends Church*, 478 N.E.2d 689, 691 (Ind. Ct. App. 1985).

¹⁴¹ *Szumigala*, 853 F.2d at 274.; *Chavers v. Nat’l Sec. Fire & Cas. Co.*, 405 So. 2d 1, 8 (Ala. 1991); *Crabb v. Nat’l Indem. Co.*, 205 N.W.2d 633, 636 (S.D. 1973).

¹⁴² *Peckham v. Cont’l Cas. Ins. Co.*, 997 F. Supp. 73, 80 (D. Mass. 1998).

include opinions that may undermine the advice of counsel defense.¹⁴³ Under these circumstances, the insurer should use caution in asserting the advice of counsel defense.

Another consideration for the insurer before invoking the defense is whether the same attorney who rendered the advice also represents the insurer in the litigation in which the insurer invokes the defense.¹⁴⁴ The attorney will most likely be called as a witness at trial. Thus, the attorney, as well as the attorney's entire firm, may be disqualified.¹⁴⁵ In that situation, the insurer would be forced to find new counsel, which may lead to increased litigation costs.

The advice of counsel defense is rarely asserted or litigated in the fidelity context.¹⁴⁶ One reason could be because of the complexity of the issues involved in fidelity law.¹⁴⁷ Often times, the fidelity insurer will rely on its counsel for advice for many issues and not just one single issue. Thus, if the insurer invokes the defense, it will be waiving the attorney-client privilege. Therefore, asserting the advice of counsel defense in the fidelity context is often a difficult decision weighing the benefit of the defense against the peril of opening the insurer's counsel's file to the insured.

The insurer does have other alternatives available outside of actually invoking the advice of counsel defense. One choice is that the insurer, without invoking the advice of counsel defense, may be able to show at trial that the denial of coverage to the insured was reasonable.

Despite the risks associated with invoking the advice of counsel defense, it is a defense available to the insurer that should be considered in bad faith litigation. An insurer should weigh the risks associated with invoking the defense and examine the alternatives.

B. OTHER DEFENSES

Some states may allow as a defense the absence of case law that is on point. If a jurisdiction does not have controlling precedent on the issue, the insurer has the option of asserting as a defense the absence of controlling case law.

An affirmative defense that should be available to the insured is comparative fault. The insurer should be able to raise the affirmative defense of comparative fault as a defense to the insured's claim for the tort of bad faith. For example, the insured may have committed a negligent act that contributed to its loss. The insured's negligent act may reduce the amount of recovery awarded to the insured.

¹⁴³ *Id.*

¹⁴⁴ *Id.*

¹⁴⁵ MODEL RULES OF PROF'L CONDUCT R. 1.7.

¹⁴⁶ *Country Club of Johnson City, Inc.*, 563 S.E.2d 269.

¹⁴⁷ *Id.*

X. Attorney–Client Privilege

As discussed above, one risk associated with asserting the advice of counsel defense is that it may lead to a partial or complete waiver of the protections afforded by the attorney-client privilege. The attorney-client privilege belongs to the client and may be asserted only by the client to protect certain communications.¹⁴⁸ The attorney-client privilege applies if the following elements are established: (1) where a party seeks legal advice of any kind; (2) the legal advice is sought from a professional legal adviser in his capacity as an attorney; (3) the communication relates to legal advice; (4) the advice is made in confidence; and (5) the client of the attorney is the one who makes the communications.¹⁴⁹

The *Restatement (Third) of the Law Governing the Law* provides that “the attorney-client privilege is waived for any relevant communications if the client asserts as a material issue in a proceeding that ... the client acted upon the advice of a lawyer or that the advice was otherwise relevant to the legal significance of the client’s conduct.”¹⁵⁰ Generally, if the insurer asserts the advice of counsel defense, it will be deemed to have waived its attorney-client privilege as to its communications with the attorney who gave the advice.¹⁵¹ Once the insurer introduces the advice of counsel as defense, the insurer voluntarily places the content and scope of the attorney’s advice at issue, which makes it a relevant subject for discovery and testimony at trial.¹⁵²

