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Asymmetrical Combat: Bad Faith Liability in Insurance Recovery Cases

William G. Passannante*

Abstract: *Policyholder counsel see claims that an insurer violated its duty of good faith and fair dealing is an essential tool in leveling the playing field in policyholder–insurer disputes, especially in high-stakes litigation. Insurance companies write the policies, employ lobbyists, exchange information with each other, and, of course, have more experience handling claims. So, the author writes, bad faith allegations bring more balance to the relationship and provide a disincentive to "the profitable breach of the insurance promise." He discusses above-policy limits risks for insurers, as well as attorneys' fees, interest on unpaid claims, punitive damages, and more.*

Bad faith insurance litigation presents high-stakes risks for insurance companies in the unbalanced battle between insurance companies and their policyholders. The asymmetric nature of the insurance claims process—insurance companies draft the insurance policies, lobby legislatures as an industry repeat litigant, exchange superior information among themselves, and have more experience with claims than any policyholder—means that policyholders need a counterbalance. Insurance company liability for bad faith and related above-policy limits liabilities can act as that counterbalance.

Insurance company bad faith and related doctrines prove useful because of the claims-handling calculus used to attempt to avoid coverage for a claim. Without more an insurance company denying a claim faces what it did at the outset—the amount of the covered claim. Insurance companies thus engage in the *profitable* breach[1] of the insurance promise.

Most purchasers of the insurance product would think of their insurance company as a fiduciary or trustee from whom one can

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expect scrupulous candor.[2] At claims time many policyholders do not receive what they expect. Still, hornbook contract law tells policyholders that every insurance policy contains within it a duty of good faith and fair dealing.[3] Enforcing that duty of good faith and fair dealing helps level the insurance claim playing field.

Some Examples of Above-Policy Limits Exposure for Insurance Companies

If instead, the policyholder shows the insurance company its exposure to (1) policyholder attorney's fees, (2) interest on the unpaid claim, (3) damages for bad faith behavior, and (4) punitive or exemplary damages—often tort-related—on account of wrongful behavior, the profitable opportunistic breach no longer appears profitable.

Bad faith liability of insurance companies has a role to play in making the insurance transaction *fairer* to policyholders.[4]

Policyholder Attorney's Fees

Insurance companies may view denying your insurance claim as a profitable opportunistic breach, but most states treat insurance claims differently by permitting recovery of attorney's fees. Most understand that insurance is different.[5] A majority of states may force the insurance company to pay your legal fees to force them to honor the policy they sold. If informal efforts to resolve the dispute with your insurance company have been unsuccessful, litigation may be the next step.

By engaging in this "opportunistic breach," the insurance company may deny coverage wrongfully, continue to collect and invest premiums during its well-financed coverage litigation, and the only penalty it risks is paying the policyholder the same coverage it owed all along. As the Colorado Supreme Court stated:

> Contract damages "offer no motivation whatsoever for the insurer not to breach. If the only damages an insurer will have to pay upon a judgment of breach are the amounts that it would have owed under the policy plus interest, it has

> every interest in retaining the money, earning the higher rates of interest on the outside market, and hoping eventually to force the insured into a settlement for less than the policy amount."[6]

There are a number of rationales for an award of attorney fees to policyholders in insurance coverage disputes. These rationales generally are founded upon: the nature of the insurance promise (for example, the nature of an insurance company's duty to defend its policyholder); the theory of consequential damages; the language of particular insurance policy provisions; public policy considerations; or specific statutory provisions.

Where the policyholder establishes the duty to defend in a declaratory judgment action, the insurance company should bear the consequences of its wrongful action and reimburse the policyholder for its attorney fees and costs in the declaratory judgment action. For example,[7] under Texas law, "an insurer who has breached the duty to defend is liable for damages including the attorneys' fees incurred in pursuing an insurance coverage action."[8]

New York courts have recognized that fees may be recoverable as consequential damages when the policyholder brings a breach of contract action against the insurance company.[9]

Other courts have found that attorney fees constitute an element of the policyholder's damages for the insurance company's bad faith refusal to pay a claim. For example, in *Taylor v. State Farm Fire & Casualty Co.*, 981 P.2d 1253, 1258 (Okla. 1999) (emphasis in original), the Supreme Court of Oklahoma held that:

> [W]hen an action is pressed for *bad-faith refusal to settle*—first recognized as a distinct tort in *Christian v. American Assur. Co.*—the plaintiff may seek damages (a) for the *loss payable under the policy* together with (b) those *other items of recovery* that are consistent with harm flowing from insurer's bad-faith breach of its implied-in-law duty to settle.

