

Unauthorized Practice of Law by Adjusters
and
Third and First Party Bad Faith

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I. INTRODUCTION

Recent years have seen a marked increase in the number of “bad faith” cases filed against insurance carriers by their policyholders, injured third party claimants and, oftentimes, both. Whatever the reasons (faltering economy, necessary byproduct of an increased number of insurance claims with decreased claims handling capacity, or plaintiff’s “how-to” bad faith seminars), the importance of understanding what is, and is not, “bad faith” claims handling conduct has never been higher for claims-handling professionals.

The “bad faith” cause of action is a hybrid combining elements of both contract and tort, and its origins are popularly attributed to two different decisions of the California Supreme Court. In *Comunale v. Traders & Gen. Ins. Co.* (1958) 50 Cal.2d 654, 658-659, the California Supreme Court held that, notwithstanding the fact an insurance policy is a contract containing explicit covenants and terms, an insured could recover extra contractual damages against him or her if the insurer is found to have breached the contract in “bad faith” based on the premise that insurance contracts also contain an implied covenant of good faith and fair dealing. The tort/contract cause of action was then extended to the first party insurance coverage arena in *Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566, 574, in which the court ruled that the implied covenant of good faith is breached when the insurer “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.” *Id.* at 1037. In both cases, the California Supreme Court determined that the covenant of good faith and fair dealing is read into every insurance policy and that it obligates the insurer to refrain from taking actions that prevent the insured from receiving benefits due under the contract.

A successful “bad faith” suit entitles the plaintiff to not only the outstanding and unpaid insurance benefits that, when paid, would make the insured “whole,” but also potentially lucrative “extra-contractual damages” for emotional distress, attorneys’ fees and even punitive damages where appropriate. It is thus not surprising that “bad faith” quickly became popular with the plaintiff’s bar across the country. Today, at least 47 states allow some form of extra-contractual recovery in insurance related disputes.

However, it is important to remember that the words “bad faith” do not have uniform meaning throughout the United States. The elements which must be proved vary from state to state, as do the types of damages allowed. The first part of this article provides an overview of the tort commonly known as “insurance bad faith” in the general context of third party and first party claims. The second part seeks to provide claims handling professionals with the contexts in which bad faith is often claimed as well as practical tips on how to avoid being accused of bad faith, or worse, adjudicated as having acted in bad faith. The article focuses on the majority rules, and the reader is reminded that the actual elements for a bad faith action against an insurer will depend on the law of jurisdiction of the reader, and, of course, the actual policy language at issue.

II. THIRD PARTY BAD FAITH

Liability insurance policies generally promise the insured a defense and indemnity for suits seeking damages for property damage, bodily injury, advertising injury or personal

injury, as those terms are defined under the policy. (*Waller v. Truck Ins. Exch.* (1995) 11 Cal.4th 1, 12; *Erdman v. Eagle Ins. Co.* (1997) 658 N.Y.S.2d 463, 466.) These policies provide that the insurer has the right and duty to defend claims brought by third parties against the insured for damages allegedly caused by the insured. Because the focus is on the allegations made by a third party, the arena is generally referred to as “third party” insurance coverage. The focus in any third party insurance dispute is always on the carrier’s duty to defend the insured.

In California, third party bad faith claims exist in the context of claimed failures of the insurer to defend, or settle, claims made against the policyholder. (*Comunale v. Traders & Gen. Ins. Co.* (1958) 50 Cal.2d 654, 659-660; *Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 431.) In other states, such as New York, tort liability for bad faith claims is limited to wrongful failure to settle claims made against the insured. (*AFIA v. Continental Ins. Co.* (1988) 140 A.D.2d 167, 168, 527 N.Y.S.2d 420, 421 [The wrongful failure to settle a covered claim will also subject an insurer to tort liability “for compensatory damages in excess of the policy limits,” where the insurer “has failed to make a reasonable settlement of a claim within policy limits.”].)

A. THE DUTY TO DEFEND

1. The Existence of the Duty to Defend

It is well recognized that the duty to defend is broader than the duty to indemnify. The reason this duty is viewed liberally is that insureds purchase liability insurance coverage not just to cover judgments which may be entered against them, but to defend them against the suits that may or may not lead to judgments. (*Montrose Chemical Corp. v. Superior Court* (1993) 6 Cal.4th 287, 295-296.) Because of this concern, liability policies obligate insurers to defend suits which are meritless or even groundless, false or fraudulent, even when there is ultimately no duty to indemnify. (*Lawyers Title Ins. Corp. v. JDC Corp.* (11th Cir. Fla. 1995) 52 F.3d 1575, 1580; *A-Mark Financial Corp. v. CIGNA Property & Casualty Companies* (1995) 34 Cal.App.4th 1179, 1185, fn.3.)

There are almost as many ways to measure an insurer’s duty to defend as there are courts. Generally speaking, the insurer’s duty to defend a claim is determined by comparing the allegations of a complaint filed against an insured with the language of the controlling policy. (*Gray v. Zurich Ins. Co.* (1966) 65 Cal.2d 263, 272, 419 P.2d 168, 177.)