An important case in the realm of the attorney-client privilege and bad faith cases is *Boone v. Vanliner Insurance Co.*¹⁵³ The Ohio Supreme Court was faced with the issue of “whether, in an action alleging bad faith denial of insurance coverage, the insured is entitled to obtain, through discovery, claims-file documents containing attorney-client communications and work-product that may cast light on whether the denial was made in bad faith.”¹⁵⁴ In *Boone*, an employee sought recovery from Vanliner and originally was denied coverage.¹⁵⁵ Subsequently, Vanliner determined that the employee was covered under the insurance policy, but the employee still filed a bad faith action.¹⁵⁶ The plaintiff-insured, Boone, sought to discover Vanliner’s claims files, and Vanliner objected on the grounds of work-product and attorney-client privilege. The Ohio Supreme Court held that “certain attorney-client communications and work-product materials were undeserving of protection, i.e., materials showing the lack of a good faith effort to settle.”¹⁵⁷ The Ohio Supreme Court appears to have established the rule in Ohio that in a bad faith action “the insured may discover claims file materials containing

¹⁴⁸ Quinn, *supra* note 135, at 38.

¹⁴⁹ Admiral Ins. v. United States District Court, 881 S.2d 1486 (9th Cir. 1989).

¹⁵⁰ RESTATEMENT (THIRD) OF THE LAW GOVERNING THE LAW § 80(1)(a) (2003).

¹⁵¹ Vicinanza v. Brunswick & Fils, Inc., 739 F. Supp. 891 (S.D.N.Y. 1990).

¹⁵² Wender v. United States Auto Ass’n, 434 A.2d 1372, 1374 (D.C. App. 1981).

¹⁵³ 744 N.E.2d 154 (Ohio 2001).

¹⁵⁴ *Id.*

¹⁵⁵ *Id.*

¹⁵⁶ *Id.*

¹⁵⁷ *Id.* at 157.

attorney-client communications related to the issue of coverage and which were created prior to the denial of coverage.”¹⁵⁸

The waiver of the attorney-client privilege may extend to all aspects of the outside counsel’s representation and advice to the insurer. According to one commentary, the defense is best asserted where the advice at issue was given by counsel on a narrow legal issue and was included in a written opinion that is in the insurer’s claim files.¹⁵⁹ By framing the issue in a narrow way, the insurer is better able to prohibit the other party from conducting discovery on the insurer and its counsel’s entire files.

Jurisdictions that require as an element of bad faith, the mental state of the insurer at the time of conduct may have instigated special rules dealing with the waiver of attorney-client privilege.¹⁶⁰ The Arizona courts have developed the following test for determining when a party impliedly has waived the attorney-client privilege: (1) assertion of the privilege was a result of some affirmative act, such as filing suit by the asserting party; (2) through this affirmative act, the asserting party put the protected information at issue by making it relevant to the case; and (3) application of the privilege would have denied the opposing party access to information vital to its defense.¹⁶¹

Merely filing a bad faith action or denying a claim in bad faith does not constitute an implied waiver of the privilege.¹⁶² A party does not waive the attorney-client privilege unless it has asserted a claim or defense that includes the information received from counsel.¹⁶³ In that situation, the party claiming the privilege has placed at issue the advice of counsel. An example when the privilege may be waived is when the party asserting the privilege claims it acted properly in denying a claim and the denial was permitted by law and this basis is on state law. In this situation, the party’s knowledge of state law is important and the party has knowledge based on the attorney’s advice.¹⁶⁴ Therefore, the advice of counsel becomes significant to the client’s conduct.

XI. Reverse Bad Faith

If the implied duty of good faith and fair dealing can be associated with tort remedies, it should also be associated with tort defenses and affirmative defenses. One defense is the doctrine of reverse bad faith. However, the only state to date to formally recognize the doctrine of reverse bad faith is California.¹⁶⁵

¹⁵⁸ Quinn, *supra* note 135, at 42.