Courts in a number of jurisdictions look to statutes to award attorney fees. Some statutes are drafted broadly, such as in New Hampshire, where N.H. Rev. Stat. Ann. § 491:22-b (2022), states:

> In any action to determine coverage of an insurance policy pursuant to [Section] 491:22, if the insured prevails in such action, he shall receive court costs and reasonable attorneys' fees from the insurer.

One commentator has criticized the refusal of courts to award attorney fees in declaratory judgment actions absent bad conduct as unfair to the policyholder, as follows:

> After all, the insurer had contracted to defend the insured, and it failed to do so. It guessed wrong as to its duty, and should be compelled to bear the consequences thereof. If the rule laid down by these courts should be followed by other authorities, it would actually amount to permitting the insurer to do by indirection that which it could not do directly. That is, the insured has a contract right to have actions against him defended by the insurer, at its expense. If the insurer can force him into a declaratory judgment proceeding and, even though it loses in such action, compel him to bear the expense of such litigation, the insured is actually no better off financially than if he had never had the contract right mentioned above. Other courts have refused to impose such a burden upon the insured.[10]

The award of policyholder attorney's fees is one way to begin to make the insurance relationship fairer by improving balance in available remedies.

Interest on the Unpaid Claim

Requiring that insurance companies pay interest—one measure of damages—for its delay in payment helps reduce the profit from the insurance company's breach. For example, Alabama permits 6 percent annual prejudgment interest. Ala. Code § 8-8-1; *Miller & Co. v. McCown,* 531 So.2d 888 (Ala. 1988). Texas law permits up to 10 percent and if the contract is silent, a 6 percent annual rate of interest. Tex. Fin. Code §§ 302.001, 302.002. Kentucky sets the interest rate for breach of contract cases at 8 percent. Ky. Rev. Stat. Ann. § 360.010; *Pursley v. Pursley*, 144 S.W.3d 820 (Ky. 2004).

Policyholders should make use of statutory and common law entitlement to prejudgment and postjudgment interest to help level the claims playing field.

New York sets 9 percent as the interest rate to be applied pre- and postjudgment in contract cases.[11] For example, *Vogel v. American Guarantee & Liability Insurance Co.*[12] awarded the statutory interest amount to the policyholder as of the date the expenses were incurred.

In New York the prevailing party in a breach of contract—including insurance cases—receives prejudgment interest, to "be computed from the earliest ascertainable date the cause of action existed." The statute "grants courts wide discretion in determining a reasonable date from which to award pre-judgment interest."[13]

An award of prejudgment and postjudgment interest on an unpaid claim is another remedy that can enhance the fair balance in the policyholder–insurance company relationship.

Damages for Bad Faith Claims Behavior

Courts have awarded lost profits from the breach of the insurance promise.[14] More broadly, a breach of the duty of good faith and fair dealing may lead to liability for compensatory damages caused by the breach of the insurance promise.[15]

The liability for improper failure to settle is not constrained by the policy limits, and an insurance company can face liability far in excess for such a breach. *Green v. J.C. Penney Auto Insurance Co.*, 806 F.2d 759, 764 (7th Cir. 1986) (liability for "entire judgment where the insurer's negligent failure to accept a settlement offer causes a judgment in excess of policy limits . . .").

Insurance companies that refuse "a settlement offer in bad faith may be held liable in damages to its insured."[16] Indeed, when an insurance company "refus[es] to settle within the policy limits, [it] risks being charged with bad faith on the premise that it has 'advanced its own interests by compromising those of its insured.'"[17] For such a breach of the implied conditions of good faith and fair dealing, the damages to the insurance company may exceed policy limits.[18]

The insurance company's fiduciary obligation includes "a duty to use the same degree of care and diligence as a person of ordinary care and prudence should exercise in the management of his own business."[19] Therefore, an insurance company must "make such decisions in good faith and with due regard" for the policyholder's interests. An insurance company has a duty to investigate and evaluate claims and fairly consider reasonable settlement offers.[20]

