CURRENT TRENDS IN BAD FAITH LITIGATION - WHAT TO DO IN THE EVENT OF A COVERAGE DISPUTE

Bruce H. Wakuzawa, Esq.
Peter Knapman, Esq.[1]

I. INTRODUCTION

In the unending struggle between insurers and their insureds over coverage for claims, insurers have numerous, specific duties to deal fairly with their insureds. An insurer's denial of coverage without meeting these requirements may constitute bad faith, a breach of contract, or unfair and deceptive trade practices.

In this article, the authors briefly survey factors to consider when a coverage dispute arises and offer practical suggestions to bolster the insureds' position. It is important to note that laws vary among jurisdictions. Thus, practitioners must be aware of the particular statutes and judicial opinions governing their particular states.

II. GENERAL OBLIGATIONS OF AN INSURER

The unequal bargaining power between insurers and insureds has given rise to remedies under statute and judicial opinions when an insurer

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[1] Bruce H. Wakuzawa is a shareholder and director of Alston Hunt Floyd & Ing. Mr. Wakuzawa represents policyholders in coverage disputes against insurance companies and in lawsuits to recover for bad faith denials of coverage. He graduated from the University of Michigan law school in 1986. Peter Knapman is an associate attorney at Alston Hunt Floyd & Ing. He graduated from the William S. Richardson School of Law at the University of Hawai`i in 1997 and concentrates in environmental and commercial litigation.

deals in bad faith with its insured. The seminal case of *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973) held that an insurer may be liable for bad faith if it "fails to deal fairly and in good faith with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy." Over the years, bad faith liability has mushroomed to encompass numerous "unreasonable" acts by an insurer which constitute bad faith.[2] For example, the Court in *Christiansen v. First Insurance Co.*,88 Hawai'i 442, 967 P.2d 639 (Hawai'i App. Mar 18, 1998) noted that:

> Bad faith in the first party context can be established by evidence that the insurer unreasonably interpreted policy provisions. First party bad faith may also be shown by an insurer's unreasonably low settlement offer, or by the insurer's unreasonable conduct after the filing of the complaint in the bad faith action. . . .
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> The duty of good faith and fair dealing obliges an insurer to inform its insured of all possible benefits and coverage available under the policy and to disclose any conflicts between its interests and those of the insured. Furthermore, an insurer may be subject to a bad faith action even though it has paid the policy limits without delay when, for the purpose of protecting its own interests, it acts improperly to impede the insured's recovery of the uninsured portion of the loss.

(*Citing* W. Shernoff, *Insurance Bad Faith* § 5.02 [1] (1997)).

An insurer's potential liability is not restricted to common-law bad faith tort actions. Statutory restrictions on an insurer also serve as a source for potential liability. For example, Hawai`i Revised Statutes § 431: 13-103 outlines numerous specific examples that constitute unfair claims handling practices by an insurer.

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[2] *See, e.g.* Stephen S. Ashley, *Bad Faith Actions: Liability and Damages* (2d ed. 1997) at § 5:06 listing seventeen examples of unreasonable claims settlement practices including a denial of a claim with no reasonable basis, inadequate investigation, delay, deception, threats or false accusations, exploiting an insured's position, conditioning partial payment on settlement of disputed portion, and abuse of process.

These include the failure to respond to a communication from an insured within 15 business days, misrepresenting the benefits of an insurance policy in advertising, and not attempting in good faith to effectuate prompt, fair and equitable settlement of claims in which liability has become relatively clear, among others.

Although there is no private right of action under this chapter,[3] the United States District Court in *Wailua Associates v. Aetna Casualty & Surety Co.*, 27 F.Supp.2d 1211 (D. Hawai`i 2001) ruled that a claimant may refer to this statute in order to establish bad faith in a tort action. Furthermore, the statutory requirements "'are read into each policy issued thereunder [] and become a part of the contract with full binding effect upon [the insurer].'" *John Doe v. Paul Revere Ins. Group,* 86 Haw. 262, 271-72, 948 P.2d 1103, 1112 (1997), *quoting, AIG Hawaii Ins. Co. v. Estate of Caraang,* 74 Haw. 620, 633, 851 P.2d 321, 328 (1993). Thus, a breach of an insurer's statutory duties may also constitute a breach of contract.

III. FACTORS TO CONSIDER

A. Adjuster Engaging in The Practice of Law?

In a very recent case, the Supreme Court of Washington held that an insurance adjuster engaged in the unauthorized practice of law in advising an accident victim to accept an unfavorable settlement and to sign a release. *Jones v. Allstate Insurance Company,* 2002 WL 925311, _ P.3d _ (Wash. en banc 5/9/02).

In *Jones,* the plaintiff was severely injured when an Allstate insured ran a stop sign and hit the plaintiff's vehicle. Three days after the accident, Allstate sent the plaintiff a letter stating in part: "Because you have been involved in an accident

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[3] The Hawai`i Insurance Commissioner has the exclusive power to address violations of this Chapter.

with an Allstate policyholder, we will provide you with quality service .... *Your* claim representative is dedicated to carrying out this Quality Service Pledge."