¹⁵⁹ *Id.*

¹⁶⁰ *Twin City Fire Ins.*, 63 P.3d at 282.

¹⁶¹ *Id.* at 285; Hearn v. Rhay, 68 F.R.D. 574, 581 (E.D. Wash. 1975).

¹⁶² *Twin City Fire Ins.*, 63 P.3d at 286.

¹⁶³ *Id.*; Mordesovitch v. Westfield Ins. Co., 2003 WL 354828 (W. Va. 2003).

¹⁶⁴ *Twin City Fire Ins.*, 63 P.3d at 286.

¹⁶⁵ Fleming v. Safeco Ins. Co., 206 Cal. Rptr. 313 (Ct. App. 1984). Other states have not approved of the doctrine of reverse bad faith. See Alexander Underwriters Gen. Agency, Inc. v. Lovett, 357 S.E.2d 258 (Ga. Ct. App. 1987); Jessen, 776 P.2d at 1244; Stephens v. Safeco Ins. Co., 852 P.2d 565 (Mont. 1993); Tokles & Son, Inc. v. Midwestern Indem. Co., 605 N.E.2d 936 (Ohio 1992).

Despite the fact that most attorneys and fidelity bond insurers relate the phrase “bad faith” to the actions of the insurer, courts have found that the insured acted in bad faith in certain instances. The U.S. District Court for the Southern District of Ohio found that a bank had acted in bad faith in submitting a proof of loss to the fidelity bond insurer.¹⁶⁶ The bank submitted a proof of loss alleging that its officer had engaged in dishonest conduct. After Hartford investigated, it informed the bank that it needed additional documentation. The bank ignored Hartford’s request and instead filed suit. The bank did not provide Hartford with a dollar amount of the loss that was incurred. Furthermore, the loan officer admitted to the bank that he acted with the intent to cause the bank to incur a loss.¹⁶⁷ However, the bank did not raise this issue until 14 months after the lawsuit was filed. Based on this information, the court concluded that the bank must have known its suit did not have merit and awarded attorneys’ fees to Hartford.¹⁶⁸

XII. The Second Exhibit to the Bad Faith Lawsuit

In every lawsuit against the insurer, the first exhibit introduced at trial is the insurance policy or bond. The second exhibit introduced at trial is most often a letter from the insurer typically providing a coverage decision or, in some instances, the denial of coverage. Thus, correspondence between the insurer and insured is of paramount importance, especially if the correspondence addresses coverage issues or can be used by the insured to show a delay in reaching a coverage decision.

The insurer should take extra precaution in providing a summary of the facts of the claim and making assumptions based on those facts. Once the insurer outlines the facts and assumptions in a coverage letter, the insurer is held to those facts and assumptions. Additional discovery by the insured could alter the assumptions and decisions reached in the coverage analysis; however, the initial assumptions will be examined by the court as the facts on which the insurer relied in issuing its original opinion. Therefore, the insurer should not assume any facts that have not clearly been provided by the insured. Also, if any facts remain unclear, the insurer should request clarification from the insured before making an assumption based on those facts.

An insurer should reference any and all legitimate defenses in all correspondence so as not to waive those defenses. If the facts do not directly apply to a defense under the bond, the insurer should still provide the insured with an analysis of the defense and explain to the insured that the defense may be applicable if certain additional facts are revealed. In the event that the facts of the claim change, the defense is not waived because it was previously mentioned. One important principle for the insurer to follow in all correspondence with the insured is to include a reservation of rights. The insurer should reserve its rights in law and in equity in every correspondence issued to the insured.

¹⁶⁶ First Bank of Marietta v. Hartford Underwriters Ins. Co., 115 F. Supp. 2d 898 (S.D. Ohio 2000).