States which follow the “four corners rule” hold that the insurer’s duty to defend is limited to an evaluation of the allegations contained in the four corners of the complaint. (*Federated Ins. Co. v. Applestein* (Fla. Dist. Ct. App. 1979) 377 So.2d 229, 232; *Travelers Indem. Co. v. Dingwell* (Me 1980) 414 A.2d 220, 224.)

“Four corner” states are a distinct minority, however, and most jurisdictions require the carrier to also look at facts made known to the insurer, or to whether or not the complaint and the facts of the dispute that led to the complaint might lead to a possibility of insurance coverage. (*Posing v. Merit Ins. Co.* (Ill.App. 1994) 629 N.E.2d 1179, 1183;

National Union Fire Ins. Co. v. Merchants Fast Motor Lines, Inc. (Tex. 1997) 939 S.W.2d 139,141; *Chantel Assocs. v. Mt. Vernon Fire Ins. Co.* (1995) 338 Md. 131, 143, 656 A.2d 779, 785.)

As a practical matter, the insurer should consider whether the allegations made against the insured (whether in the complaint or made known to the insurer) state a cause of action or allege facts that would support a cause of action within the coverage of the policy. If so, the insurer must defend. If, on the other hand, the facts and the allegations do not support a claim that would be covered by the policy, then a denial of defense may be issued. (*Hawaiian Holiday Macadamia Nut Co. v. Industrial Indem. Co.* (Haw. 1994) 872 P.2d 230, 233 [“Where pleadings fail to allege any basis for recovery within the coverage clause, the insurer has no obligation to defend.”]; *Previews Inc. v. California Union Ins. Co.* (9th Cir. 1981) 640 F.2d 1026, 1027-1028 [California Law.]; *Novak Insurance Admin Unlimited, Inc.* (1980) 91 Ill. App.3d 148, 414 NE2d 258, 260; *Touchette Corp. v. Merchants Mut. Ins. Co.* (1980) 76 AD2d 7, 429 NYS2d 952, 954.)

The insurer cannot disclaim coverage because the allegations against the insured are frivolous and completely without merit, as most liability insurance policies promise to defend even where the allegations are groundless, false or fraudulent. (*Lawyers Title Ins. Corp. v. JDC Corp.* (11th Cir. Fla. 1995) 52 F.3d 1575, 1580 [“The duty to defend is broader than the duty to indemnify in the sense that the insurer must defend even if facts alleged are actually untrue or legal theories unsound.”]; *A-Mark Financial Corp. v. CIGNA Property & Casualty Companies* (1995) 34 Cal.App.4th 1179, 1185, fn.3 [The fact that it was established in the underlying litigation that the insured did not advertise its products – a prerequisite to coverage – does not eliminate a duty to defend because the plaintiffs claimed and sought to prove otherwise.]

Also, in analyzing whether or not a defense is owed, the carrier should not focus exclusively on the labels the third party claimant places on his or her claims against the insured. Typical general liability insurance policies promise to defend any suit seeking damages for “bodily injury” or “property damage” caused by an “accident” or “occurrence.” The focus is thus on the harm, not the name of the cause of action. (*Vandenberg v. Superior Court* (1999) 21 Cal.4th 815, 839, 88 Cal.Rptr.2d 366, 383-4 [“Predicting coverage upon an injured party’s choice of remedy of the form of action sought is not the law of this state.”])

The duty to defend is broad, but it is not unlimited. For example, as noted above, in most states the insurer evaluating its defense obligation must consider extrinsic facts made known to the insurer. However, this rule is generally applicable only if the insurer was aware or should have been aware of such extrinsic evidence when it refused to defend. (*Associated Indem. Co. v. Insurance Co. of North America* (1979) 68 Ill App.3d 807, 386 NE2d 529, 537; *Gunderson v. Fire Ins. Exchange* (1995) 37 Cal.App.4th 1106, 1112 [“The issue [is] what facts [the insurer] knew at the time [the insureds] tendered the defense and whether those known facts created a potential for coverage.”]; *Controlled Lasting, Inc. v. Ranger Ins. Co.* (1997) 225 Ga. App. 373, 484 S.E.2d 47, 49 [The correctness of an insurer’s decision to defend or not cannot be determined by later-

revealed facts of which the insurer has no knowledge or notice.”].) Put another way, the existence of a duty to defend cannot be determined based upon hindsight. (*Aetna Cas. & Sur. Co. v. Dow Chemical Co.* (E.D. Mich. 1997) 44 F.Supp.2d 847, 856 [Proving existence of duty.]; *Amato v. Mercury Cas. Co.* (1997) 53 Cal.App.4th 825, 833 [Proving non-existence of duty.]) Put yet another way, the carrier does not have an obligation to speculate about unpled claims that may be pled in the future.

