

1988

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Recommended Citation

Russell H. McMains, *Bad Faith Claims Handling - New Frontiers: A Multi-State Cause of Action in Search of a Home*, 53 J. AIR L. & COM. 901 (1988)
<https://scholar.smu.edu/jalc/vol53/iss4/2>

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BAD FAITH CLAIMS HANDLING—NEW FRONTIERS: A MULTI-STATE CAUSE OF ACTION IN SEARCH OF A HOME

RUSSELL H. McMains*

I. OBJECTIVE AND SCOPE OF ARTICLE

THE JURISPRUDENTIAL MARCH toward imposing extracontractual liability upon insurers (both first-party and liability)¹ has been frequently lamented or lauded by courts and commentators depending upon their personal perspective.² Insurance industry doom-sayers and trial lawyer prognosticators have tended to overstate the impact of such claims upon the insurance industry. But the growing prevalence of the assertion of such claims warrants close attention by counsel and industry representatives in all facets of insurance practice.

When the author undertook to update the available treatise materials and articles on this subject, the author's computer-assisted research revealed more than 200 opinions since January 1987 on the subject of bad faith in the insurance claims arena. More than 130 of these cases represent appellate opinions from the various state tribunals

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¹ First party coverage refers to situations where the insured seeks direct coverage for losses the insured suffers. W. SHERNOFF, S. GAGE & H. LEVINE, *INSURANCE BAD FAITH LITIGATION* § 3.01 (1987) [hereinafter W. SHERNOFF]. Third party or liability coverage refers to situations where the insured seeks the insurer to indemnify the insured from a third party claim. *Id.*

² See generally *id.* §§ 1.01-.08; Langdon & Sytsma, *The Duty of Good Faith and Fair Dealing and the Pre-Adjudicatory Role of the Insurance Company Advocate*, 45 *INS. COUNS. J.* 309 (1978).

and another 80-plus opinions emanate from the Federal district and appellate courts throughout the United States. Thus, by sheer magnitude, insurance claims personnel and trial lawyers (for both plaintiffs and defendants) must constantly struggle to keep abreast of the ebb and flow of such litigation in their own jurisdiction.

The following materials are not designed to rehash comprehensively all of the developing jurisprudence in the many jurisdictions that are confronting these issues. Rather, it is the author's intent to provide an analytical overview of the differential treatment of the common and recurring issues in this developing area with a view towards identifying the overriding judicial concerns. The author also intends to focus upon hitherto obscured issues that may well be outcome-determinative in any particular case. In this latter regard, the author was shocked to discover that a critical segment of the applicable substantive law has been almost totally ignored by commentators and treatise writers in the bad faith claims handling area.³ The all-important question of conflicts or choice of law issues may be outcome-determinative and should be examined by the thorough practitioner in advising his respective client (whether plaintiff or defendant) and assessing the potential for success of a particular extra-contractual insurance claim. This subject is treated in Section IV of these materials.

A third and salutary function of this article is to supply a basis for a guarded forecast of potential new developments in the ever-expanding arena of extra-contractual liability of insurers. But any such prognosis initially depends upon a thorough understanding of the judicially expressed concerns and policies that have driven the current bad faith movement.

³ See, e.g., W. SHERNOFF, *supra* note 1; Langdon & Sytsma, *supra* note 2.

II. HISTORICAL RESUME OF BAD FAITH LEGAL DEVELOPMENTS

The roots of extra-contractual liability of insurers in this nation run deep in many jurisdictions besides those commonly classified as jurisprudentially radical such as California.⁴ While California has significantly contributed to the rather forthright statement of principles involved in assessing liability against insurers above and beyond that expressed in their contracts,⁵ many other jurisdictions have, for several well-defined policy reasons, imposed such liability upon insurers since the early 1900's.⁶ This is true relative to the traditional extra-contractual liability of insurers for third-party recoveries of excess judgments against liability insurance carriers, as well as the more recent vogue of making bad faith and other tortious claims against first-party insurers.⁷

All of the jurisdictions which have considered and imposed liability, as well as those which, for the time being, have remained in the conservative camp, have relied upon one or more of four inter-related justifications (with varying degrees of assigned weight) as warranting the accept-

⁴ See W. SHERNOFF, *supra* note 1, § 1.01 n.3 (citing cases in 22 states other than California which have recognized some duty of insurance companies to deal fairly and in good faith with policyholders).

⁵ See, e.g., *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973) (recognizing a cause of action in tort against insurer for breach of duty to deal in good faith with insured); *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967) (liability based on an implied covenant exists when insurer unreasonably refuses settlement offer).

⁶ See, e.g., *G.A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d 544 (Tex. Comm'n App. 1929) (stating that the court has a duty "to give effect to all the provisions of the policy, and it would certainly be a very harsh rule to say that the indemnity company, in a case such as this, owed no duty whatsoever to the insured further than the face of the policy . . ."); see also *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d 659, 456 P.2d 674, 79 Cal. Rptr. 106 (1969); *Duffy v. Banker's Life Ass'n*, 160 Iowa 19, 139 N.W. 1087 (1913); *Ryer v. Missouri State Life Ins. Co.*, 132 Wash. 378, 232 P. 346 (1925) (the "quasi-public" nature of the insurance business imposes a duty upon the insurer to conduct reasonable investigation of insurability after issuance of liability policy).

⁷ See W. SHERNOFF, *supra* note 1, § 1.07[2] n.17 and cases cited therein for a list of states which have held that a violation of the duty of good faith and fair dealing subjects the insurer to liability in tort.

ance of extra-contractual liability claims.⁸ The first and perhaps foremost recognized justification is the acknowledged public interest character of the insurance industry.⁹ The place of an insurance company in modern society has long been compared to that of a public utility insofar as the enhanced requirements imposed upon such public service companies is concerned.¹⁰ This comparison has engendered the notion of good faith and fair dealing.¹¹

A second and related concern is the expectation of the insurance-consuming public which the industry has fostered itself. Allstate's slogan "You're in Good Hands," Travelers' motto of protection "Under the Umbrella," and Fireman's Fund's symbolic protection beneath the "Fireman's Hat," exemplify the industry's own efforts to portray itself as a repository of the public trust. But with the public trust may be visited responsibility for a violation of such trust as evidenced by recent recognition of extra-contractual "rights" of insureds or tortious responsibility of insurers beyond the four corners of its insuring agreement—particularly in the first-party area.¹²

Third, the adhesion nature of most insurance contracts is such that policies are written in standard form and frequently must conform to the dictates of various public regulatory bodies. The courts have often referred to this

⁸ See *id.* §§ 1.02-05.

⁹ See, e.g., *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d at 659, 456 P.2d at 674, 79 Cal. Rptr. at 106. The court notes the long recognized "quasi-public" nature of the insurance business, together with the state's statutory policies as the source of an insurer's duty to its insured and the public. *Id.* 456 P.2d at 680-81.

¹⁰ See E. PATTERSON, *ESSENTIALS OF INSURANCE LAW* § 1 (1935) (concluding that although the insurance industry is not completely equated with public utilities, it nevertheless "lingers in that twilight zone that separates public from private business.").

¹¹ See Tobriner & Grodin, *The Individual and the Public Service Enterprise in the Industrial State*, 55 CALIF. L. REV. 1247 (1967). The authors state that courts "now impose public obligations upon private undertakings [including insurers] in order to protect the individual from the economically more powerful enterprises." *Id.* at 1265. The courts' strongest argument in favor of this imposition is that, by virtue of its "public service" nature, the insurer has a duty "to render such performance as fulfills the reasonable expectation of the other party." *Id.* at 1266.

¹² See W. SHERNOFF, *supra* note 1, § 1.07 [1], [2] for a discussion of the historical extension of extra-contractual liability into the area of tort.

adhesion contract analysis in distinguishing the insurance agreement from an ordinary consensual arrangement negotiated at arms length.¹³ Indeed the almost universally recognized principle that insurance contracts are strictly construed against the insurance company and in favor of the insured,¹⁴ is a by-product of the adhesion nature of the agreement that fuels the "bad faith" fires currently raging across the nation.