Thereafter, the plaintiff and the Allstate adjustor had extensive contact. The adjustor assisted the plaintiff in finding medical coverage to pay for the medical bills and obtaining subrogation waivers. At some point, the adjustor sent the plaintiff a letter, a release of all claims, and a check for a sum which was less than the plaintiff's medical expenses. The plaintiff signed the release and cashed the check.

The plaintiff later attempted to return the money, but Allstate stated that the claim was settled and closed. The plaintiff sued Allstate, alleging that it engaged in the unlicensed and negligent practice of law in preparing the release and advising the plaintiff to sign it. The Supreme Court of Washington agreed:

> [T[o safeguard the public interest, we hold that insurance claims adjusters, when preparing and completing documents which affect the legal rights of third party claimants and when advising third parties to sign such documents, must comply with the standard of care of a practicing attorney.

2002 WL 925311 at 9.

The court then held that the adjuster breached the standard of care in (1) advising the plaintiff to sign the release, (2) not explaining the legal consequences of doing so or referring the plaintiff to independent counsel, (3) failing to disclose the adjuster's conflict of interest, and (4) following Allstate's policy of discouraging accident victims from retaining counsel. *Id.* at 11. The court remanded the case for consideration of the plaintiff's bad faith, civil fraud, and Consumer Protection Act claims. *Id.* at 13.

The Jones' case levels the playing field between unrepresented accident victims and insurers. The *Jones'* principles would seemingly apply when an insured,

as opposed to a third-party accident victim, is involved since an insurer's obligations to its insured are generally higher than to a third-party.

However, the court noted that in many cases, an adjustor may not be engaged in the practice of law: "[A] plainly adversarial posture generally prevents the typical claims adjuster from engaging in the unauthorized practice of law. Here the trial court found that [the adjuster] had embarked on a course of conduct which could reasonably cause a person to believe that she was *not* an adversary and her relationship with the Joneses thus began to mimic an attorney-client relationship." *Id.* at 8. Thus, when counsel is representing a client who dealt with an insurance adjuster while unrepresented, counsel should investigate whether the adjuster (1) lulled the client into thinking that the adjuster was assisting the client and (2) caused the client to act, or refrain from acting, to his prejudice. In this scenario, *Jones* may support a claim for bad faith, *inter alia.*

B. An Insurer May be Liable Per Se for Ignoring Governing Law

In *Ellwein v. Hartford Accident and Indemnity Co.*, 15 P.3d 640 (Wa. 2001), the Court held that the insurer was liable for bad faith as a matter of law for appropriating an expert witness initially retained for the insured and then using that witness against the insured in an uninsured motorist claim. The Court strongly cautioned that "[w]hen an insurer defends its insured under a reservation of rights, an insurer is nearly a fiduciary of the insured." The insurer is required to give "equal consideration" to the insured's interests as to its own interests. Even when the relationship becomes adversarial, "the insured still has the reasonable expectation that he will be dealt with fairly and in good faith by the insurer."

Similarly, in *Freidline v. Shelby Insurance Co.*, 739 N.E.2d 178 (Ind. App. 2000), the court granted summary judgment in favor of the insured on a bad faith

claim. The insurer relied upon a "pollution exclusion" to deny coverage. However, the court noted that prior case law established that the exclusion was ambiguous and that the insured's counsel provided that case law to the insurer. "Thus, since [the insurer] knew that the 'pollution exclusion' it was relying on to deny coverage to the [insureds] had been previously found ambiguous by the Indiana Supreme Court, [the insurer] did not act in good faith in refusing to defend and indemnify the [insured]." 739 N.E.2d at 185.

The *Ellwein* Court held that existing case law should have informed the insurer that its act of appropriating the expert was unlawful. Even though not a settled proposition, "where sufficient jurisprudence exists to give guidance to insurance companies in determining whether a claim should be denied, **the risk of erroneous interpretation falls on the insurer.**" 15 P.3d at 646. The *Freidline* Court specifically noted that the insureds' counsel provided the case law to the insurer. Based on these cases, counsel for the insured should bring governing law to the attention of the insurer in attempting to secure coverage. This serves at least two purposes. First, an insurer may reconsider its position and accept coverage. Second, if the insurer stubbornly refuses to alter its position, the insurer may be liable for bad faith.