Once the duty to defend has been triggered, it extends to all of the claims made against the insured, not just those that may actually be covered by the policy’s indemnity agreements. (*Matsushita Elec. Corp. of Am. v. Home Indem. Co.* (N.D. Ill. 1995) 907 F.Supp. 1193, 1196; *St. Paul Fire & Marine Ins. Co. v. Sears Roebuck & Co.* (9th Cir. 1979) 603 F.2d 780, 786 [California Law.]) There is an exception to this rule in the rare case where defense costs can be readily apportioned between covered and non-covered items. In those cases, the insurer is only required to defend the covered claims. (*Sentex Sys. v. Hartford Accident & Indem. Co.* (C.D. Cal.1995) 882 F.Supp. 930, 947 [Although insurer wrongfully refused to defend, it was not liable for that portion of the defense costs incurred solely because of the non-covered claims.]; *Enron Corp. v. Lawyers Title Ins. Co.* (8th Cir. 1991) 940 F.2d 307, 311 [Carrier’s duty to defend does not extend to non-covered claims if an allocation can be made.]) However, this exception is extremely limited, and as a practical matter most courts will require that the insurer defend all of the claims, reserving its right to later seek reimbursement from the insured for defense costs attributable to non-covered claims. (*Buss v. Superior Court* (1997) 16 Cal.4th 35, 65, Cal. Rptr.2d 366, 939 P.2d 777-778.)

In many jurisdictions, the scope of the duty to defend can obligate an insurer to defend more than traditional lawsuits. (*Hi-Mill Mfg. Co. v. Aetna Casualty & Sur. Co.* (E.D. Mich. 1995) 884 F.Supp. 1109, 1117 [Insured’s reimbursement of EPA’s oversight costs were covered under the duty to defend.]. (*Harrow Products, Inc. v. Liberty Mut. Ins. Co.* (6th Cir. 1995) 64 F.3d 1015, 1025.) But, in many others, courts have held that the insurer is only obligated to defend “suits” seeking “damages,” and have excused insurers from having to defend against administrative proceedings such as federal or state environmental investigations or proceedings. (*Lapham-Hickey Steel Corp. v. Protection Mut. Ins. Co.* (1995) 166 Ill.2d 520, 211 Ill.Dec. 459, 655 N.E.2d 842, 847; *Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.* (1998) 18 Cal.4th 857, 77 Cal. Rptr.2d 107; *Reisner v. Vigilant Ins. Co.* (1987) 138 Misc.2d 542, 524 N.Y.S.2d 602, 604.)

2. Damages for Breach of the Duty to Defend

A breach of the duty to defend allows the insured to recover costs and attorneys’ fees the insured incurred in defending the underlying lawsuit. (*Arenson v. National Auto. & Cas. Co.* (1957) 48 Cal.2d 528, 537; *Burroughs Welcome Co. v. Commercial Union Insurance Co.* (S.D.N.Y. 1989) 713 F.Supp. 694, 697.) The insurer may also be bound by any reasonable settlement or judgment entered against the insured. *Green v. J.C. Penney Auto Ins. Co., Inc.* (7th Cir. 1986) 806 F.2d 759.

In addition to these monetary damages, the insurer may lose certain rights it had under the policy such as a lack of cooperation or late notice. (*Hartford Acc. & Indem. Co. v. Civil Service Emp. Ins. Co.* (1973) 33 Cal.App.3d 26, 35; *Wausau v. Elcho Liquidating Trust* (Ill. 1999) 708 N.E.2d 1122, 1135-36.) The insurer may also lose the right to control the defense of the underlying litigation. (*Rhodes v. Chicago Insurance Co.* (5th Cir. 1983) 719 F.2d 116, 120.) Another defense lost to the insurer if it wrongfully fails to defend is that the insured will not be required to obtain the insurer's approval prior to settling the case. (*Guillen v. Potomac Insurance Co.* (Ill. 2001) 751 N.E.10, 116.)

B. DUTY TO SETTLE

1. The Nature of the Duty to Settle

Another important duty imposed on a liability insurer is the duty to settle claims against its insured. This duty arises from the now well established precept that among the duties imposed by the implied covenant of good faith and fair dealing is the duty to settle claims that have been brought against the insured when it is "appropriate" to do so. As a practical matter, it is "appropriate" (and hence necessary) for a defending insurer to evaluate settlement demands made by third party claimants keeping in mind the risk that a judgment exceeding policy limits may result if the settlement is refused and the case tried.

The rule is not absolute. The insurer only has a duty to settle, if, based on the facts that are or should have been known to the insurer, a risk of an excess policy limits verdict is likely. (*Riske v. Truck Ins. Exch.* (8th Cir. 1974) 490 F.2d 1079, 1083 [When determining whether insurer breached duty to settle, the company will be deemed to have had knowledge of those facts which a proper investigation would have disclosed]); *Dairyland Ins. Co. v. Herman* (1997) 124 N.M. 624, 954 P.2d 56, 61 [Insurer has duty to settle when there is a substantial likelihood of recovery in excess of policy limits]; *Walbrook Ins. Co. v. Liberty Mut. Ins. Co.* (1996) 5 Cal.App.4th 1445, 1460-1461, 7 Cal. Rptr.2d 513, 522 [Substantial likelihood or strong possibility].).

In short, the insurance company must treat the claim as if it alone might be liable for any verdict that might be entered and commit its policy limits accordingly. However, if there is no reasonable possibility of a (covered) judgment in excess of the policy limits, the insurer should not, in general, have a duty to settle. (*Comunale v. Traders & Gen. Ins. Co.* (1958) 50 Cal.2d 654, 659-660 [There is no duty even to negotiate, let alone settle, when the demand is less than the policy limits].)