Fourth, and finally, a related, but nonetheless distinct, acknowledgement of the fiduciary responsibilities of the insurer (particularly the liability insurance carrier) has served as a vehicle for imposing extra-contractual responsibilities on insurers and has resulted in corresponding extra-contractual recoveries by insureds.¹⁵

To these traditional policy justifications for imposing additional liability and responsibility upon insurers must be added the statutory and regulatory framework of consumer protection laws enacted by the various states, including the Unfair Claim Settlement Practices Act recommended by the Council of State Insurance Commissioners.¹⁶ A number of jurisdictions now recognize direct liability of insurers for a violation of these statutes or reg-

¹³ See generally *id.* § 1.03 and cases cited therein; see also *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165 (Tex. 1987) (holding that the "special relationship" necessary for the duty of good faith and fair dealing "arises out of the parties' unequal bargaining power and the nature of insurance contracts which would allow unscrupulous insurers to take advantage of their insureds' misfortunes in bargaining for settlement or resolution of claims.").

¹⁴ See, e.g., *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, 267, 419 P.2d 168, 171, 54 Cal. Rptr. 104, 107 (1966); *Healy Tibbets Constr. Co. v. Employers' Surplus Lines Ins. Co.*, 72 Cal. App. 3d 741, 749, 140 Cal. Rptr. 375, 379 (1977).

¹⁵ See *W. SHERNOFF*, *supra* note 1, § 1.05. Historically, courts have failed to find a level of trust between insurer and insured sufficient to establish a fiduciary trust. 2A G. COUCH, *COUCH ON INSURANCE* 2D § 23.11 (1960). However, courts have recently begun recognizing a fiduciary relationship between insurer and insured. See, e.g., *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 598 P.2d 452, 169 Cal. Rptr. 482 (1979), *cert. denied*, 445 U.S. 912 (1980) (punitive damages justified when insurers hold themselves out as fiduciaries); see also *Spindle v. Chubb/Pacific Indem. Group*, 89 Cal. App. 3d 706, 152 Cal. Rptr. 776 (1979) (insurer's duty of good faith is "fiduciary in nature").

¹⁶ Most states have adopted statutory schemes which prohibit unfair claims settlement practices. Langdon & Sytsma, *supra* note 2, at 314; see, e.g., Unfair Claim Settlement Practices Act, TEX. INS. CODE ANN. art. 21.21-2 (Vernon 1981).

ulations enacted thereunder.¹⁷ Most jurisdictions hold that the existence of such statutes and regulations does not preclude common law claims.¹⁸

Texas is a recent example of a jurisdiction which has straddled this issue. The Texas Insurance Code¹⁹ provides a private right of action against an insurer who violates any regulation promulgated pursuant to the statute or violates the contemporaneously enacted Deceptive Trade Practices-Consumer Protection Act.²⁰ This statute provides for recovery of treble damages from insurers who knowingly violate its provisions.²¹ Texas has not yet absolutely recognized a private right of action for an insurer's violation of the Unfair Claim Settlement Practices Act.²² Texas has recognized a carrier's potential private liability for repeated violations of the Unfair Claim Settlement Practices Act where carriers "commit or perform [such acts] with such frequency as to indicate a general business practice."²³

The latter recognition of a private cause of action for regular violations of the insurance regulations has the effect of putting in issue, in every case, the results and practices of the insurer in otherwise unrelated cases.

¹⁷ See, e.g., *Royal Globe Ins. Co. v. Superior Court*, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 842 (1979) (California Supreme Court expressly held that the violation of the state's unfair claim settlement statute gave rise to a private cause of action); *Klaudt v. Flink*, 202 Mont. 247, 658 P.2d 1065 (1983) (unfair claim settlement practices statute does create an obligation running from insurer to the claimant and breach of this duty is the basis for civil action); *Jenkins v. J.C. Penney Casualty Ins. Co.*, 280 S.E.2d 252 (W. Va. 1981) (West Virginia Supreme Court held that the state's unfair claim practices statute creates an implied private cause of action). See generally W. SHERNOFF, *supra* note 1, § 6.04[2](a).

¹⁸ In many jurisdictions, the statute clearly states that it does not preempt rights under common law. See, e.g., CAL. INS. CODE § 790.09 (West 1972); FLA STAT. ANN. § 626.9631 (West 1984). The Arkansas Supreme Court has confirmed that the existence of unfair claim practices statute does not preempt the common law tort action for bad faith. *Aetna Casualty & Sur. Co. v. Broadway Arms Corp.*, 281 Ark. 128, 664 S.W.2d 463, 465 (1984). See generally W. SHERNOFF, *supra* note 1, § 6.04[4].

¹⁹ TEX. INS. CODE ANN. art. 21.21 § 16 (Vernon Supp. 1988).

²⁰ TEX. INS. CODE ANN. art. 17.41-.826 (Vernon 1987).

²¹ *Id.* art. 17.50.

²² TEX. INS. CODE ANN. art. 21.21-2 (Vernon Supp. 1981).

²³ *Chitsey v. National Lloyds Ins. Co.*, 738 S.W.2d 641, 643 (Tex. 1987).

Moreover, the insurance practitioner may seriously question the legal significance of distinguishing in front of a jury an isolated act of bad faith from a regular course of dealing. For example, how is an insurance manager, supervisor or representative to respond to a question regarding treatment of a particular insured when asked whether this insured was treated in the same manner that the insurer always deals with its insureds or whether this particular insured was singled out for mistreatment and mishandling? The adverse risks of responding to that question are evident. The avoidance of that risk is virtually impossible.

With the foregoing justifications and articulated policy concerns in mind, a review of the recent developments in bad faith claims handling litigation is appropriate.

III. BAD FAITH ACTIONS IN PRACTICE

In the course of reviewing the myriad of cases from many jurisdictions, as well as the various treatises, one is immediately struck with the recurrence of the particular conduct that supplies a basis for the imposition of liability both under and beyond the insurer's contractual undertaking. These conduct themes overlap or manifest themselves repeatedly in the same case. Indeed, the first three recurring conduct patterns that have been utilized to fix liability upon insurers may actually precede the referral of a case by the insurance company to its lawyer. Thus, the industry must be particularly responsive to the early stages of a dispute, either with its insured or a third-party claimant, lest it be too late for an attorney to repair the damage that may later ensue.

First of all, a number of cases have imposed liability as a result of either no investigation or inadequate investigation by the insurance company prior to denying a claim or referring it to an attorney.²⁴ These cases arise in both

²⁴ See, e.g., *Ballard v. Ocean Accident & Guar. Co.*, 86 F.2d 449 (7th Cir. 1936) (insurer's failure to interview any of the plaintiff's neighbors before trial indicated a lack of diligence in investigating the claim); *Attleboro Mfg. Co. v. Frankfort*

first-party and liability insurance context.²⁵

Second, is the insurer's manner of evaluating a particular claim with regard to payment or settlement, whether such evaluation is made in connection with a claim by the insured or by a third-party claimant against the insured. Insurers and lawyers who participate in the evaluation process must be sensitive to the possibility that the methodology for evaluation may well be second-guessed after an adverse result in the ultimate trial or handling of the claim at the adjudication stage.²⁶

The third, and perhaps most frequent, source of the insurer's extra-contractual liability is in the arena of settlement. Most jurisdictions have long imposed liability on a liability insurance carrier for failing to settle a claim within the limits of an insurance policy when the insured is ulti-

Marine Accident & Plate Glass Ins. Co., 240 F. 573 (1st Cir. 1917) (employer's insurer negligently conducted the defense of a suit against insured by failing to conduct adequate investigation of the claim). See generally Annotation, *Liability Insurer's Negligence or Bad Faith in Conducting Defense as Ground of Liability to Insured*, 34 A.L.R. 3d 533, §§ 7,9 (1970).

²⁵ See generally Annotation, *supra* note 24, §§ 7,9.