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

Another important rule to follow in relation to the bad faith context is that all correspondence should be written with clarity and simplicity. If coverage issues are properly conveyed to the insured, it could avoid a bad faith lawsuit being brought against the insurer. When correspondence relating to coverage and other issues is written clearly and in a language understood by the ordinary person, the insured is better able to understand the reasons advanced by the insurer for denial of coverage. In that event, the insured is less likely to bring an action against the insurer because he can understand the reason that coverage is denied. Coverage letters filled with legalese and unclear language can confuse and agitate an insured.

Additionally, correspondence transmitted between the insurer and insured will set the tone for the lawsuit, as a court is unlikely to award bad faith damages if the insurer has a well-reasoned analysis and a supportable position relating to the denial or issuance of coverage. For this reason, the insurer and its counsel should ensure that all provisions relating to denial of coverage are given the meaning intended by the underwriters of the bond or policy. The insurer should be careful to cite the provision of the bond or policy on which it relies to deny coverage and support the denial by relying on all applicable facts.

Two principles to keep in mind when corresponding with the insured are that correspondence should be written to educate the insured, and all correspondence should be written with the court or a jury as the intended audience. In other words, correspondence between the insurer and insured should not be written in legal jargon but in words understandable by a lay person. Additionally, an insurer should analyze how a jury or court would view the facts of the claim and how a court would interpret applicable case law or statutes.

XIII. Time Constraints Under Bad Faith Statutes

If the claim is denied, the insured may base a claim against the insurer on bad faith denial of the claim or on delay by the insurer and non-responsiveness to correspondence of the insured. This section assumes that the insurer acted diligently and did not engage in dilatory conduct.

Bad faith statutes are generally written for individual consumer and liability insurers.¹⁶⁹ Those statutes provide the insurer with a certain number of days in which to make payment after the insured makes the demand. For example, the Georgia statute provides the insurer with sixty days in which to make payment to the insured after the demand is made.¹⁷⁰ Wisconsin only provides the insurer with thirty days from the date of the receipt of the proof of loss to pay a claim.¹⁷¹ In the context of individual consumer and liability insurance policies, the loss is quickly ascertained and the statutes protect

¹⁶⁹ TENN. CODE ANN. § 56-7-105; GA. CODE ANN. § 33-4-6; ARK. CODE ANN. § 23-79-208 (2002); WIS. STAT. ANN. § 628.46 (2002); IDAHO CODE § 41-1839 (2002); VA. CODE ANN. § 38.2-209 (2002); PA. CONS. STAT. ANN. § 8371; S.C. CODE ANN. § 38-59-40 (2002); OR. REV. STAT. § 742.061 (2002).

¹⁷⁰ GA. CODE ANN. § 33-4-6.

¹⁷¹ WIS. STAT. ANN. § 628.46.

consumers from undue delay. Also, in those contexts, the coverage issues are simpler, and greater importance is placed on prompt decision making because often legal actions are pending.

In contrast to the individual consumer and liability insurance, in the fidelity bond context, the parties are more sophisticated and the loss is often a large financial loss incurred by the insured. Thus, payment and timing, while important, often cannot be resolved within short periods of time. Therefore, the time periods enacted by the legislatures often are unreasonably short when applicable to the fidelity bond context.

Once a fidelity insurer receives a claim, the first thing the insurer should do is determine the jurisdiction in which the claim arose. Next, the insurer should consider whether any bad faith cases have been decided or if the jurisdiction has enacted any statutes that apply to bad faith handling of claims. Additionally, the insurer should be aware of any express time provisions in which payment should be made after the insured conveys the demand to the insurer. Some jurisdictions may require the insurer to respond to the insured based solely on the information available even if the information is incomplete and the insured has not fully documented its claim. If the jurisdiction has a specific time period in which the insurer must respond, the insurer should attempt to respond within that time. Moreover, the insurer should attempt to obtain an extension of time or execute a tolling agreement with the insured. The insurer should be sure to document every correspondence and every extension of time in the event that the insured later accuses the insurer of being delinquent.