"A claim for bad faith failure to settle is 'founded upon the obligation of the insurer to pay when all conditions under the policy would require an insurer exercising good faith and fair dealing towards its insured to pay.'"[21] Some states have statutory rules permitting a policyholder to bring a bad faith action against an insurance company if the insurance company does not attempt "in good faith to settle claims when, under the circumstances, it could and should have done so, had it acted fairly and honestly toward its insured and with due regard for her or his interest[.]"[22]

If an insurance company fails to authorize a favorable settlement within its policy limits, or if further delay causes this settlement opportunity to be lost, it can be held liable for any eventual judgment and other damages, even uninsured losses.[23]

Although insurance companies fight the basic premise that they are liable for the consequences of their breach of promise, they do face liability for consequential damages quite apart from what might be called insurance "bad faith." Policyholders may recover consequential damages in insurance cases involving a breach.[24]

An award of damages for bad faith claims behavior also can bring fairness and enhance the symmetry of bargaining power between policyholder and insurance company.

Punitive or Exemplary Damages Against the Insurance Company

A number of states permit the recovery of punitive damage against insurance companies for their breach of the duty of good faith and fair dealing. For example, Louisiana[25] and New Mexico,[26] California[27] and New York among a number of others.

Even without the "punitive" label, other courts will permit the recovery of tort damages for a breach of the duty of good faith and fair dealing; for example, in Colorado a policyholder may recover damages in tort for breach of the duty of good faith and fair dealing for emotional distress.[28]

Developments in punitive damages law—including *State Farm Mutual Automobile Insurance Co. v. Campbell*, 538 U.S. 408 (2003)—have impacted claims for punitive damages.[29]

The financial realities of insurance coverage and the need for the availability of punitive damages for bad faith claims handling was explained by no less than a standard textbook of the insurance industry, as follows:

> When an insurance company fails to pay claims it owes or engages in other wrongful practices, contractual damages are inadequate. It is hardly a penalty *to require an insurer to pay the insured what it owed all along.*[30]

An award of punitive or exemplary damages against the insurance company for the breach of the duty of good faith and fair dealing is another factor that can enhance the balance between the parties in the policyholder–insurance company relationship.

Bad Faith Liability of Insurance Companies Has a Role to Play in Making the Insurance Transaction *Fairer* to Policyholders

Insurance policies are a unique product that requires the policyholder perform first—by paying insurance premiums—while the insurance company's performance—the payment of the claim amount—is delayed until the insurance company determines to do so. The policyholder is left at claims time relying upon the good faith and fiduciary nature of the insurance company in meeting its promise. This disjointed performance of the parties to the insurance policy leads particularly in difficult matters to wrongful and abusive claims practices aimed at protecting the insurance company's financial self-interest rather than the interests of the policyholder in protecting itself from liability and minimizing losses.

The potential remains for the abuse of policyholder rights by the expert insurance company claims department, which handles more claims every day than a policyholder will during its existence. By using "opportunistic breach," the insurance company denies coverage wrongfully and continues to collect and invest premiums during its well-financed coverage litigation. The only penalty it risks is paying the policyholder the same coverage it owed all along.

Reducing the potential for opportunistic *profitable* breach by the insurance company at claims time can enhance the level of fairness in the policyholder insurance company claims relationship.

Indeed, one commentator has suggested that use of *institutional* bad faith evidence can help the legal system take a broader perspective. Institutional bad faith evidence shows "systemic violation of claim practices, that injures many policyholders and threatens all policyholders . . . ." Such evidence is yet another counterbalance available for policyholders.[31]

Conclusion: Some Symmetry in the Insurance Recovery Battle?

The high stakes presented in bad faith insurance litigation can help balance the battle between insurance companies and their policyholders. Introducing some symmetry into the insurance claims process by showing the exposure to liability for bad faith and related above-policy limits liabilities can act as a counterbalance. It may help avoid the *profitable* breach of the insurance promise. Enforcing the duty of good faith and fair dealing can help policyholders level the playing field.

Notes

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1. Insurance companies realize that it may be profitable for them to breach their duties under the insurance policy. *See* Eugene R. Ander-

son, et al., *Insurance Coverage Litigation* § 2.00 (2d ed. 2009); E. Allen Farnsworth, *Legal Remedies for Breach of Contract*, 70 Colum. L. Rev. 1145 (Nov. 1970).

2. A fiduciary is "a person holding the character of a trustee, or a character analogous to that of a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. Thus, a person Is a fiduciary who is invested with rights and powers to be exercised for the benefit of another person." Black's Law Dictionary, available at https://thelawdictionary.org/fiduciary/ (last visited March 24, 2022).