²⁶ See Arnold v. National County Mut. Fire Ins. Co., 725 S.W.2d at 165. In this case the Texas Supreme Court recognized a cause of action for breach of the insurer's duty of good faith and fair dealing where the plaintiff alleged there was no basis for the denial of the claim or delay in payment of the claim. *Id.* at 167. The court found that the plaintiff had produced enough summary judgment proof to raise a material fact that the insurance company knew it lacked a reasonable basis for refusing to pay the claim and nevertheless forced the plaintiff to a trial on the accident before it would pay the claim. *Id.*; see also Gruenberg v. Aetna Ins. Co., 9 Cal. 3d at 566, 510 P.2d at 1032, 108 Cal. Rptr. at 480 (when the insurer unreasonably and in bad faith withholds payment of the claim of its insured, it is subject to tort liability); Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78 (1970) (insurer has an implied-in-law duty of good faith and fair dealing to settle claims against the insured in good faith); Wolfberg v. Prudence Mut. Casualty Co., 98 Ill. App. 2d 190, 240 N.E.2d 176 (1968) (conduct constituting fraud, negligence, or bad faith may make insurer liable for the excess of a judgment over its policy limits); Henke v. Iowa Home Mut. Casualty Co., 250 Iowa 1123, 97 N.W.2d 168 (1959) (court held that rejecting settlement proposals which the insurer knew were reasonable and within the policy limits manifested bad faith toward the insured); Bollinger v. Nuss, 202 Kan. 326, 449 P.2d 502 (1969) (insurer has a duty to consider the interests of its insured in all settlement negotiations and must keep insured informed of all settlement offers received); Boling v. New Amsterdam Casualty Co., 173 Okla. 160, 46 P.2d 916 (1935) (insurer assuming control of claim against insured owes insured duty to act in good faith when settlement offer is made).

mately exposed by settlement or judgment to liability that exceeds the available policy limits.²⁷ While the standards for imposition of such liability may vary by jurisdiction, the jeopardy to insurers and its claims handling personnel (including its lawyers) for failing to achieve a settlement within policy limits or, at least to try, is almost universally recognized.²⁸

Closely related, but only recently enunciated as a basis for recovery, is the liability insurance carrier's obligation to defend in a manner that is suitable and reasonable from the standpoint of the insured. Recently the Texas Supreme Court recognized that the defense counsel retained by the insurance company for the defense of the claim by a third-party is but a sub-agent of the insurance company.²⁹ As a consequence, any defalcation of such chosen defense attorney is an ample justification for visiting tortious liability upon the insurer.³⁰

An additional source of burgeoning liability involves the denial of coverage or a refusal to defend the insured. This often results in some form of settlement or arrangement between the insured and the third-party, which inevitably operates to the significant disadvantage of the insurer on all issues apart from the disputed coverage issue.³¹

²⁷ *G.A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d at 544. As this case indicates, courts have recognized this extra-contractual liability for many years. *Id.*

²⁸ *See, e.g., Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d 656 (Tex. 1987) (court held that insurer was negligent for failing to settle claim within policy limits where there was evidence that the insurer failed to advise the insured of any settlement offer and failed to offer policy limits despite awareness that a jury verdict would likely exceed policy limits). *See generally* Annotation, *supra* note 24; Annotation, *Recoverability of Punitive Damages in Action By Insured Against Liability Insurer For Failure to Settle Claim Against Insured*, 85 A.L.R.3d 1211 (1978).

²⁹ *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d at 658.

³⁰ *Id.*

³¹ *See, e.g., Dairyland Ins. Co. v. Hawkins*, 292 F. Supp. 947 (S.D. Iowa 1968) (Iowa applies bad faith test to cases where insurer wrongfully refused to defend and refuses to settle within policy limits); *American Fidelity Fire Ins. Co. v. Johnson*, 177 So. 2d 679 (Fla. Distr. Ct. App. 1965), *cert. denied*, 183 So. 2d 835 (Fla. 1966) (liability insurance carrier which defends insured and in bad faith refuses to settle the claim subjects itself to liability for amount of judgment over policy lim-

Similarly, an insurance company's cancellation or non-renewal of a policy has been another source of bad faith claims. This type of claim arises particularly in those states with statutes requiring sufficient notice and/or cause for cancellation or non-renewal, despite any conflicting policy provisions that would otherwise protect the insurer.³²

Even the initial placement of insurance may subject the insurer to liability if the particular type of insurance sought by the insured is either erroneously not obtained or is improperly obtained.³³ The acts of agents, such as local recording agents, who have binding authority for particular insurers may subject the insurer to liability.³⁴

An overriding and recurrent theme for imposing extracontractual liability on insurers or their agents in performing, or failing to perform, any of the previously mentioned conduct is the concept of timeliness and diligence.³⁵ In recent years, astute plaintiffs' attorneys have made time-related demands that whether because of industry inertia or simple procrastination have not been met by the insurer and later result in disastrous consequences.³⁶ Similarly, in first-party cases the untimeliness of evaluation or the failure to offer sufficient funds to

its). See generally Annotation, *Insurer's Tort Liability for Consequential or Punitive Damages for Wrongful Failure or Refusal to Defend Insured*, 20 A.L.R.4th 23 (1983).

³² See, e.g., *Spindle v. Travelers Ins. Co.*, 66 Cal. App. 3d 951, 136 Cal. Rptr. 404 (1977) (cancellation provision in a medical malpractice policy is subject to the covenant of good faith and fair dealing). But see *Gautreau v. Southern Farm Bureau Casualty Ins. Co.*, 429 So. 2d 866 (La. 1983) (when an insurer includes in a policy the option not to renew the insurer can decline to renew with or without cause). See generally W. SHERNOFF, *supra* note 1, § 330 n.3.

³³ *Royal Globe Ins. Co. v. Bar Consultants, Inc.*, 577 S.W.2d 688 (Tex. 1979) (insurer held liable for policy coverage where insured relied on misrepresentations made by the local recording agent that the policy covered any loss caused by vandalism when in actuality the policy did not cover such losses).

³⁴ *Id.*

³⁵ See *Hayes Bros., Inc. v. Economy Fire & Casualty Co.*, 634 F.2d 1119 (8th Cir. 1980) (insurer acts in bad faith by failing to settle the insured's claim); *Allstate Ins. Co. v. Kelly*, 680 S.W.2d 595 (Tex. App. 1984) (exemplary damages awarded to insured for insurer's failure to settle claim within policy limits).

³⁶ See, e.g., *Hayes Bros., Inc. v. Economy Fire & Casualty Co.*, 634 F.2d at 1119; *Allstate Ins. Co. v. Kelly*, 680 S.W.2d at 595.

achieve settlement have resulted in insurer liability for consequential economic damages for the perceived improprieties associated with bad faith performance of the insurance agreement. A recent lament sounded by a federal judge in Idaho is that bad faith almost always involves the insurer's state of mind, and, thus, is particularly insusceptible to disposition without full development by trial.³⁷ The jeopardy presented by trial of a bad faith claim is well documented.³⁸

Apart from the recurring patterns of conduct that have resulted in an insurer's extra-contractual liability as well as the proliferation of claims in that area, is the issue of who can be held liable and what persons and parties are entitled to assert these claims. The obvious initial answer to the first question is that an insurer may be held liable, but that may include an excess insurer or even a reinsurer depending upon the role of each carrier in performing a function pertinent to its insured.³⁹

More threatening perhaps is the recent recognition by some courts of the personal liability of claim representa-

³⁷ *State Farm Fire & Casualty Co. v. Trumble*, 663 F. Supp. 317, 321 (D. Idaho 1987). The court stated, "Bad faith connotes a state of mind, which inherently and nearly always avoids summary dismissal in deference to jury determination." *Id.*

³⁸ See generally *W. SHERNOFF*, *supra* note 1, §§ 7.01-.05, 8.01-.09.

