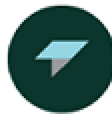
“We Have to Do THAT For Our Insureds?”

~ A Bad Faith Memoir



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Introduction

I once attended a seminar at which an insurance company claims executive, who had the aspirations and talent to perform stand-up comedy pleaded with the audience: "Please don't assume that the insurance company conduct you're seeing is bad faith. It's probably just stupidity." While clearly intended to get a laugh (and it did), the speaker simultaneously raised and missed a good point. Under the law of most states, evil intent on the part of an insurance company – the "being bad" part of "bad faith," is not really required. Indeed, oftentimes mere delay, whether caused by malfeasance, nonfeasance, bad training, systemic flaws or even stupidity, is probably enough to expose a company to bad faith claims or damages and are often the functional equivalent of a decision to treat the insured badly. It is therefore dangerous to assume that, merely because a company's employees mean well, bad faith exposure has been eliminated. To the contrary, as court dockets and industry periodicals nationwide reveal every day, bad faith is alive and well and, like most litigation, today involves ever-increasing amounts of money. Bad faith is not an exposure any insurer can or should take lightly.

This overview is intended merely to identify some of the key factors that give rise to bad faith claims – the legal source of such claims, the company conduct that seems repeatedly to lead to them and the strategies and practical steps that can be taken to mitigate the risk of bad faith. It is also intended to complement the panel discussion on this subject, which will focus on the practical and strategic steps for avoiding bad faith and on certain aspects of the trial of a bad faith case. This paper is not a discussion of the law of any particular state and, for that reason alone, should not be relied upon for ultimate guidance with respect to any particular jurisdiction or case. The complexities of differing state statutes and case law make oversimplification of bad faith law in the United States, while easy and enticing, a very slippery slope. Indeed, it is just that kind of shortcut that will often cause a company to find itself enmeshed in a bad faith claim.

Sources of Bad Faith

In the various states, bad faith law typically will have more than one source. They are not, however, all the same. In Illinois for example, bad faith is known as "unreasonable and vexatious delay" and is governed by statute as interpreted and applied by the court. Other states have no statute but, based on the same view of the obligation of good faith implied in insurance and other contracts, have developed a strong common law tradition of bad faith law. Several states have a common law tradition that has been codified into statute, leading to still more and sometimes different court treatment than preceded the statute, due, in part, to the rules of construction applicable to legislation than to parsing the facts of a case and the wording of old court opinions.

Never assume that yesterday's bad faith case in another jurisdiction is good guidance for defending such a claim in the state you find yourself in today. The rights of the insured and the corollary obligations of an insurer do indeed differ from state to state and mundane issues such as the length of time, if any, in which claims must be answered, the requirements for communications with an insured, the obligations to settle, the proper practice when confronted by a conflict of interest and the need, if any, to file declaratory judgment lawsuits when denying coverage or reserving rights, are treated in very nuanced and different ways by the courts of the various states.

With these disclaimers in mind, it is hoped that this brief paper will help identify many of the crucial issues to be considered in effectively handling claims so as to avoid bad faith and to offer some specific strategies for minimizing that risk.

General Duties of Good Faith

It is well and generally accepted that insurance companies owe their insureds the duty of good faith. Precisely what that means is not as easily summarized. It would not be too simplistic

to suggest, however, that insurer typically will be increasing the likelihood of being found to have breached its duty of good faith if it fails to reasonably investigate, evaluate and negotiate the claim (and defend it if it is a third-party claim and there is at least the potential for coverage based on, at minimum, the allegations of the complaint), if it fails to indemnify its insured if there is coverage or if it fails to reasonably and effectively communicate with its insured throughout the time the claim remains open.

Breach of the duty to investigate is not the most common cause of bad faith claims against insurers. Nevertheless, it may come into play when an insurer clearly pre-judges a claim and reaches dubious or simply incorrect conclusions before conducting any meaningful investigation and then failing to view the results of the later investigation with an open mind. In general, an insurer should make certain that its investigation of a claim made under its policy is prompt, is comprehensive and is fair. The investigation should be well documented and the salient facts confirmed. Making decisions either in advance or in contradiction of the investigation may be viewed as a breach of an insurer's good faith obligations and of the duty to investigate.