The insurer should promptly and frequently advise the insured with written correspondence as to what documentation or information is necessary to provide a coverage decision. The insurer should always request an extension of time in a jurisdiction with time limits to respond to the notice of claim. The extension of time should be in writing.¹⁷² If the insured does not cooperate and provide the additional documentation and the jurisdiction has an express time period within which the insurer must respond, the insurer should consider issuing a coverage decision based on the information it has to date. The burden of proof to provide documentation that supports coverage is on the insured. Also, the responsibility to provide documentation and information to support coverage is on the insured.

If the insured fails to provide additional documentation and information and the insurer must reach a coverage decision, the insurer should not assume facts which have not been demonstrated by the insured. Instead, the insurer must base the coverage decision specifically and solely on the information available.

¹⁷² Dolores A. Parr, et al., *Investigation of Fidelity Claims and Development of Relevant Facts* (unpublished paper presented at 2002 ABA Midwinter Meeting, New York, New York, Jan. 25, 2002) (paper on file with authors).

XIV. Resources on Bad Faith

Many commentators have written journal articles on the tort of bad faith in insurance, surety, and fidelity law.¹⁷³ In 1998, in *The Fidelity Law Association Journal*, Charles Thomas and Dirk Ehlers provide a thorough analysis of the history of bad faith and its evolution into fidelity law.¹⁷⁴ The article summarizes the variations among the states that recognize the tort of bad faith.

XV. Future of Bad Faith

In the 1950s and 1960s, the extension of the duty of good faith and fair dealing into the tort arena led to much debate and discussion. However, in the past several decades, the tort of bad faith in insurance contexts has gained stability and maturity.¹⁷⁵ Most states have recognized a common law tort of bad faith or have enacted statutes that require the insurer to act in good faith and fair dealing when handling claims of their insureds. The tort of bad faith has not gained as much attention in the fidelity context although several jurisdictions have recognized the tort in the surety context.

XVI. Conclusion

The tort of bad faith has gained popularity in the past few decades and has now been recognized by most states. Knowledge of and familiarity with cases and statutes governing the methods and procedures implemented by insurers in analyzing insurance claims is important for insurers to assure compliance with the applicable law and avoid potential exposure to extra-contractual damages.

¹⁷³ For a detailed analysis, see the following articles: Stephen S. Ashley, *BAD FAITH ACTIONS, LIABILITY & DAMAGES* (2d ed. 1997); Daniel S. Bopp, *Tort and Contract in Bad Faith Cases: Is The Honeymoon Over?* 59 DEF. COUNS. J. 524 (1992); Douglas R. Richmond, *An Overview of Insurance Bad Faith and Litigation*, 25 SETON HALL L. REV. 74 (1994); Patricia Thompson & Alicia Kirshenbaum, *Insureds' Bad Faith and Fraud—What's a Fidelity Insurer to Do?* (unpublished paper presented to the 1998 Annual Meeting of the Surety Claims Inst., June 1998) (on file with authors); Caroll J. Miller, *What Constitutes Bad Faith on Part of Insurer Render it Liable for Statutory Penalty Imposed for Bad Faith in Failure to Pay, or Delay in Paying, Insured's Claim*, Annotation., 33 A.L.R. 4th 579 (1981).

¹⁷⁴ Charles D. Thomas & Dirk E. Ehlers, *Bad Faith: Trends in Statutory and Common Law Framework and Review of Recent Cases*, IV FID. L.J. 19 (1998).

¹⁷⁵ Kenneth S. Abraham, *The Natural History of the Insurer's Liability for Bad Faith*, 72 TEX. L. REV. 1295 (1994); JERRY, *supra* note 2.