³⁹ See *Pacific Employees Ins. Co. v. United Gen. Ins. Co.*, 664 F. Supp. 1022 (W.D. La. 1987) (primary insurer did not owe a duty to excess insurer to settle the case within the limits of the primary policy solely to avoid exposing excess insurer to liability); *Occidental Fire & Casualty Co. v. Lumbermens Mut. Casualty Co.*, 667 F. Supp. 679 (N.D. Cal. 1987) (a primary insurer who breaches the implied covenant of good faith and fair dealing due to failure to settle the claim within its policy limit when it had an opportunity to do so, cannot recover contribution for the excess from a secondary insurer); *Central Nat'l Ins. Co. v. Prudential Reinsurance Co.*, 196 Cal. App. 3d 342, 241 Cal. Rptr. 773 (1987) (reinsurer is not held liable beyond terms of its contract solely because the original insurer settles the claim in excess of the original contract); *Phoenix Ins. Co. v. United States Fire Ins. Co.*, 189 Cal. App. 3d 1511, 235 Cal. Rptr. 185 (1987) (excess carrier is able to sue a primary carrier for failure to defend or settle); *Firemen's Fund Ins. Co. v. Continental Ins. Co.*, 308 Md. 315, 519 A.2d 202 (1987) (excess insurer had a cause of action against primary insurer for bad faith failure to settle a claim within the policy limits). *Cf. Commercial Union Ins. Co. v. Mission Ins. Co.*, 835 F.2d 587 (5th Cir. 1988) (excess insurer cannot recover from primary insurer based on allegations of bad faith failure to settle a claim within the policy limits when the primary insurer is not presented with a firm settlement offer).

tives or managerial agents of insurers.⁴⁰ The potential exposure cannot be lightly disregarded just because the liability of these particular persons varies from state to state depending upon the justification frequently recognized by a particular state as the basis for imposing liability. Depending upon the standard of liability imposed by a particular jurisdiction, an employee or managerial agent may not be immune from his own tortious conduct merely because he is "following orders." The "following orders" defense to the imposition of an individual claim agent's liability was recently rejected in Texas in *Allstate Insurance Co. v. Kelly*.⁴¹ Other jurisdictions, however, have rejected imposing liability on such individuals by focusing on the insurer, who is the party to the contract and the entity charged with heightened public interest responsibilities.⁴² Nonetheless, it is a sobering development.

The third group of individuals who is exposed to bad faith liability and/or tortious conduct in claims handling is the defense attorney. This is another sobering, but burgeoning, area of exposure to those involved in insurance litigation.⁴³ The magnitude of this risk should not be taken lightly. The author was recently involved in an extensive piece of Texas litigation, which eventually resulted in a settlement payment by the handling defense attorneys (that is, their insurers) of an amount four times greater than that contributed by the insurer who hired them. Thus, the role of the defense lawyer in settlement negotiations and evaluation takes on added significance in the development and prosecution of litigation.

Because of this exposure, the proclivities of defense

⁴⁰ *Allstate Ins. Co. v. Kelly*, 680 S.W.2d at 595.

⁴¹ *Id.*

⁴² See W. SHERNOFF, *supra* note 1, § 6.05[2].

⁴³ See, e.g., *Lysick v. Walcom*, 258 Cal. App. 2d 136, 65 Cal. Rptr. 406 (1968) (attorney appointed by insurer to defend insured, who continued as counsel after discovering conflict of interest between parties, can be held negligent if insured's interests are damaged by the settlement agreement); *Ranger County Mut. Ins. Co. v. Guin*, 723 S.W.2d at 656 (insured's basis for claim against insurer for negligent failure to settle a claim within policy limits extends to insurer's duty to prepare for trial).

counsel to protect themselves by advising and recommending settlement at levels unacceptable to the insurer, and consequently documenting the file, only increases the risk to the insurer in the event of an adverse litigation result. Moreover, the role of the defense lawyer in attempting to represent an insured in a situation in which there are manifest conflicts of interest between the insurer and insured has resulted in startling new duties and responsibilities.⁴⁴ Coupled with an already increasing trend in the legal malpractice arena, more and more jurisdictions have recognized the absolute liability of attorneys in cases where attorneys represent conflicting interests.⁴⁵ In addition, the canons of legal ethics of both the American Bar Association and most states which govern the legal profession recognize the insurance area as a case of inherent (or apparent) conflict of interest.⁴⁶

Finally, another source of liability may be found in the form of insurance agents and brokers whose errors and omissions may be visited upon insurance carriers not only through the common law, but through the application of various states' consumer protection statutes.⁴⁷ This is a particularly troublesome arena of responsibility in cases where there are denials of coverage or claimed applicability of exclusions.

It is not just the number of classes of defendants that is expanding, but also the classes of plaintiffs seeking extra-contractual recovery. In those jurisdictions that recognize a cause of action for bad faith or the like, the insured or the insured's assignees have generally been held entitled

⁴⁴ See *Tank v. State Farm Fire & Casualty Co.*, 105 Wash. 2d 381, 715 P.2d 1133 (1986) (defense counsel owes a duty of full and ongoing disclosure to insured when retained by insurer to defend insured).

⁴⁵ See generally Annotation, *Malpractice: Liability of Attorney Representing Conflicting Interests*, 28 A.L.R.3d 389 (1969).

⁴⁶ MODEL RULES OF PROFESSIONAL CONDUCT Rule 1.7 comment (1983) ("When . . . the insurer is required to provide special counsel for the insured, the arrangement should assure the special counsel's professional independence.").

⁴⁷ See, e.g., *Allstate Ins. Co. v. Kelly*, 680 S.W.2d at 595 (insured entitled to protection under the Texas Deceptive Trade Practices Act). See generally W. SHERNOFF, *supra* note 1, § 6.05[2].

to prosecute such an action.⁴⁸ Now excess insurers and re-insurers have joined the fray against primary carriers. This occurs particularly in liability situations where extra-contractual damages are sought against the primary carrier or its agents for failing to achieve settlement or to investigate or evaluate claims so that a settlement might be achieved within policy limits.⁴⁹ Most jurisdictions that have recognized the existence of such a cause of action in favor of re-insurers or excess insurers have based liability on a concept of equitable subrogation to the rights of the insured.⁵⁰ This is a growing trend evidenced by the number of cases that have made their way into the litigation process and is of particular significance in fields, such as aviation insurance, which are heavily reinsured in foreign markets.⁵¹

Most jurisdictions have not taken the extra step of recognizing the right of a judgment creditor, either as a claimed third-party beneficiary or otherwise, to sue directly for the fruits of an excess judgment. However, the seeds of such liability expansion have been planted in jurisdictions such as Texas because the insurance codes frequently do not limit the right to sue only to the insurance consumer.⁵²

Perhaps the most divergent concept in the bad faith arena is the standard of liability utilized to impose extra-contractual consequences upon an insurer, its agents or representatives. The standard most recently articulated emanates from California and imposes a duty of good

⁴⁸ Annotation, *Insured's Payment of Excess Judgment, or a Portion Thereof, as Prerequisites of Recovery Against Liability Insurer for Wrongful Failure to Settle Claim Against Insured*, 63 A.L.R.3d 627 (1975); Annotation, *Liability Insurer's Potential Liability for Failure to Settle Claim Against Insured as Subject to Garnishment by Insured's Judgment Creditors*, 60 A.L.R.3d 1190 (1975).

⁴⁹ See, e.g., *supra* note 39 and cases cited therein.

⁵⁰ See, e.g., *id.*

⁵¹ See, e.g., *id.*

⁵² See, e.g., TEX INS. CODE ANN., art. 21.21, § 16 (Vernon Supp. 1988). See generally G. KORNBLUM, M. KAUFMAN & H. LEVINE, *BAD FAITH PRACTICE GUIDE* §§ 7:243-:260 (1986); W. KILGARLIN, M. KNOX & K. PURCELL, *BAD FAITH PRACTICE GUIDE, TEXAS SUPPLEMENT* §§ 7:243- :259 (1987).

faith and fair dealing upon insurers, both first-party and liability carriers.⁵³ California initiated this approach with a recognition of a quasi-contractual source of such duty that is applicable in all kinds of contractual undertakings.⁵⁴ Other jurisdictions have recognized this duty solely in the insurance context for the policy justifications that have been previously identified, including the public interest character of insurance, the adhesion nature of the agreement and the special relationship or fiduciary responsibility enjoyed by and imposed upon the insurer in a particular set of circumstances.⁵⁵

Classically, the issue of extra-contractual recovery arose in liability insurance cases in which a third party claimant recovers a judgment in excess of policy limits against the insured. Many jurisdictions recognized that an insurer had a right to consider its own interests in deciding whether or not a case should have been settled at or below the insurance limits.⁵⁶ However, these jurisdictions further observed that the insurer had an obligation not to exercise bad faith in its exclusive decision of determining when and whether a settlement occurred.⁵⁷ Other jurisdictions, such as Texas, recognized very early that such liability for extra-contractual consequences could be imposed upon an insurer for ordinary negligence⁵⁸ — a standard generally considered to be a lower standard of

⁵³ *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d at 566, 510 P.2d at 1032, 108 Cal. Rptr. at 480 (insurer must deal fairly and in good faith with insured and failure to do so may result in a cause of action for breach of an implied covenant of good faith and fair dealing).