Fairness is again the watchword with respect to an insurer's duty to evaluate the claim. It is not particularly common for an insurer to suffer from an abject failure to evaluate at all. Rather, it is the alleged taint of bad faith, prejudice or pre-determination that an insurer brings to its evaluation or the flawed methodology used to evaluate that causes problems. In order to adequately fulfill its duty in this regard, an insurer should take conduct an evaluation that is fair, prompt and unbiased. Perhaps most important, it should make certain that it has adequate and in a comprehensive manner considered all material information before denying a claim or deciding on a particularly low value. Its claims positions should be adopted only after full investigation, as noted above, and should be based on specific reasons, facts and policy provisions. Unbiased legal and expert support should be obtained and documented when

needed and appropriate. The claims file should reflect what went into the claim evaluation and offer a reasoned analysis leading to the ultimate conclusion.

One element of good faith that is particularly state sensitive is the duty to negotiate the claim. I recall as a young Illinois lawyer sitting in an informal settlement meeting in Los Angeles. The attorney for the catastrophically injured plaintiff in a lawsuit pending in California made a settlement demand. My client, an Illinois insurance producer, thankfully was not a party to that litigation but had been sued in Illinois by a defendant in the California case. Once the plaintiff's attorney made his demand and exited the room, the defendant's lawyer turned to me and told me that my client's insurer "had" to make an offer and it "had" to be an offer at a certain minimum amount or it would be in bad faith.

What I knew about California law at that time was limited. I did, however, know that sitting in a room in Los Angeles did not make me a California lawyer and did not make my client a California defendant. I somewhat impolitely suggested that the defendants could all do what they want and could then find us back in Illinois where good faith does not require settlement offers simply because a demand has been thrown down.

State statute and common law raise different issues with respect to the duty to negotiate and will almost certainly consider the refusal to negotiate without reason or explanation to be a breach of good faith. Some of the issues that an insurer must consider in each jurisdiction include:

> Is there an obligation to initiate settlement discussions?
>
> If so, does that obligation exist only when liability is "clear?"
>
> Is there a danger of bad faith is an insurer makes an "unreasonably" low settlement offer? Does this differ in depending on whether it is a first or third-party claim?
>
> Does an insurer risk bad faith liability if it uses a settlement software system that eliminates judgment?
>
> Are settlement negotiations subject to time deadlines? Can an insurer's obligations be affected by a claimant's or an insured's arbitrary deadline when making a demand?

The negotiation of claims is one of the areas where an abundance of talented and knowledgeable policyholder attorneys wreak havoc for insurance companies. Laying trap after trap designed to create bad faith where none would otherwise exist, these attorneys will often deliberately manipulate the negotiation process, employing ambiguous demands to which there can be no response, insisting on immediate unconditional surrender and doing their utmost to bait the insurer into a stalemate in negotiations. An impasse will be staged so that the insured's attorney can attempt to enrage a jury with stories of the insurer's refusal to pay. Insurers are also set up through the use of deliberately ambiguous demands coupled with arbitrary and short deadlines, correspondence to the wrong people, often corporate executives, failure to use claim numbers, self-serving correspondence, letters that are belligerent and/or indignant or that raise a false sense of urgency. An insurer will be told or led to believe that its "delay" is causing the insured to go out of business and is causing great emotional stress.

Depending on the particular laws of the state in which the claim arises, such tactics can either be a daily nightmare for the insurer or mean practically nothing. What is clear, however, is that negotiation of claims must be done with good faith, however defined within a particular jurisdiction and an insurer needs to understand the rules governing that particularly dangerous exchange. This is an area regularly mined by policyholders and their counsel and insurers are well advised to fully comprehend the rules and to get out ahead of the policyholder in order to control claim negotiations and avoid the obstacle courses created by the policyholder bar.

Another area where bad faith is often found to lurk is with respect to the manner in which insurers communicate with their insureds. As in a Grisham novel, even well-meaning claims professionals can be prone to a certain emotional attachment to the position and interests of their employers. At times, if we are not careful, this can result in what looks like an adversarial relationship between a claimant/policyholder and its insurer. Above perhaps anything else that may be counseled on this subject, it is safe to suggest that **THE CLAIMS FILE SHOULD NOT MAKE IT LOOK LIKE YOU**

CONSIDER YOUR POLICYHOLDER AS AN ADVERSARY TO BE BEATEN AND VANQUISHED!