The duty to settle non-covered claims can be problematic. Suits by third parties that trigger a duty to defend often include claims that will not be covered by the policy. For example, a land use dispute between adjoining landowners relating to easements and building restrictions might include a cause of action that alleges bodily injury or property damage caused by construction activities. Under most liability insurance policies, there would be no coverage for suits seeking injunctive relief relating to enforcement of building restrictions or easements, but the allegations of property damage and bodily

injury could be argued to trigger at least a duty to defend. In such cases, where a settlement demand is made which is below policy limits and there is a likelihood that the verdict will exceed the policy limits, the carrier may not wish to fund the entire settlement for covered and uncovered claims. However, most Courts hold it is incumbent upon the insurer to remove its insured from harm's way by accepting the demand, even though the bulk of the claims asserted may not be covered. (*Camelot By the Bay Condominium Owners' Ass'n, Inc. v. Scottsdale Ins. Co.* (1994) 27 Cal.App.4th 33, 52, 32 Cal.Rptr.2d 354, 364; *Magnum Foods, Inc. v. Continental Cas. Co.* (10th Cir. 1994) 36 F.3d 1491, 1501-1506.) Courts analyzing this issue rationalize the result by reasoning that the issue of whether or not the entire settlement was covered by the policy can be resolved later, after the insured has been extricated from the litigation.

But, in many states an insurer is not required to offer any monies to settle claims for punitive damages against the insured, because punitive damages are uninsurable. (*PPG Industries, Inc. v. Transamerica Ins. Co.* (1999) 20 Cal.4th 310, 317, 84 Cal.Rptr.2d 455, 460 [The insurer's duty to settle does not extend to offering any amount in settlement of a punitive damage claim.]; *J.B. Aguerre, Inc. v. American Guar. & Liability Ins. Co.* (1997) 59 Cal.App.4th 6, 16, 68 Cal.Rptr.2d 837, 843 [Public policy forbids an insurer from paying punitive damages pursuant to the duty to settle or indemnify.].) In such cases, the insurer must be prepared to put forth settlement amounts that will cover the reasonable value of the non-punitive claims, and may request the insured fund the settlement demand that is attributable to the punitive damages. However, this cause of conduct is easier to suggest than implement, and, as a practical matter, the safest practice would be for the insurer to fund the settlement if the insured cannot, or will not, reserve its right to seek reimbursement in a later proceeding.

Finally, it is important to remember the decision as to whether to settle belongs to the insurer, as most CGL policies provide that the insurer has the "right and duty" to settle claims against the insured. This right was confirmed recently in California, in *Hurvitz v. St. Paul Fire & Marine Ins. Co.* (2003) 109 Cal.App.4th 918, where the Court upheld the insurer's right to settle claims against its insured even though the insured opposed the settlement, contending that settlement would destroy its malicious prosecution rights against the third party claimant. (*Id.*, at pp. 928-934.)

2. Damages for Breach of the Duty to Settle

A common misconception is that failure to accept a reasonable settlement demand within policy limits necessarily results in the insurer being held responsible for payment of any judgment later entered, even if the judgment exceeds policy limits. This is not the case, however, as there is currently a split of authority regarding the amount recoverable for a settlement or judgment entered against the insured. For instance, some jurisdictions limit the insured's recovery to amounts not in excess of the policy limits. (*United States Fid. & Guar. Co. v. Copfer* (1979) 48 N.Y.S.2d 871, 400 N.E.2d 298, 303 [Insurer required only to reimburse insured in an amount up to the coverage limits absent a showing of bad faith.].) In others, Courts have held where an insurer wrongfully breaches the duty to defend, the insured may recover the amount of the settlement or judgment entered against

the insured even if that amount exceeds the applicable policy limits. (*Newhouse v. Citizens Sec. Mut. Ins. Co.* (Wis. 1993) 501 N.W.2d 1, 6-7 [Insurer may be held liable for any damages that are the natural and probable result of its breach of the duty to defend, including any amounts in excess of the policy limits.].) The key factor will always be whether the insurer acted unreasonably in failing to discharge its duty to settle. As such, a thorough and documented investigation into the value of the claims asserted in response to any settlement demand should always be undertaken any time a decision is made to reject a within-limits settlement demand.

III. FIRST PARTY BAD FAITH

A. NATURE OF FIRST PARTY BAD FAITH

First party policies generally reimburse the insured for losses that he incurs as a result of an injury to himself or damage to property he owns or leases. (*Bumberger v. Insurance Co. of N. Am.* (3rd Dist.1991) 952 F.2d 764, 765, fn.1; *Zephyr Park, Ltd. v. Superior Court* (1989) 213 Cal.App.3d 833, 834-835.) In this context, the insured has suffered some loss, and contends the loss should be covered by his or her insurance policy. The vast majority of bad faith claims in this context generally arise out of an insurer's claimed failure to adequately investigate the reported loss, which results in the delay and/or failure to pay a covered loss.