⁵⁴ *Id.* 510 P.2d at 1040. The court stated that the insurer's duty "arises from a contract relationship existing between the parties." *Id.*

⁵⁵ See, e.g., *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d at 165. See *supra* notes 8-15 and accompanying text for a discussion of the policy justifications for imposing liability on insurers.

⁵⁶ See generally W. SHERNOFF, *supra* note 1, § 3.02.

⁵⁷ *Id.*

⁵⁸ *G.A. Stowers Furniture Co. v. American Indem. Co.*, 15 S.W.2d at 547 (insurer held to standard of care "which an ordinary prudent person would exercise in the management of his own business. . ."); *Highway Ins. Underwriters v. Lufkin-Beaumont Motor Coaches, Inc.*, 215 S.W.2d 904, 927 (Tex. Civ. App. 1948) (standard of conduct to be followed by insurer is due care).

liability than that recognized in the "bad faith" jurisdictions.⁵⁹ While commentators and treatise writers frequently articulate these characterizations of the qualitative difference in the two standards,⁶⁰ most of the courts, in practice, have considered that negligence on the part of an insurance company is probative, if not determinative, of the ultimate issue of bad faith.⁶¹ Thus, the legal jargon that attempts to distinguish between the two doctrines frequently resulting in extra-contractual liability of insurers, or at least have been sufficient to maintain such a claim, is a distinction that has become increasingly ethereal.

Several years ago the California Supreme Court indicated a willingness to go so far as to impose a form of strict liability upon the insurer where there was a failure to settle in derogation of the insured's rights.⁶² However, the *Crisci v. Security Insurance Co.* predisposition for such a result has not materialized and most commentators have generally acknowledged that such a step is probably unnecessary.⁶³ In most cases where claims could have been settled within policy limits and were not, and the insurer incurred excess liability damages, the insureds have successfully tried and/or settled their extra-contractual claims without the assistance of any further expansion of the doctrines of insurer responsibility.⁶⁴

There are, however, further potential developments in this area that, rather than being separate and distinct, merely represent the application of an elevated standard

⁵⁹ See generally W. KILGARLIN, M. KNOX & K. PURCELL, *supra* note 52, 7:69.

⁶⁰ See, e.g., W. SHERNOFF, *supra* note 1, §§ 3.03-.04.

⁶¹ See, e.g., *State Farm Mut. Auto. Ins. Co. v. White*, 248 Md. 324, 236 A.2d 269, 273 (1967) (insurer's negligence is relevant in determining whether insurer acted in good faith).

⁶² *Crisci v. Security Ins. Co.*, 66 Cal.2d at 425, 426 P.2d at 173, 58 Cal. Rptr. at 13. The court stated: "there is more than a small amount of elementary justice in a rule that . . . the insurer which may reap the benefits of its determination not to settle, should also suffer the detriment of its decision." *Id.* at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17.

⁶³ W. SHERNOFF, *supra* note 1, § 3.03[2].

⁶⁴ See, e.g., *supra* notes 27-28 and authorities cited therein.

of care that actually derives from the theoretical justifications for the imposition of liability in the first instance. Many jurisdictions recognize the fiduciary character of the insurance policy, both first-party and liability, and the inevitable conflicts of interest that arise between the insurer and the insured in the handling of any particular piece of litigation.⁶⁵ In traditional fiduciary terms concerning a conflict of interest, courts have generally recognized a duty of utmost good faith and loyalty to the interests of the beneficiary.⁶⁶ It is not uncommon in this area, particularly when issues of self-dealing by a fiduciary are concerned, to impose upon such fiduciary the burden of establishing the fairness of a particular transaction vis-à-vis the person to whom the fiduciary duty is owed.⁶⁷ Thus, in the insurer/insured area it is not unforeseeable that the courts may ultimately and effectively place the burden of proving the fairness and good faith in *not* settling a particular controversy upon the insurer, with the failure to meet that burden resulting in liability for the inevitable and foreseeable consequences of such act (such as the recovery of an excess judgment).

Indeed, many practitioners who defend bad faith and negligent failure to settle cases already inform the insurance company that the burden is on the insurance company to establish the reasonableness and fairness of a decision not to settle. This is because it is obvious that the consequences of failure to settle has resulted in some disaster that the plaintiff will utilize in hindsight to impose upon the insurer an unrealistic ability to presage.

The discussion of bad faith actions in their practical application has thus far focused on the substantive principles that justify the imposition of extra-contractual liability on the insurer. The greatest legal effect of such recoveries, however, is obviously in the area of authoriz-

⁶⁵ See *supra* note 15 and accompanying text.

⁶⁶ See, e.g., *Carnes v. Meador*, 533 S.W.2d 365 (Tex. Civ. App. 1975) (spouse has fiduciary duty to dispose of community property fairly).

⁶⁷ *Id.* at 370.

ing damages that are not available in an ordinary contract action.

First and foremost in the area of recoverable damages in the liability insurance context is the recovery of an excess judgment against an insured.⁶⁸ Courts frequently impose this remedy upon an insurer without regard to the capacity of the insured to pay the excess judgment,⁶⁹ and perhaps even with covenants in effect pursuant to which the insured may not ever have to suffer enforcement of the judgment.⁷⁰ This is the most commonly recognized extra-contractual liability form of damages.⁷¹

The second type of additional damages represents the recovery of mental anguish damages that may be visited upon an insurer both in a liability or in a first-party context.⁷² These damages are specifically related to the consumer expectation justification for imposing bad faith liability.⁷³ It is the peace-of-mind disruption that flows as a foreseeable consequence of the insurer's failure to fulfill the consumer's expectation in regards to the good faith exercise by the insurer of its contractual undertaking. This is a recovery that generally would be unavailable in a pure contractual context. However, California and other jurisdictions have justified recovery based on either a quasi-contractual theory or a recognized element of tor-

⁶⁸ See generally W. SHERNOFF, *supra* note 1, §§ 3.01, 3.07[1],[2].

⁶⁹ See *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 319 P.2d 69 (1957); *Carter v. Pioneer Mut. Casualty Co.*, 67 Ohio St. 2d 146, 423 N.E.2d 188 (1981). But see *Dumas v. Hartford Accident & Indem. Co.*, 92 N.H. 140, 26 A.2d 361 (1942). See generally Annotation, *supra* note 48, 63 A.L.R.3d at 627.

⁷⁰ See generally Annotation, *Value of Insured's Assets as Limitation, in Action by Insured or Insured's Assignee for Liability Insurer's Wrongful Failure to Defend, on Recovery of Amount of Judgment Against Insured in Excess of Policy Amount*, 36 A.L.R.4th 922 (1985).

⁷¹ W. SHERNOFF, *supra* note 1, § 3.07[1],[2].

⁷² *Gruenberg v. Aetna Ins. Co.*, 9 Cal. 3d at 566, 510 P.2d at 1032, 108 Cal. Rptr. at 480 (damages for mental anguish recoverable); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d at 165 (damages for mental anguish and exemplary damages recoverable); see also W. SHERNOFF, *supra* note 1, § 7.04[2]; G. KORNBLUM, M. KAUFMAN & H. LEVINE, *supra* note 52, §§ 11:42-:84; Annotation, *supra* note 31, at 50-51.