To the contrary, in order to demonstrate your commitment to good faith dealings with your insured, your communications should be frequent, truthful, thorough, professional and courteous. You should certainly disclose to your insured all benefits, coverages, settlement opportunities, time limits and possible litigation outcomes (e.g., excess) that may apply. When defending an insured in a third-party claim, your file should reflect a partnership with your policyholder. When dealing with a first-party claim, it should demonstrate your honesty, integrity and commitment to service and fairness under a contract that you know and understand better than does your policyholder. Frustration, competition, one-upsmanship, anger and annoyance with your insured have no place in your written or oral communication with anyone or in your file notes. The failure to purge ourselves of an adversary relationship with our insureds offers a surefire path to an angry insured and a bad faith claim, neither of which is particularly helpful or recommended.

The duty to defend is another of the insurer's duty that is fraught with peril. Besides understanding the basics of insurance coverage law in the particular jurisdiction in which the claim arises, careful attention must be paid in third-party claims to the requirements and triggers of the duty to defend. Sometimes it is as easy as the old canard that the duty exists whenever the allegations of the claim even potentially give rise to coverage under the policy but it is often much more complicated than that. For example, while insurers typically know how to look to the named insured when considering its obligations, are there others against whom the claim is made who may be entitled to coverage and/or a defense? Do those others exist because of the terms of the policy, under contract with your insured or otherwise? What precisely must be defended, when must that determination be made and on what "evidence" or facts can it be based? If you know that Jones I not an employee of your insured but it is alleged he is, is he entitled to a defense? When and how must you reserve your rights as to your

policyholder when there are potential coverage defenses? What must the reservation say? What can or should it not say? What if some parts of the claim or certain causes of action alleged are covered and some clearly are not? What does the defense, if any, look like? Are you entitled to recoup your defense fees if you defend under a reservation of rights and it turns out there is no coverage? If so, how do you preserve that right? Can you do so without creating a conflict of interest with your policyholder? Does every reservation of right create a conflict of interest? If not, when? If there is a conflict, what does that mean and what *can* you do versus what *must* you do? When should an insurer utilize two claims professionals, one for defense and one for coverage? Does failure to do so equal bad faith? When, if ever, should you or must you file a complaint for declaratory judgment? What are the ramifications of a breach of the duty to defend?

All of these are crucial questions and all of them should be well within the knowledge base of those handling claims in any particular jurisdiction. Failure to fulfill the duty to defend can carry a double whammy – loss of your coverage defenses *and* an invitation to the bad faith litigation dance

Almost every (although surprisingly not all) bad faith claim involves an alleged breach by the insurer of its duty to indemnify. Failure to pay is usually the genesis of the complaint but it need not always be so. An insurer owes its insured many independent duties and its failure to act in good faith in certain respects may still be actionable even if indemnity is eventually paid. The converse, however, is more typical. If we don't indemnify when under an obligation to do so, a bad faith claim is certainly a common appendage to our insured's prayer for damages.

Strategies and Maxims for Avoiding/Confronting Bad Faith

- Set up objective standards which guarantee complete comprehension of all facts and circumstances.
- Set up administrative procedures and training for claims professionals and staff that will bring about adequacy, thoroughness, and timeliness, with deadlines for decision.

- Consider and reconsider all assertions made by claimant and reply in writing specifically and promptly.

- The Insured always gets the benefit of reasonable doubts, with due notation of this in the file.

- Entire context of doubts and defenses should fully recorded in the file.

- Suspicions and possible defenses should be understandable from reading the file notes and not appear arbitrary or capricious. File should be kept as though it will someday be a jury exhibit. In a bad faith case, it will be.

- Avoid defenses or delays which, while technically correct, lack substance.

- Procedure and Claims Manuals should be clear and simple. They should also contain language to the effect that the procedures outlined are aids and suggestions toward intelligent and fair claim handling, but are not ironclad rules. These manuals are more and more subject to discovery and policyholders' attorneys attempt to use them to "set the standard of care."

- The insured should have every reasonable opportunity to comply with policy conditions and reasonable extensions should, absent extreme and justifiable circumstances, be granted whenever requested.

- Claim denial should be in writing, advising the insured specifically of the grounds, policy conditions or requirements on which the denial was based. (Some states require that policy denials be in writing.)

- Do not require that an insured submit additional information or comply with uncompleted policy conditions if a decision has already been made to deny the claim.