1. California

California employs a two part analysis in determining whether a bad faith cause of action will lie against an insurer for the wrongful handling of a first party insurance claim: (1) Whether policy benefits are outstanding to the insured; and (2) Whether the insurer acted unreasonably in the handling of the insured's claim. (*Love v. Fire Ins. Exch.* (1990) 221 Cal.App.3d 1136, 1151.)

2. New York

New York historically allowed only recovery of contract damages as a result of the insurer's wrongful handling of a first party claim. (*Rocanova v. Equitable Life Assur. Soc. 'y* (1994) 83 N.Y.2d 603, 634 N.E.2d 940, 943, 612 N.Y.S.2d 339, 342.) This rule has eroded, and now a New York plaintiff may seek punitive damages as an additional remedy when a claim arises from a breach of contract by establishing that: (1) The Defendant's conduct is actionable as an independent tort; (2) The tortious conduct is of an egregious nature; (3) The egregious conduct is directed to the plaintiff; and (4) The egregious conduct is part of a pattern directed at the public generally. (*New York University v. Continental Ins. Co.* (1995) 87 N.Y.2d 308, 316, 662 N.E.2d 763, 767, 639 N.Y.S.2d 283, 287.) In *Acquista v. New York Life Insurance Company* (2001) 730 N.Y.S.2d 272, 277, a New York appellate Court found, even without explicitly recognizing an independent first party bad faith tort cause of action, that an insurer may be liable for extra-contractual damages if it mishandles a first party claim.

B. STATES REFUSING TO RECOGNIZE FIRST PARTY BAD FAITH

While the majority of states have followed the California and New York rules by recognizing some form of tort liability for breach of the implied covenant of good faith and fair dealing in the first party context, a number of other states have refused to recognize the existence of an independent tort remedy for an insurer who refuses to provide coverage. (*Tackett v. State Farm Fire & Casualty Ins. Co.* (Del. 1995) 653 A.2d 254; *State Farm Mut. Auto Ins. Co. v. Laforet* (Fla. 1995) 658 So.2d 55; *Guarantee Abstract & Title Co. v. Interstate Fire & Casualty Co.* (1982) 232 Kan. 76; 652 P.2d 665; *Marquis v. Farm Family Mut. Ins. Co.* (Me. 1993) 628 A.2d 644; *Johnson v. Federal Kemper Ins. Co.* (1988) 74 Md.App. 243, 536 A.2d 1211; *Kewin v. Massachusetts Mut. Life Ins. Co.* (1980) 409 Mich. 401, 295 N.W.2d 50; *Haagenson v. National Farmers Union Property & Casualty Co.* (Minn. 1979) 277 N.W.2d 648; *Catron v. Columbia Mut. Ins. Co.* (Mo. 1987) 723 S.W.2d 5; *Jarvis v. Prudential Ins. Co. of Am.* (1982) 122 N.H. 648, 448 A.2d 407; *Pickett v. Lloyd's* (1993) 131 N.J. 457, 621 A.2d 445; *Farris v. United States Fidel & Guar. Co.* (1978) 284 Or. 453, 587 P.2d 1015; *D'Ambrosio v. Pennsylvania Nat'l Mut. Casualty Ins. Co.* (1981) 494 Pa. 501, 431 A.2d 966; *Beck v. Farmers Ins. Exch.* (Utah 1985) 701 P.2d 795; *A & E Supply Co., Inc. v. Nationwide Mut. Fire Ins. Co.* (4th Cir. 1986) 798 F.2d 669 [Applying Virginia law]; *Hayseeds, Inc. v. State Farm Fire & Casualty Co.* (1986) 177 W. Va. 323, 352 S.E.2d 73.)

C. DUTY TO INVESTIGATE

In those states recognizing some form of first party bad faith, the central issue is how the insurer discharged its contractual duty to investigate claims made by insureds. The implied covenant of good faith and fair dealing requires the insurer to conduct any necessary investigation in a timely fashion and to conduct a reasonable investigation before reaching its decision on coverage. The California Supreme Court, in one of the first reported decisions addressing first party bad faith, *Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809, 819, articulated the insurer's duty of competent investigation in the first party context, holding that "an insurer cannot reasonably and in good faith deny payments to its insured without thoroughly investigating the foundation of its denial."

States that recognize first party bad faith claims hold that an insurer's duty to investigate arises when the insured submits a claim or makes a good faith effort to comply with the claims procedure. (*Trailer Marine Transport Corp. v. Chicago Ins.* (N.D. Cal. 1992) 791 F.Supp. 809.) The duty to investigate ends when the insurer pays the claim. (*Winburn v. Insurance Co. of North America* (1985) 287 S.C. 435, 339 S.E.2d 142.) The jury may consider the competence of the insurer's investigators and the manner in which they investigated the claim in determining whether the insurer performed its duty. (*Benke v. Mukwonago-Vernon Mut. Ins. Co.* (1982) 110 Wis.2d 356, 363, 329 N.W.2d 243 [Insurer found to have breached duty to investigate when it fired its first expert, who had concluded that a covered risk caused the insured's loss and hired a second expert in order to build a case that non-covered risk caused the loss.]; *Nichols v. State Farm Mut. Auto. Ins. Co.* (1983) 279 S.C. 336, 341, 306 S.E.2d 616.) An insurer may not absolve itself of its duty to investigate by delegating the task to another entity. (*Meier v. Aetna Life and*

Cas. Standard Fire Ins. Co. (1986) 149 Ill.App.3d 932, 103 Ill.Dec. 25, 500 N.E.2d 1096 [An insurer found to improperly rely upon computer valuation service.]