3. "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement." Restatement (Second) of Contracts § 205 (1981); E. Allan Farnsworth, *Contracts* § 7.17 (4th ed. 2004).

4. *E.g.*, William G. Passannante, *Bad Faith Legislation: Good For Insurance Policyholders*?, Propertycasualty360, National Underwriter—Perspective (September 12, 2019) (available at https://www.andersonkill.com//Custom/PublicationPDF/PublicationID_1798_Bad-Faith-Legislation-Good-for-Insurance-Policyholders.pdf).

5. *See* William G. Passannante & Vivian Costandy Michael, *Attorney Fees and Liability Insurance: Recovering Fees Paid to Plaintiffs and Fees Incurred by Policyholders*, Westlaw Journal Insurance Coverage (Volume 25, Issue 21, Feb. 27, 2015) (available at https://www.andersonkill.com/webpdfext/Attorneys-Fees-and-Liability-Insurance.pdf); Jane Massey Draper, *Insured's Right to Recover Attorney Fees Incurred In Declaratory Judgment Action to Determine Existence of Coverage Under Liability Policy*, A.L.R. 3d, 87 (1996); Floyd A. Wisner, *Insurer's Liability for Insured's Attorney Fees In Declaratory Judgment Actions*, The Brief (Fall 1998). Under the "American rule," each side is generally responsible for its own attorney fees in civil cases. See *Alyeska Pipeline Serv. Co. v. Wilderness Soc'y*, 421 U.S. 240, 257 (1975). A fair majority, however, do not always apply that view in "cases between policyholders and insurers to be one of the prominent instances where the American rule concerning attorneys' fees works badly." *Hayseeds, Inc. v. State Farm Fire & Cas.,* 352 S.E.2d 73, 78 (W. Va. 1986). Courts have noted that the "disparity of bargaining power between an insurance company and its policyholder makes the insurance contract substantially different from other commercial contracts." *Olympic Steamship Co. v. Centennial Ins. Co.,* 811 P.2d 673, 681 (Wash. 1991).

6. *Cary v. United of Omaha Life Ins. Co.*, 68 P.3d 462, 468 (Colo. 2003) (quoting *Dodge v. Fid. & Deposit Co. of Maryland*, 778 P.2d 1240, 1242-43 (Ariz. 1989)).

7. *Legacy Partners, Inc. v. Travelers Ins. Co.*, No. C 00 3413 SI, 2002 WL 500771, at *5 (N.D. Cal. Mar. 29, 2002), *aff'd*, 83 F. App'x 183 (9th Cir. 2003).

8. *See also Montgomery Ward & Co. v. Pac. Indem. Co.,* 557 F.2d 51 (3d Cir. 1977) (upheld award of attorney fees because of public policy considerations under Pennsylvania law).

9. *See Chernish v. Mass. Mut. Life Ins. Co.,* No. 08 Civ. 0957, 2009 WL 385418 (N.D.N.Y. Feb. 10, 2009) (stating "consequential damages . . . may be asserted in an insurance contract context, so long as the damages were 'within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting'") (*citing Panasia Estates Inc. v. Hudson Ins. Co.*, 886 N.E.2d 135 (N.Y. 2008); *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co. of N.Y.*, 886 N.E.2d 127 (N.Y. 2008)).

10. John A. Appleman, *Insurance Law & Practice* § 4691 (Walter F. Berdal ed. 1979).

11. N.Y.C.P.L.R. § 5004

12. No. 006748/12, 2015 WL 13376634, at *3 (N.Y. Sup. Ct. Mar. 24, 2015) (policyholder was "awarded pre-judgment interest on their expenses as of the date on which they were incurred."); *Granite Ridge Energy, LLC v. Allianz Glob. Risk U.S. Ins. Co.*, 979 F. Supp. 2d 385, 393-94 (S.D.N.Y. 2013) (entitled to prejudgment interest "computed from the earliest ascertainable date the cause of action existed" citing N.Y. C.P.L.R. § 5001)

13. *Conway v. Icahn & Co.*, 16 F.3d 504, 512 (2d Cir. 1994); *see State Farm Ins. Co. v. Domotor*, 266 A.D.2d 219, 220 (2d Dep't 1999) ("An insurance carrier may not, after repudiating liability, create grounds for its refusal to pay by demanding compliance with proof of loss provisions of the policy."). Interest continues to accrue in such cases until "the date of entry of final judgment." N.Y.C.P.L.R. §§ 5001(c), 5002.