- If a written denial contains accusations of fraud, concealment, arson, or overvaluation, or other accusations of wrongdoing, do not copy others unless you are in a state in which communications to a legal representative chosen by the insured are privileged. It is a better practice to send a separate letter to others who need to know (mortgagees, public adjusters, etc.) simply advising that the claim was denied. Denial letters should be sent by certified mail marked for restricted delivery.

- If part of a claim is disputed, tender the amount not in dispute, "no strings attached."

- If a policy is to be paid, the full amount due should be offered. Do not make a “low ball” offer or otherwise attempt to get the insured to accept less than what is owed.

Each claim should be subject to the following considerations:

A. Has an adequate and complete analysis been performed and recorded?
B. Has a fair and reasonable evaluation been completed and documented?
C. Based on the analysis and evaluation, what goals do you have for resolving the claim? These should be revisited regularly for reasonableness and for consideration of new evidence and other factors.
D. Is a legal opinion needed and, if so, has it been obtained and considered before making any final determinations
E. Has care been taken to protect privileged documents from inadvertent disclosure? How does the particular jurisdiction treat the file of defense counsel if a coverage dispute arises?
F. Can your position (i.e., denial of defense) lead to waiver or estoppels with respect to other solid coverage defenses if unsuccessful? If so, is it worth it to take that position?
G. In third-party claims, can you avoid a coverage dispute and possible bad faith action by entering into a standstill agreement with your insured, essentially agreeing to hold off on any coverage fights until after the underlying case has been resolved?

If any of these questions remain unresolved or incomplete, best practices would suggest that further attention to the claim and the claim file may be needed. As with anything else in law, the mere fact that something may or may not have happened, may or may not have been said or may or may not have been considered is fairly meaningless. If the claim file does not document what was considered, communicated and what transpired, you will have more difficulty proving what happened and will, instead, leave the insured's counsel more room for argument and innuendo. Simply put, well documented files minimize bad faith risk. Even if what ends up being documented is not particularly favorable, the fact that it can be reviewed helps prevent the company from proceeding even further with a dangerous bad faith claim.

Towards an Overarching Policy of Good Faith and Professionalism

It has often been said that the tone is truly set at the top. Companies should make it abundantly clear that claims professionals and, indeed, all employees, are to be held accountable to a high standard of professionalism and courtesy towards policyholders and even third-party claimants. It seems rather silly but the best way to avoid bad faith is to consistently strive to act in good faith at all times and in all dealings. This takes training, repetition and emphasis. Be careful about snide comments and jokes about insureds and claims. The attitude that is set is eventually communicated. Make sure that it is one that fosters the faithful performance of your good faith obligations and paints a flattering portrait of your company and how it deals with its customer-insureds.

10 Tips for Avoiding Bad Faith or Lessons Learned Bad Faith and Near-Bad Faith Experiences[1]

1. Know your policy before you tell the insured what is and is not covered.
2. Pay what is owed – quickly!
3. Pay undisputed amounts if you can.
4. Delay is a fertile breeding ground for bad faith.
5. Proofread – especially when you cut and paste from another claim.
6. Do not voluntarily assume or accept duties or responsibilities not in the policy.
7. Do not put your own or your company's interests first.
8. Do not get emotional or take things personally.
9. Give the insured the benefit of the doubt (tie goes to the insured).
10. In an ideal world, the testimony explaining claims decisions that are offered in deposition and trial should bear some resemblance to explanations contained in written correspondence to the insured and internal claims documents.

Conclusion

Bad faith claims are still rampant and, in my experience at least, are still more often asserted in order to try to obtain leverage over the insurer than because the company truly breached its good faith obligations. Nevertheless, in true "Pogo"[2] fashion, insurers are often their own worst enemies when it

[1] Case names and citations are omitted to protect the innocent, the guilty and the confused.
[2] "We have met the enemy and he is us."

comes to creating bad faith exposure and liability. Most bad faith situations can be avoided through effective training and communication, careful analysis and documentation and heightened professionalism. Most mistakes are avoidable and can usually be corrected or eradicated before it's too late. Nevertheless, like your good faith obligations, your bad faith exposure in any given case should not be ignored or taken lightly. The disciplined and professional approach to claims is, at times, painstaking and frustrating, but pales in comparison to sitting for deposition and being cross-examined at trial. Although, admittedly, nothing can insulate an insurer from allegations of bad faith should an insured wish to make them, your day-to-day practices can make the pursuit of such claims far less attractive and far less likely to succeed.