⁷³ W. SHERNOFF, *supra* note 1, §§ 3.07[4], 7.04[2](a).

tious recovery.⁷⁴

Third, and of equal impact, are the growing number of cases recognizing the recoverability of damages to an insured's credit reputation that inevitably result when an insured is cast in judgment or incurs debt as a result of non-satisfaction of a first-party insurance claim.⁷⁵ In such cases a growing element of recovery has been damage to credit reputation, or even actual loss of profits as a result of delays in payment (particularly in the first-party area).

Fourth, a recent case in California illustrates the imaginative approach that some lawyers, representing aggrieved insureds, have taken in the bad faith area. In a liability insurance context, an insured sued its insurer for damages to the goodwill of the insured resulting from allegedly unreasonable delays in satisfying third party claims made against the insured and its carrier.⁷⁶ This is a form of consequential economic damage that is separate, above, and maybe in addition to, the actual payment of all that is due under the policy.⁷⁷ Because of the overlay of untimeliness and lack of concern for the insured's interest, courts are beginning to authorize such additional actual damages.

Finally, there is a growing trend toward permitting recovery of exemplary damages against an insurer in a bad faith action.⁷⁸ In addition to the well-publicized Califor-

⁷⁴ See *supra* note 72 for a list of cases discussing damages for emotional distress.

⁷⁵ See, e.g., *Mead v. Johnson Group, Inc.*, 615 S.W.2d 685, 687 (Tex. 1981) (holding that actual damages may include consequential damages for loss of credit). See generally *W. KILGARLIN, M. KNOX & K. PURCELL, supra* note 52, at 11:55.

⁷⁶ *Bodenhamer v. Superior Court*, 189 Cal. App. 3d 976, 234 Cal. Rptr. 712 (1987). The insurer issued to the insured, a jewelry store, a special business owner's policy covering business interruption loss and claims asserted against the insured by third parties. *Id.* 234 Cal. Rptr. at 713. The customer of the insured complained that they had "ill feelings" toward the insured because of a fifteen month delay in payment of insurance proceeds following robbery of the store. *Id.*

⁷⁷ *Id.* 234 Cal. Rptr. at 716. The court wrote, "The express term of the liability contract is to pay claims of third parties where the insurer is liable. An implied promise is to process the claims in a manner which will not injure the insured, which in this case includes injury to the business." *Id.*

⁷⁸ See generally Annotation, *supra* note 28; *W. SHERNOFF, supra* note 1, §§ 8.01-09.

nia cases awarding enormous punitive damages, the author is personally aware of punitive damage awards of ten million dollars against first-party insurance carriers for delay in payment of a claim of only twenty thousand dollars. Recently a court imposed fifteen million dollars in punitive damages against a Texas insurer in a case brought by a corporate insured.⁷⁹ The potential for astronomical liability in these cases, while perhaps representing the exception rather than the rule, cannot go unobserved or undefended by the industry and handling counsel.

The recoverability of exemplary damages, however, is frequently dependent upon the characterization of the insurer's conduct and liability as sounding in tort.⁸⁰ Therefore, the legal characterization of the responsibilities of the insurer as contractual or tortious has an increasing significance in the handling and assessment of this type of litigation.

IV. THE SIGNIFICANCE OF CHARACTERIZATION — TORT, CONTRACT, STATUTORY

As illustrated in the previous discussion of the recoverability of exemplary damages, the characterization of the nature of the action against the insurer may be dispositive in a particular case. Such characterization, however, may also be outcome-determinative in a context other than simple recovery of exemplary damages or the extent of particular damage liability.

Surprisingly, most commentators and observers in the bad faith area have essentially treated as irrelevant the question of whether the duty of good faith and fair dealing is imposed by common law principles under the guise of traditional contract or tort principles.⁸¹ To the contrary, the author believes that this characterization may be

⁷⁹ See generally W. SHERNOFF, *supra* note 1, § 8.05[2], [3] for a discussion of the relationship between punitive and actual damages.

⁸⁰ See generally *id.* § 8.03.

⁸¹ See W. SHERNOFF, *supra* note 1, §§ 7.03, 8.03.

altogether important in areas other than simply the recovery of extra-contractual damages and in defining the scope of such recoveries.

Several recent cases illustrate this concern. The threshold issue is the jurisdiction of a particular state over the acts or conduct of an insurer concerning the maintenance of a bad faith claim. A recent case in Arizona is illustrative of a jurisdictional determination adverse to the insured who had suffered an automobile accident in the state of Arizona.⁸² The third-party involved in that accident brought suit in Arizona, and the insured attempted to prosecute his suit for bad faith against his home state insurance company which wrote and issued the policy in Tennessee.⁸³ The Arizona Supreme Court rejected the argument that the insurance covered the insured in any state to which the insured might be exposed to liability suit, i.e., a state in which the insured was travelling at the time.⁸⁴ Therefore, the court held that the Tennessee insurer was not amenable to process or suit in that state on the insured's bad faith claim.⁸⁵

Contrast this jurisdictional decision with one from a Connecticut federal court which recently determined that a Scandinavian insurer *was* amenable to process in that state and recognized that the insured's potential liability in any state was foreseeable by the insurer's issuance of the insurance policy.⁸⁶ Thus, the court explicitly rejected the jurisdictional plea of the Scandinavian insurer.⁸⁷ The opinions of these two courts irreconcilably conflict.

⁸² *Batton v. Tennessee Farmers Mut. Ins. Co.*, 153 Ariz. 268, 736 P.2d 2 (1987).

⁸³ *Id.* 736 P.2d at 3-4.

⁸⁴ *Id.* at 6-7.

⁸⁵ *Id.* at 8. The court concluded that Arizona lacked sufficient minimum contacts to assert jurisdiction over the Tennessee insurer. *Id.*

⁸⁶ *Teleco Oilfield Servs., Inc. v. Skandia Ins. Co.*, 656 F. Supp. 753, 758 (D. Conn. 1987). The court held that the insurer's alleged tortious conduct occurred in Connecticut because the insurer was required to pay claims under the policy in Connecticut, and therefore failure to pay such claim is deemed to have occurred in Connecticut. *Id.* at 757. In addition, the insurer was to send an explanation for denying payment to Connecticut. *Id.* Finally, any misrepresentation by the insurer would occur in communications received by the insured in Connecticut. *Id.*

⁸⁷ *Id.*

This is a new issue, however, particularly in the area of aviation insurance. The question of amenability of foreign reinsurers of underwriters is one that may well plague the aviation insurance industry, as well as potential claimants, in the future.

Closely connected to the jurisdiction question is the question of characterization of the basis for liability. If the claim is characterized as a tort, the particular "tortious wrong" may be sufficient to assert jurisdiction upon the carrier in the particular jurisdiction in which the "bad faith" caused injury or damage. It must be recognized, however, that there may be multi-state, or even multi-national contacts by any particular liability or first-party insurer that are highly fortuitous. These contacts may well give rise to jurisdictional defenses by the insurers and jurisdictional assertions by insureds or their assignees.

Similarly, reference to the characterization of the particular conduct in issue as being tortious or contractual may determine the questions of which parties one may sue or whether such parties are amenable to service of process. Consider the earlier discussion about the liability of a particular claims representative or managerial supervisor.⁸⁸ This person may not have set foot in a particular jurisdiction, but may have called the shots on evaluating or settling a claim pending in that jurisdiction. The characterization of the cause of action as one sounding in tort or contract may determine that party's amenability to process, as well as legal responsibility. The same determination applies with regard to the liability both for and of attorneys representing the insurance companies,⁸⁹ who may have an office (and be admitted to practice) in any jurisdiction other than the one in which either the injury occurs or the suit is brought.

A third issue relates to the propriety of party plaintiffs and the question of the assignability of a particular claim. While most jurisdictions recognize the assignability of

⁸⁸ See *supra* notes 40-42 and accompanying text.

⁸⁹ See *supra* notes 43-46 and accompanying text.

contractual claims,⁹⁰ some jurisdictions delimit the assignability of tort claims.⁹¹ Thus, plaintiffs must be wary that how and where a cause of action arises or can be asserted may determine the effectiveness of an insured's assignment of a claim.