An insurer that performs an adequate investigation is not guilty of bad faith, even if the jury disagrees with the insurer's findings. (*Sharpe v. Employers Mut. Cas. Co.* (5th Cir. 1987) 808 F.2d 1110 [Insurer's denial of claim based on two independent inspections was reasonable, even if mistaken.]) Moreover, an insurer has no duty to investigate a claim that is excluded by clear and unambiguous language in the policy. (*Pacific Group v. First State Ins. Co.* (9th Cir. 1995) 70 F.3d 524.)

1. Concurrent Causes of Loss

A common problem associated with investigating a first party insurance claim is presented when two different causes combine to jointly lead to a loss. One of the causes is excluded by the policy, the other is not. The insurer's decision on which "cause" led to the loss, reached during its investigation of the claim, often becomes the primary issue in later bad faith litigation.

Under the majority rule, coverage depends on which cause is dominant. If the policy provides coverage for the dominant cause, then the policy covers the entire loss. (*Shinrone, Inc. v. Insurance Co. of North America* (8th Cir. 1978) 570 F.2d 715.) In California, the Courts employ a test under which the insurer need only provide coverage when the "efficient proximate cause" (the predominating cause) is covered. (*Garvey v. State Farm Fire and Cas. Co.* (1989) 48 Cal.3d 395, 403, 257 Cal.Rptr. 292, 296, 770 P.2d 704, 708.)

Regardless, it is imperative that claims personnel thoroughly consider all potential causes for the loss, including employment of experts in the field, so that the final decision to cover or not cover the loss can be shown as the result of a careful, reasoned investigation.

D. THE STANDARD TO PROVE BAD FAITH

When determining whether an insurer has acted in bad faith, the general rule is whether the insurer has struck an improper balance between its own and the insured's interests:

“[T]he strength of the injured claimant's case on the issues of liability and damages; attempts by the insurer to induce the insured to contribute to a settlement; failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; the insurer's rejection of advice of its own attorney or agent; failure of the insurer to inform the insured of a compromise offer; the amount of financial risk to which each party is exposed in the event of a refusal to settle; the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts and other factors tending to establish or negate bad faith on the part of the insurer.”

(*Allen v. Allstate Ins. Co.* (9th Cir. 1981) 656 F.2d 487, 489.)

In some jurisdictions the rule is more stringent. For example, in New York, the plaintiff must establish that the insurer has acted with gross disregard of the insured's interests:

“[I]n order to establish a prima facie case of bad faith, the plaintiff must establish that the insurer's conduct constituted a ‘gross disregard’ of the insured's interests - that is, a deliberate or reckless failure to place on equal footing the interests of its insured with its insured with its own interests when considering a settlement offer. In other words, a bad-faith plaintiff must establish that the defendant insurer engaged in a pattern of behavior evincing a conscious or knowing indifference to the probability that an insured would be held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted. The gross standard . . . strikes a fair balance between two extremes by requiring more than ordinary negligence and less than a showing of dishonest motives.”

(*Gordon v. Nationwide Mutual Co.* (1972) 30 N.Y.2d 427, 437, 285 N.E.2d 849, 854, 334 N.Y.S.2d 601, 609.)

Given the split of authority, it is important for defense counsel to thoroughly review the law of the pertinent jurisdiction. However, as a general rule, the insured is required to prove much more than mistakes in claims handling - the conduct must rise to a level of “unreasonableness” which, more often than not, is found when a carrier adjusts a claim with its own interests held above those of its insured.

IV. BAD FAITH DAMAGES

Where the trier of fact has determined the insurer breached the covenant of good faith and fair dealing by acting unreasonably in discharging its duties, the insurer will be held responsible to pay all damages proximately caused by the breach or flowing from the wrongful act. Typically, these extra-contractual damages sought include those for emotional distress suffered by the insured caused by the denial of the claim and the attorneys' fees expended in pursuit of the wrongfully withheld insurance coverage benefits. (*Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 431 [Approving award of emotional distress and punitive damages.]; (*Brandt v. Superior Court* (1985) 37 Cal.3d 813, 819 [Approving award of attorneys' fees.]

Many people assume that a finding of bad faith equals entitlement to recovery of punitive damages. This is not the case in most states, however, as the threshold for punitive damages is much higher than that necessary to establish bad faith.

The precise conduct that will justify an award of punitive damages varies from jurisdiction to jurisdiction. For instance, in California, the insured must prove, by clear and convincing evidence, “despicable” conduct on the part of the insurer which was

undertaken with the intent to cause injury to the Plaintiff. The California rule is best shown in the decision of the *Tomaselli v. Transamerica Ins. Co.* (1994) 25 Cal.App.4th 1269, 1289, which found that conduct amounting to overzealous or witless claims handling may constitute unreasonable conduct to support a bad faith finding, but was still not enough to support an award of punitive damages.