14. *Earth Scientists, Ltd. v. United States Fid. & Guar. Co.,* 619 F. Supp. 1465, 1475 (D. Kan. 1985).

15. *Birth Center v. St. Paul Cos.*, 787 A.2d 376, 387-89 (Pa. 2001).

16. *Soto v. State Farm Ins. Co.*, 83 N.Y.2d 718, 723 (1994) (citing *Gordon v. Nationwide Mut. Ins. Co.*, 30 N.Y.2d 427 (1972)).

17. *Pavia v. State Farm Mut. Auto. Ins. Co.*, 82 N.Y.2d 445, 452 (1993) (*quoting Gordon*, 30 N.Y.2d at 446).

18. *Soto*, 83 N.Y.2d at 723 (citing 7C *Appleman, Ins. Law and Prac.* § 4711); *Gordon*, 30 N.Y.2d at 436-37.

19. *Berges v. Infinity Ins. Co.*, 896 So. 2d 665, 668 (Fla. 2004) (quoting *Boston Old Colony Ins. Co. v. Gutierrez*, 386 So. 2d 783, 785 (Fla. 1980)).

20. *Berges*, 896 So. 2d at 669.

21. *316, Inc. v. Md. Cas. Co.*, 625 F. Supp. 2d 1187, 1191-92 (N.D. Fla. 2008) (quoting *Vest v. Travelers Ins. Co.*, 753 So. 2d 1270, 1275 (Fla. 2000)).

22. *See e.g.*, Fla. Stat. § 624.155(1)(b)(1).

23. *See Clough v. Government Employees Ins. Co.*, 636 So. 2d 127, 129 (Fla. Dist. Ct. App. 1994), *disapproved on other grounds*, *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55 (Fla. 1995); *Dunn v. National Sec. Fire & Cas. Co.*, 631 So. 2d 1103, 1106 (Fla. Dist. Ct. App. 1993) ("At common law in Florida, the essence of a bad faith cause of action against an insurance company … is that the insurer breached its fiduciary duty owed to its insured by wrongfully refusing to defend its insured in a liability context, or by wrongfully refusing to settle the case within the policy limits, and exposing its insured to a judgment which exceeds the coverage provided by the policy.").

24. *Bi-Economy Mkt., Inc. v. Harleysville Ins. Co.*, 10 N.Y.3d 187 (2008) (policyholder could seek policy limits as well as consequential damages); *see also Panasia Estates, Inc. v. Hudson Ins. Co.*, 10 N.Y.3d 200 (2008) (citing *Bi-Economy* in denying insurance company motion on consequential damages).

25. *Dickerson v. Lexington Ins. Co.,* 556 F.3d 290 (5th Cir. 2009).

26. *Sloan v. State Farm Mut. Auto. Ins. Co.*, 85 P.3d 230, 238 (N.M. 2004) ("We conclude, therefore, in failure-to-settle cases, it is the insurer's failure to treat the insured honestly and in good faith, giving 'equal consideration to its own interests and the interests of the insured,' … that renders the insurer liable for insurance bad faith and also merits an instruction on punitive damages").

27. Cal. Civ. Code § 3294; *Jordan v. Allstate Ins. Co.*, 56 Cal. Rptr. 3d 312 (Cal. Ct. App. 2007) (punitive damages available in cases of "malice, oppression or fraud").

28. *Goodson v. American Standard Ins. Co.*, 89 P.3d 409, 411 (Colo. 2004); *Machan v. Unum Life Ins. Co.,* 116 P.3d 342 (Utah 2005).

29. Jeffrey W. Stempel & Erik S. Knutsen, Stempel and Knutsen on Insurance Coverage [C] (4th Edition, 2022-1 Supp. 2015), noting that

State Farm Mutual Automobile Insurance Co. v. Campbell, 538 U.S. 408 (2003) seeming view that punitive-to-compensatory awards exceeding a 10:1 ratio presumptively violate constitutional due process. Many state supreme courts had for years used higher ratios.

30. James J. Markham, et al., *The Claims Environment* 274 (1993) (emphasis added).

31. Jay M. Feinman, *Effective Use of Institutional Bad Faith Evidence in Prosecuting a Bad Faith Claim*, 2009 Winter AAJPapers 2 (American Association for Justice 2009)