The question of limitations will also vary depending upon the characterization of the action as contractual or tortious. The initial characterization may govern the availability and applicability of a particular limitations defense, which, in general, would be a limitation statute applied by the state where suit is filed, assuming that the defendants are amenable to process in that state. To the extent a particular state, such as Texas, recognizes a statutory cause of action arising under its particular insurance statutes, the limitations provisions of that statute may well be carried forward by the assertion of that claim in another jurisdiction, thereby becoming a part of the substantive rights involved in the particular cause of action.⁹² Of course, the aviation industry for years has focused upon, and dealt with, these questions in the context of wrongful death statutes and determination of whether the particular limitations provision of a statute is substantive or procedural and remedial or prescriptive.⁹³

As noted earlier, the particular damages that are recoverable may depend upon whether the action sounds in tort or in contract may thus be outcome-determinative, particularly in the area of exemplary damages.

The most significant, but as yet unarticulated issue in the bad faith area, is the significance of characterization of the claim against insurers in determination of the choice of law involved in applying the substantive principles that control the progress and outcome of the litigation. Too

⁹⁰ See generally M. KORNBLUM, M. KAUFMANN & H. LEVINE, *supra* note 52, §§ 1.11, 7.216.

⁹¹ *Id.*; see, e.g., *Murphy v. Allstate Ins. Co.*, 17 Cal. 3d 937, 553 P.2d 284, 132 Cal. Rptr. 424 (1976) (damages for emotional distress not assignable).

⁹² See generally R. LEFLAR, *AMERICAN CONFLICTS LAW* § 81 (1959).

⁹³ See generally Kinzy, *Current Aviation Decisions in Conflicts of Laws*, 41 J. AIR L. & COM. 311, 323-26 (1975).

often, lawyers parochially review a case that is filed in their jurisdiction as being controlled by their own jurisdiction without identifying other jurisdictions that may have an arguably superior interest in the determination of a particular issue. Some lawyers never give any meaningful consideration to this threshold and fundamentally important question.

For instance, in a case involving a California insurer defending a particular claim and making settlement and evaluation decisions in California that affect a piece of Texas litigation, it may well behoove the Texas bad faith plaintiff, who is also a California insured, to sue in Texas, but seek the application of California legal principles with regards to substantive liability.

In crafting an analytical approach to these issues, the characterization of the action is all-important in influencing the choice of law determination. Many jurisdictions that have recognized the more modern RESTATEMENT approach of most significant contacts or center of gravity⁹⁴ nonetheless adhere to the more archaic principles for determining choice of law if the issue to be determined is characterized as sounding in contract.⁹⁵ The options available if this characterization prevails may be the place the parties made the contract or the place of performance of the contract.⁹⁶ In a liability insurance context the place of performance may well be the state where the defense of the action was undertaken. On the other hand, even in a traditional conflicts analysis of the law of the place of the wrong (if a tort characterization prevails) involving an out-of-state insured (which is frequently the case in the context of products liability cases), then it does not necessarily follow that the place of the wrong is the place where the product failed. It may well be that in the bad faith

⁹⁴ RESTATEMENT (SECOND) CONFLICT OF LAWS § 188(1)(1971). In absence of a choice of law clause in the contract, the law applied is that of the state which "has the most significant relationship to the transaction and the parties" *Id.*

⁹⁵ Annotation, *Conflict of Laws As to Elements and Measure of Damages Recoverable for Breach of Contract*, 50 A.L.R.2d 227 § 2(a) (1956).

⁹⁶ *Id.* § 3(a).

cause of action, the place of the wrong analysis would be where the insured suffered economic effects of the mishandling of the litigation rather than where liability is initially incurred.

There is of course a predisposition by the forums entertaining these actions to apply their own law when possible and, in fact, to engraft public policy exceptions to the application of another state's law if such application would adversely affect the policy interest of the forum.⁹⁷ But these are all factors which require the careful practitioner to scrutinize the totality of the relationship between the insurer and the insured, including the incident requiring the invocation of the insurance coverage and even the slightest of the various contacts involved in processing the particular decisions. These are all factors that, if ignored, may well lead to further disaster by the handling attorney (representing either the plaintiff or the defendant) or at least to missing a golden opportunity to apply different legal principles, which could be advantageous to the assertion or defense of a bad faith claim.

This author was appalled to find that while there were three cases in 1987 which dealt with these issues,⁹⁸ none of the recognized commentators discussed these concerns. This all-too-neglected substantive area of the law may be dispositive in any particular bad faith case. The author postulates no solutions to these problem areas, but merely suggests that an analytical framework must be fashioned by the bad faith claim litigator that accounts for the existence and potential of interstate factors that work both to potential advantage and disadvantage as a factor in assessing litigation risk.

V. CONFLICTING INTEREST PROBLEM AREAS

In reviewing more than three hundred cases in the bad

⁹⁷ R. LEFLAR, *supra* note 92.

⁹⁸ *Teleco Oilfield Servs., Inc. v. Skandia Ins. Co.*, 656 F. Supp. at 753; *Home Ins. Co. v. Service Am. Corp.*, 654 F. Supp. 157 (N.D. Ill. 1987); *Batton v. Tennessee Farmers Mut. Ins. Co.*, 153 Ariz. at 268, 736 P.2d at 2.

faith area, the author has discerned that one of the overriding, though frequently and insufficiently articulated, concerns expressed by the courts (and almost universally recognized by juries) is the problem of conflicting interests between the insurer and the insured. These conflicts may be heightened by the added conflict between the lawyer hired by the insurer for the insured and the interests of the hiring insurer.⁹⁹ The greatest conflict of interest area lies with the representation by attorneys who insufficiently disclose these conflicting interests to their clients—the insured. Perhaps the most common conflict of interest situation involves a claim in which there is both a claim that comes within coverage and other asserted claims that are outside coverage.

Courts have often rejected the standard form unilateral reservation of rights by insurers as not being fully responsive to the needs of the insured to understand the limitations that frequently are imposed upon lawyers handling such cases at the behest of the insurer.¹⁰⁰ California has attempted a resolution of these issues in a manner that has been much criticized as unworkable.¹⁰¹ California has required separate employment of counsel for the insured as well as a right of participation in both settlement and conduct of the trial, though the correlative rights between the two sets of lawyers that are hired and both paid by the insurer is somewhat unclear and undeveloped.¹⁰² The state of Washington has recently articulated such a concern in this traditional acceptance of employment by an attorney in a non-waiver or reservation of rights type situ-

⁹⁹ See *Tank v. State Farm Fire & Casualty Co.*, 715 P.2d at 1133.

¹⁰⁰ See generally *W. SHERNOFF*, *supra* note 1, § 3.24[2].

¹⁰¹ *San Diego Navy Fed. Credit Union v. Cumis Ins. Soc'y, Inc.*, 162 Cal. App. 3d 358, 208 Cal. Rptr. 494 (1984). In this case, the insurer reserved its right to deny coverage but agreed to represent the insured on all claims asserted against the insured. *Id.* at 361-62, 208 Cal. Rptr. at 496. The court held that this situation created a conflict of interest, and that in the absence of consent on the part of the insured, the insurer had a duty to provide independent counsel. *Id.* at 375, 208 Cal. Rptr. at 506.

¹⁰² *Id.* 375, 208 Cal. Rptr. at 506.

ation.¹⁰³ One can synthesize the concerns expressed by the courts into the conflict of interest approach that highlights the tendency that is natural (but impermissible) for an insurer to elevate its own interests above its insured's.¹⁰⁴ In such situations Washington has responded by finding an elevated duty on the part of the insurer and its retained counsel to protect and fully inform the insured.¹⁰⁵

The conflicts of interest issue manifests itself more in the settlement area than any other. The simple and single conflict between the insured and the insurer may be that the claim is one which vastly exceeds or might exceed the limits of insurance available to satisfy any particular claim or group of claims. The courts have been particularly sensitive to the interests of the insured in this context, and have demanded that the insured be fully and completely informed as to every facet of the litigation, and particularly with regards to evaluation and settlement.¹⁰⁶ This is simply not routinely done in the industry and following a devastating litigation result or lost settlement opportunity almost inevitably results in the bringing of an extra-contractual liability claim with consequent charges of bad faith or gross negligence.¹⁰⁷ Liability for exemplary damages often follows.