In New York, a punitive damage award must be “based upon tortuous acts which involve ingredients of malice, fraud, oppression, insult, wanton or reckless disregard of the plaintiff’s rights or other circumstances of aggravation.” (*Le Mistral, Inc. v. Columbia Broadcasting Sys.* (1978) 61 A.D.2d 491, 494, 402 N.Y.S.2d 815, 817.) In New Jersey, the plaintiff must prove “actual malice, which is nothing more or less than intentional wrongdoing – an evil-minded act . . . or an act accompanied by a wanton and willful disregard of the rights of another. (*La Bruno v. Lawrence* (1961) 64 N.J.Super 570, 166 A.2d 822, 824.)

Courts generally agree that punitive damages may not be awarded for a breach of contract or a showing of “mere” or “ordinary” negligence. (*Riordan v. Nationwide Mut. Fire Ins. Co.* (S.D.N.Y. 1990) 756 F.Supp. 732, 756; *Johnson & Higgins of Alaska v. Bloomfield* (Alaska 1995) 907 P.2d 1371, 1376; *Tri-Aspen Constr. Co. v. Johnson* (Colo. 1986) 714 P.2d 484, 488.) However, some states have relaxed the standard to a certain degree by finding that “gross negligence” or “reckless disregard” falls within the standard of conduct that may justify an award of punitive damages. (*Simbeck, Inc. v. Dodd Sisk Whitlock Corp.* (1999) 257 Va. 53, 58, 508 S.E.2d 601, 604; *Cirrinzione v. Johnson* (1998) 184 Ill.2d 109, 115-116, 703 N.E.2d 67, 70.)

V. DEFENSES TO BAD FAITH CLAIMS

A. NO COVERAGE

In many states, Courts have held that there can be no breach of the implied covenant of good faith and fair dealing where there is no coverage under the relevant policy. (*Love v. Fire Ins. Exch.* (1990) 221 Cal.App.3d 1136, 1151 [No award for bad faith can be made without first establishing that coverage exists.]; *Hydro Systems, Inc. Continental Ins. Co.* (1991) 929 F.2d 472, 477 [Where insurance policy’s pollution exclusion unambiguously barred coverage of insured’s claims, insured’s bad faith claim fails.]; *Healy Tibbitts Constr. Co. v. Insurance Co. of N. Am.* (9th Cir. 1982) 679 F.2d 803, 804-805 [“There is no merit to the insured’s allegations of bad faith. The fact that the claim was excluded from coverage excludes a question of bad faith refusal to settle.”].)

Thus, the insured may not create coverage, where none otherwise exists, based upon the insurer’s conduct. (*FDIC v. Duffy* (5th Cir. La. 1995) 47 F.3d 146, 150 [“Conduct in paying one claim under the policy does not prevent the insurer from raising defenses to the policy.”]; *Downey v. Venture LMI Ins. Co.* (1998) 66 Cal.App.4th 478, 78 Cal. Rptr.2d 142, 162 [Since coverage for intentional wrongdoing was against public policy, such coverage could not be created by estoppel.])

B. GENUINE ISSUE DOCTRINE

Though California takes its lumps for being the birthplace of bad faith, it bears noting that one of the more potent defenses to bad faith has also developed in California. Recent cases have established that an insurer has not breached the implied covenant by mistakenly withholding policy benefits if such withholding is reasonable or based upon a legitimate dispute as to the insurer's liability under California law. (*Tomaselli v. Transamerica Ins. Co.* (1994) 25 Cal.App.4th 1269, 1280-1281.) It is for this reason that there is no basis for bad faith liability when an insurer's denial of coverage is based upon a disputed issue of law. (*Franceschi v. American Motorists Ins. Co.* (9th Cir. 1988) 852 F.2d 1217, 1220 [So long as there existed a genuine issue as to the insurer's liability, insurer's denial of claim not unreasonable.]; *Safeco Ins. Co. of Am. v. Guyton* (9th Cir. 1982) 692 F.2d 551, 557 ["[S]ince the policy in dispute involved a genuine issue concerning liability, [insurer] could not, as a matter of law, have been acting in bad faith by refusing to pay on the Policyholders' claims."].)

The "genuine issue" doctrine has also recently been extended to cover factual disputes between the insured and the insurers. In *Chateau Chamberay Homeowners Association v. Associated International Ins. Co.* (2001) 90 Cal.App.4th 335, 347, the Court of Appeals held that in evaluating whether a summary adjudication on bad faith is proper, "the reasonableness of the insurer's decisions and actions must be evaluated as of the time that they were made; the evaluation cannot fairly be made in the light of subsequent events which may provide evidence of the insurers errors." The *Chamberay* Court then explained "while many, if not most of the cases finding a genuine dispute over an insurer's coverage liability have involved legal rather than factual disputes, we see no reason why the genuine issue doctrine should be limited to legal issues." (*Id.*, at p. 348.) Thus, a summary adjudication ruling of no bad faith was upheld where the insurer and insured disputed the cause of the loss, but the insurer was able to establish its position was genuine and based upon reasonable expert opinions.