APPENDIX A

STATE	BAD FAITH CITATION	UNFAIR CLAIMS PRACTICES ACT
Alabama	<i>Chavers v. Nat'l Sec. Fire & Cas. Co.</i> , 405 So. 2d 1, 6 (Ala. 1981).	ALA. CODE § 27-12-24
Alaska	<i>United Servs. Auto Ass'n v. Werley</i> , 526 P.2d 28 (Alaska 1974).	ALASKA STAT. § 21.36.125
Arizona	<i>Noble v. Nat'l American Life Ins. Co.</i> , 624 P.2d 866 (Ariz. 1981).	ARIZ. REV. STAT. § 20-461
Arkansas	<i>Aetna Cas. & Sur. Co. v. Broadway Arms Corp.</i> , 664 S.W.2d 463, 465 (Ark. 1984).	ARK. CODE ANN. § 23-66-206
California	<i>Crisci v. Security Ins. Co.</i> , 426 P.2d 173 (Cal. 1967); <i>Comunale v. Traders & General Ins. Co.</i> , 328 P.2d 198 (Cal. 1958).	CAL. INS. CODE § 790.03(H)
Colorado	<i>Rederscheid v. Comprecare, Inc.</i> , 667 P.2d 766 (Colo. Ct. App. 1983).	COLO. REV. STAT. § 10-3-1104(H)
Connecticut	<i>Grand Sheet Metal Prod. Co. v. Protection Mut. Ins. Co.</i> , 375 A. 2d 428 (Conn. 1977).	CONN. GEN. STAT. ANN. § 38A-816
Delaware	<i>Int'l Fid. Ins. Co. v. Delmarva Sys. Corp.</i> , 2001 WL 541469 (Del. Super. Ct. 2001).	DEL. CODE ANN. TIT. 18, § 2304(16)
Florida	<i>Rowland v. Safeco Ins. Co. of Am.</i> , 634 F. Supp. 613 (M.D. Fla. 1986).	FLA. STAT. ANN. § 626.9541(i)
Georgia	GA. CODE ANN. § 33-4-6	GA. CODE ANN. § 33-6-34
Hawaii	<i>The Best Place, Inc. v. Penn Am. Ins. Co.</i> , 920 P.2d 334 (Hawaii 1996).	HAW. REV. STAT. § 431:13-103(10)
Idaho	<i>White v. Unigard Mut. Ins. Co.</i> , 730 P.2d 1014, 1017-20 (Idaho 1986).	IDAHO CODE § 41-1329
Illinois	215 ILL. COMP. STAT. ANN. 5/155	215 ILL. COMP. STAT. ANN. 5/154.6
Indiana	<i>Erie Ins. Co. v. Hickman</i> , 622 N.E.2d 515 (Ind. 1993).	IND. CODE ANN. § 27-4-1-4.5
Iowa	<i>Dolan v. Aid Ins. Co.</i> , 431 N.W.2d 790, 794 (Iowa 1988).	IOWA CODE ANN. § 507B.4(9)