C. An Insurer May be Required to Reserve Rights Prior to Interviewing Insured and Must Promptly Inform the Insured of Potential Coverage Defenses

In *Lloyd's v. Institute of London*, 2 P.3d 1199 (Alaska 2000), the Court held that an insurer's failure to reserve rights prior to interviewing its insured precluded it from later asserting coverage defenses. The insurer knew about potential defenses, but failed to timely notify its insured and conducted a two month investigation before issuing a reservation of rights. Interestingly, there was no factual

question that denial of coverage was correct and the insured (as the dissent pointed out) was not prejudiced by the late notice since he had no reasonable expectation of coverage in any event. Nevertheless, the Alaska Supreme Court affirmed a $763,290 judgment in favor of the insured. The Court presumed that the insured was prejudiced by the delay and held that the insurer was estopped from asserting coverage defenses.

If an insured was interviewed by the insurer before retaining counsel, counsel should review all communications (written and oral) from the insurer which occurred before the interview. Did the insurer explain the purpose of the interview? Was the insured informed of potential coverage defenses and a reservation of rights? If not, the interview may represent the insurer's attempt to gather facts to deny coverage, rather than a good faith investigation to determine if coverage existed.

D. Review of the Insurer's Advertising Materials May Be Helpful

In *Riffe v. Home Finders Assoc.*, 517 S.E.2d 313 (W. Va. 1999), the West Virginia Supreme Court reversed summary judgment in favor of the insured. The Court found that advertising materials produced by the insurer and given to the insureds by their insurance agent contradicted the policy language. The apparent promises in the promotional materials **bound the insurer** despite contradictory language in the insurance policy. The Court utilized the well-established propositions that (a) ambiguity in an insurance policy is construed against the insurer and in favor of coverage and (b) insurance policies are construed according to the objectively reasonable expectations of insureds. The Court found that the insurer's interpretation of the pre-existing condition exclusion would have violated the insured's reasonable expectation of coverage. The Court reviewed the promotional materials to assist its determination of the insured's expectations.

This is an interesting case in which the promotional materials trumped the policy's exclusion of preexisting conditions.

E. An Insurer May Not Force Its Insured to Go Through Excessive Processes to Secure Coverage

In *Zilisch v. State Farm Mutual Automobile Ins. Co.,* 196 Ariz. 234, 995 P.2d 276, 280 (Ariz. 2000), the Court held that an insurer " should not force an insured to go through needless adversarial hoops to achieve its rights under the policy." The Court strongly reprimanded the insurance carrier for the procedural obstacles that it imposed before making a settlement offer in a first-party insurance case. The fact that liability under the claim was "fairly debatable" did not excuse the insurer's actions.

Zilisch is a useful case for insureds because, even though an insurer's acts may be authorized by the policy language or statute, at some point even the lawful exercise of an insurer's power becomes unreasonable and illegitimate. The insurer cannot continually force an insured to expend money and time in order to secure rights due under the policy.

F. Insurer's Duty of Good Faith Continues Even After Filing Suit

It is helpful to remember and remind the insurance company that its duty of good faith and fair dealing continues during a coverage dispute, and even after the insured files suit. An insurer's overly zealous defense may just compound the insured's damages and expose it to further liability. *See White v. Western Title Ins. Co.,* 40 Cal.3d 870, 221 Cal. Rptr. 509, 710 P.2d 309 (1992); *Gregory v. Continental Ins. Co.*, 575 So.2d 534, 541- 42 (Miss. 1990) (duty to pay "does not end because a lawsuit has been filed against it...."); *UTI Corp. v. Fireman's Fund Ins. Co.,* 896 F. Supp. 362, 368 (D.N.J. 1995)(duty of good faith "extends through litigation.").

Often, counsel retained by an insurer will engage in aggressive litigation tactics in defense of a coverage action. The typical "zealous representation" of a client is at odds with the insurer's continuing fiduciary duty to its insured. An insured should cite to the above-referenced cases and remind the insurer and its counsel that it has a continuing duty to deal fairly and in good faith despite the existence of an adversary proceeding.

G. Chateau Chamberay

An important recent case, although unfavorable to insureds, is *Chateau Chamberay Homeowners Association v. Associated International Ins. Co.*, 108 Cal Rptr. 2d 776 (Ct. App. 2001). In this case, the California Court of Appeals upheld summary judgment in favor of an insurer where there was a "genuine dispute" over the facts underlying coverage. This case is significant because previous judicial opinions limited the "genuine dispute" defense to legal, not factual, issues. The holding of *Chateau Chamberay* is, however, limited and factually unusual.

Where there was no genuine issue that the insurer relied upon an expert's opinion, denial of coverage would not lead to bad faith. This case and its progeny is likely to be cited with increasing frequency in future disputes. However, ultimately *Chateau Chamberay* does not impact an insurer's duty to act in good faith and avoid the unfair acts which are the true hallmark of a tortious bad faith claim. Insurers who unreasonably delay, attempt to secure an unfair advantage or otherwise act to the detriment of their insureds are not insulated from liability even if there is a genuine factual dispute regarding coverage.

IV. CONCLUSION

The past few years have seen multiple large verdicts against insurers. Practitioners should be aware of the above cases to increase their arsenal of arguments and legal theories when dealing with an insurer on coverage issues.