This problem is endemic to the relationship between

¹⁰³ Tank v. State Farm Fire & Casualty Co., 715 P.2d at 1133.

¹⁰⁴ See *id.* 715 P.2d at 1136-1137. See generally W. SHERNOFF, *supra* note 1, § 3.22.

¹⁰⁵ Tank v. State Farm Fire & Casualty Co., 715 P.2d at 1137. The court identified specific criteria which need to be fulfilled for the enhanced obligation to be met. These criteria include thorough investigation of the incident, retention of competent defense counsel for the insured (with a clear understanding that the insured is the only client), full disclosure to the insured of the reservation of rights defense and of the development and progress of the litigation (including all settlement offers). Furthermore, the insurance company must avoid any action which demonstrates greater interest for the insured monetary interest than for the insured's financial risk. *Id.*

¹⁰⁶ *Id.*; see generally W. SHERNOFF, *supra* note 1, § 3.04[3].

¹⁰⁷ Cf. Continental Casualty Co. v. Huizar, 740 S.W.2d 429 (Tex. 1987) (insurer argued that it paid judgment against insured under duress because insured commenced action seeking the payment of policy limits plus extra-contractual liability).

the insurer and insured in which courts and juries perceive the insured (rightly or wrongly) as the disadvantaged party to the transaction. For it is the insurer that is in possession of the policy limits and the information supposedly necessary to evaluate and conclude a claim by settlement. It is also the insurer that is exclusively vested by contract with control of the settlement negotiations. It is this contractual exclusivity that mandates exceptional attention to the interests of the insured to the point of elevating them over the insurer's own interests. Otherwise liability will almost certainly be fixed upon the insurer that proves wrong in its particular settlement evaluation or defense decision.

Overlaying this inherent conflict of interest that arises in the liability insurance context is the heightened conflict of interest problem that depends upon the type of insurance policy that applies to the particular case. For example, the per person/per occurrence policies create significant potential for the insurer to fashion the settlement negotiations in such a way as to shave its responsibility on its per person limit as to certain claims at the expense of the insured rather than considering the settlement of the overall litigation. In those jurisdictions where the standard of care imposed is one of negligence,¹⁰⁸ it is usually the question of whether the insurer exercised the ordinary care a person situated as the insured would exercise for his own protection. Thus, in a situation where a particular policy has policy limits of \$100,000 per person and \$300,000 per occurrence and three people are injured and demand is made by a single claimant's attorney for the entire policy limits, a predisposition of the insurance company to attempt to bicker over one or more of the claims is manifest. However, if one of the injured persons is quadriplegic or brain-damaged (such that excess liability is virtually assured) then applying the standard principles of negligence to rejection of such an offer may

¹⁰⁸ See *supra* notes 58-61 and accompanying text.

well visit liability upon the insurer simply because of the conflict of interest presented by the policy itself.

Even more disastrous may be the consequence of policies that are couched in terms of liability or payment for "ultimate net loss" which subtracts from the available liability limits the amount of fees or claims expense that are incurred. Thus, the longer a case is litigated the more the limits of a particular insurance policy are depleted, such that there is a manifest conflict of interest between the continuance of the litigation and the maintenance of sufficient limits to satisfy any particular claim. This is particularly true in those situations where such policies do not have (as they frequently do not) a supplementary payments provision that would render the carrier liable for interest accruing on any judgment that is rendered. Thus, the maintenance of an appeal or a processing through finality of a claim that has resulted in an excess judgment has the effect of continuously reducing the available limits for the satisfaction of a claim while depositing the money into the coffers of the insurance defense attorney at the arguable expense of the insured. It is unlikely that such manifest conflicts of interest will be treated lightly by an ensuing jury determination of bad faith or gross negligence.

An even greater problem is presented by policies that are cast in terms of aggregate limits, which are "claims-made" policies. There the significant item that the industry and defense lawyers almost universally overlook in a particular case is the determination of the total amount of claim exposure insofar as assessing the available amounts for settlement of any particular claim. The premature exhaustion of aggregate limits to the detriment of the insured may also visit liability upon the liability insurance carrier. It is not infrequent that, as a result of all of the claims that have been made during a given policy year, such claims are settled on an individual basis without regard to the overall impact on the aggregate coverage

available to the particular insured. Worse yet, the insured is seldom informed of this plight.

It has been the author's experience that the handling lawyers on "claims-made" policies generally do not even know of the existence of other claims, let alone the relative exposure of the insured to such other claims insofar as the assessment of the availability of particular proceeds for the application to a particular loss. This again presents an inherent conflict of interest that would at least require disclosure to the insured. It is in the disclosure area that the courts most often seek solace in visiting liability upon insurers, their agents, representatives and counsel.

Finally, there are many insurance policies with large retentions or deductibles that require the approval of an insured for settlement use. This is used as a shield by insurers or defense lawyers to the obligation to attempt to settle any particular piece of litigation. Again, full disclosure is the requirement in any conflicting interest situation—full and educated disclosure—so that the insured can have sufficient information to protect itself adequately when trying to make decisions.

A recently reported imaginative settlement arrangement was litigated in which the entire problem of a deductible was undercut by an agreement between an insured, a primary carrier and a claimant. The \$250,000.00 deductible was essentially wrapped into a settlement proposal wherein the insurer advanced its \$460,000.00-plus limits in return for an acknowledgement by the claimant of satisfaction of the first \$750,000.00 of liability on the part of the insured.¹⁰⁹ The insured made demand upon the excess carrier, who in turn requested the \$250,000 deductible contribution from the insured.¹¹⁰ In response to that demand the insured refused and

¹⁰⁹ *Kelley Co. v. Central Nat'l Ins. Co.*, 662 F. Supp. 1284 (E.D. Wis. 1987) (settlement agreement freed insured from paying deductible to excess insurer).

¹¹⁰ *Id.* at 1285.

sought a declaratory judgment.¹¹¹ It was then determined that the self-insured risk, i.e., the deductible, had already been settled and disposed of by the insured (despite the failure to pay any funds) and all liability for the additional agreed settlement amount was imposed upon the excess carrier.¹¹² Such an innovative settlement tool by both the claimant and a particular insured may well operate, as is obviously the case, to the disadvantage of the upline carrier. Indeed, such arrangement may also profit the primary carrier.

VI. TAKING ADVANTAGE OF THE CONFLICTS—
AGGRESSIVE PLAINTIFF STRATEGIES AND TACTICS
IN THE SETTLEMENT ARENA

This heading amply identifies the posture of the author in the prosecution of bad faith actions. However, the lesson that must be learned by both sides of the docket is to be attuned to imaginative efforts to add to that body of already existing law in the bad faith area or to move the courts further down the road in the direction of imposing liability where none exists by contract. The key to aggressive plaintiff strategies in the settlement of claims against insureds that may then give rise to ensuing bad faith or extra-contractual responsibility on insurers is understanding the role that conflicts of interest play in influencing subsequent fact finders, as well as subsequent courts of law. The fashioning of settlement offers to emphasize or highlight the conflicting interests in a particular context can be the critical difference in the bottom line determination of an insurer's ultimate liability beyond its policy, be it a first-party or liability insurance case.

Similarly, the responsiveness and attentiveness of the insurer to such offers require perhaps even greater imagination in avoidance of conflicts which are both inherent to the insurer/insured relationship and prevalent in the in-

¹¹¹ *Id.*

¹¹² *Id.* at 1290.

surance industry practices. But a sensitivity to this problem and an attempt to address it will go a long way towards reducing the insurer's exposure to the later made extra-contractual liability claims by the insured or the insured's assignee. An appreciation of these concerns is as essential to estimating the potential liability insurers face as is good underwriting practice in undertaking the insurance risk. An appreciation of the consequences of not adequately responding to the needs of the insured must be brought home to defense counsel as well, so that they can assist in the process rather than becoming a hindrance to its execution. Kneejerk rejections of imaginative and unusual settlement proposals may prove more costly in the long run than acceptance (or, at least, further negotiation).