STATE	BAD FAITH CITATION	UNFAIR CLAIMS PRACTICES ACT
Kansas	Does not recognize	KAN. STAT. ANN. § 40-2404
Kentucky	<i>Curry v. Fireman's Fund Ins. Co.</i> , 784 S.W.2d 176 (Ky. 1989).	KY. REV. STAT. ANN. § 304.12-230
Louisiana	Does not recognize	LA. REV. STAT. ANN. § 22:1214
Maine	Does not recognize	ME. REV. STAT. ANN. TIT. 24-A, § 2164-D
Maryland	Does not recognize	MD. INS. CODE ANN. § 27-303
Massachusetts	Not yet decided	MASS. GEN. LAWS CH176D, §3.
Michigan	Does not recognize	MICH. COMP. LAWS ANN. § 500.2026
Minnesota	Does not recognize	MINN. STAT. ANN. § 72A.20
Mississippi	<i>State Farm Fire & Cas. Co., v. Simpson</i> , 477 So. 2d 242, 248-52 (Miss. 1985).	MISS. CODE ANN. § 83-57-59
Missouri	Does not recognize	MO. ANN. STAT. § 375.1007
Montana	<i>Lipinski v. Title Ins. Co.</i> , 655 P.2d 970 (Mont. 1982).	MONT. CODE ANN. § 33-18-201
Nebraska	<i>Braesch v. Union Ins. Co.</i> , 464 N.W.2d 769, 772-76 (Neb. 1989).	NEB. REV. STAT. § 44-1540
Nevada	<i>Pemberton v. Farmers Ins.</i> , 858 P.2d 380 (Nev. 1993).	NEV. REV. STAT. § 686A.310
New Hampshire	Does not recognize	N.H. REV. STAT. § 417:4
New Jersey	<i>Pickett v. Lloyd's</i> , 621 A.2d 445 (N.J. 1992).	N.J. STAT. ANN. § 7:29B-4
New Mexico	<i>State Farm Gen. Ins. Co. v. Clifton</i> , 527 P.2d 798, 800 (N.M. 1974).	N.M. STAT. ANN. § 59A-16-20
New York	Does not recognize	N.Y. INS. LAWS § 2601.
North Carolina	<i>Daily v. Integon General Ins. Corp.</i> , 331 S.E.2d 148 (N.C. App. 1985).	N.C. GEN. STAT. § 58-63-15
North Dakota	<i>Farmer's Union Cent. Exch. v. Reliance Ins. Co.</i> , 626 F. Supp. 583 (D. N.D. 1985).	N.D.C.C. § 26.1-04-03
Ohio	<i>Suver v. Personal Service Ins. Co.</i> , 462 N.E.2d 415 (Ohio 1984).	OHIO REV. CODE ANN. § 2315.21

STATE	BAD FAITH CITATION	UNFAIR CLAIMS PRACTICES ACT
Oklahoma	<i>Rodgers v. Tecumseh Bank</i> , 756 P.2d 1223, 1227 (Okla. 1988).	OKLA. STAT. TIT. 36 § 1250.1
Oregon	Does not recognize	OR. REV. STAT. § 746.230
Pennsylvania	42 PA. C.S.A. § 8371 <i>Turner Const. Co. v. First Indem. of America Ins. Co.</i> , 829 F. Supp. 752 (E.D. Pa. 1993).	40 PA. C.S.A. § 1171.1
Rhode Island	R.I. GEN. LAWS § 27-9.1-4; <i>Bibeault v. Hanover Ins. Co.</i> , 417 A.2d 313 (R.I. 1980).	R.I. GEN. LAWS § 27-9.1-4
South Carolina	<i>Nichols v. State Farm Mut. Auto Ins. Co.</i> , 306 S.E.2d 616, 619 (S.C. 1983).	S.C. CODE ANN. § 38-59-20
South Dakota	<i>In re Certification of a Question of Law</i> , 399 N.W.2d 320 (S.D. 1987).	S.D. CODIFIED LAWS § 58-33-67
Tennessee	TENN. CODE ANN. § 56-7-105	TENN. CODE ANN. § 56-8-104(8)
Texas	<i>Arnold v. Nat'l County Mut. Fire Ins. Co.</i> , 725 S.W. 2d 165, 167 (Tex. 1987).	TEX. INS. CODE ANN. ART. 21.21-2
Utah	Does not recognize	UTAH CODE ANN. § 31A-26-303
Vermont	<i>Bushey v. Allstate Ins. Co.</i> , 670 A.2d 807 (Vt. 1995).	VT. STAT. ANN. TIT. 8, § 4724(9)
Virginia	Does not recognize	VA. CODE ANN. § 38.2-510
Washington	<i>Industrial Indemnity Co. of the Northwest v. Kallevig</i> , 792 P.2d 520 (Wash. 1990).	WASH. ADMIN. CODE § 284-30-330
West Virginia	W. VA. CODE § 33-11-4	W. VA. CODE § 3-11-4
Wisconsin	<i>Anderson v. Continental Ins. Co.</i> , 271 N.W.2d 368, 374 (Wis. 1978).	WIS. STAT. § 628.46
Wyoming	<i>McCullough v. Golden Rule Ins. Co.</i> , 789 P.2d 855, 856-60 (Wyo. 1990).	WYO. STAT. ANN. § 26-13-124