C. ADVICE OF COUNSEL

The insurer often consults with counsel when determining the position to take with respect to a particular claim and then, in determining whether its position is right or wrong, will state that he or she relied on the advice of counsel in order to avoid allegations of bad faith. Good faith reliance on advice of counsel, even if the advice turned out later to be incorrect, can negate a claim of bad faith. The advice must be followed, however, as most Courts traditionally held that the failure of the insurer to follow the advice of counsel is evidence of bad faith. Recently, however, courts have held that reliance on the advice of counsel is only one of the factors that should be considered when determining whether an insurer acted in bad faith, as opposed to operating as an actual defense to the claim. (*St. Paul Surplus Lines Ins. Co. v. Dal-Worth Tank Co.* (Tex. App. 1995) 917 S.W.2d 29.) It should also be noted that reliance on the advice of counsel must be reasonable under the circumstances. (*Allen v. Allstate Insurance Co.* (1981) 656 F.2d 487.)

There is a split of authority regarding whether reliance upon erroneous advice inoculates the insurer from bad faith. In *Gordon v. Nationwide Mutual Insurance Co.* (1972) 30 N.Y.2d 427, 334 N.Y.S.2d 601, the New York Court of Appeals held that reliance on advice of counsel is an absolute defense and noted: “It would be an extraordinary result to hold a client guilty of breach of the implied covenant of good faith and fair dealing, with large punitive damages, because it acts on the advice of counsel – even mistaken advice ...”

In contrast, the Fifth Circuit Court of Appeals held in *Blakely v. American Emp. Insurance Co.* (5th Cir. 1970) 424 F.2d 728, 734, that insurer’s reliance on the advice of counsel was irrelevant: “We do not hold the view that an insurer can relieve itself of its duty to investigate, negotiate, settle or defend a claim by showing advices from its investigators, adjusters or legal counsel.”

VI. PRACTICAL CONSIDERATIONS FOR AVOIDING BAD FAITH CLAIMS

Claims handling professionals having read the above overview of bad faith principles may understandably scratch their heads and mutter to themselves “well that’s all well and good, but what does it mean?” The short answer is that a bad faith case inevitably turns on the reasonableness, or unreasonableness, of the claims handler’s conduct, because when a claim is decided, and a claimant remains unsatisfied, the end result will be independent review of the claims handler’s activities, as evidenced by the claim file and the testimony of that claims handler and any persons enlisted to aid the claims handler in discharging the insurer’s duties under the insurance contract. It is therefore imperative that the claim handling activities are conducted so that, when reviewed months or years later by lawyers, experts, judges, and/or juries, reasonable minds will not be able to differ but will instead have to agree that conduct was reasonable, objective and fair. The purpose of the following sections of this article is to provide practical tips on achieving this result and to point out traps along the way.

A. UNFAIR CLAIMS PRACTICES ACTS

Most states have enacted statutes and/or regulations that govern the manner in which insurers must respond to and evaluate claims for insurance coverage. For the most part, these statutes are based on the Model Unfair Claims Practices Act, (“UCPA”) section 4(9) and prohibit:

- Misrepresenting pertinent facts or insurance coverage provisions relating to coverage;
- Failing to act reasonably promptly upon communications with the insured;
- Failing to adopt and implement reasonable standards for prompt investigation of claims;
- Refusing to pay claims without reasonable investigation;

- Failing to affirm or deny coverage within a reasonable time after proof of loss statements have been completed;
- Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims when liability is reasonably clear;
- Compelling insureds to institute litigation to recover amounts due under the insurance policy by offering substantially less than the amount ultimately recovered in actions brought by insureds;
- Attempting to settle a claim for less than the amount for which a reasonable insured would have believed he or she was entitled to by reference to written or printed advertising material accompanying or made part of an application;
- Attempting to settle claims based on the basis of an application which was altered without notice to or knowledge or consent of the insured; and
- Making claims payments to insureds or beneficiaries not accompanied by a statement setting forth the coverage under which payments are being made.

Most states that have codified the Model rules have also modified them. It is therefore critical for claims handling professionals to obtain the most current version of the UCPA statutes or regulations for the states in that person's territory, to read and become familiar with them, and keep abreast of legislative changes. Rest assured, one of the first areas a plaintiff's bad faith lawyer will inquire into is the claims handling deponent's knowledge of/familiarity with the Insurance Codes and Regulations dealing with proscribed "unfair" claims handling practices.

Some states, such as Montana, New Mexico, Texas and Florida, expressly allow third party claimants a private right of action for breach of their Unfair Claims Practices Act. (*Mont. Code Ann.* § 33-18-242(1) "Both an insured and a third-party claimant may bring suit against the insurer for violations of the Unfair Trade Practices Act"; See also *N.M. Stat. Ann.* § 59A-16-30; *Tex. Ins. Code Ann.* art. 21.21 § 16; *Fla. Ins. Code* § 626.9641 and *Fla. Stat. Ann.* § 624.155(1)(b).)

Other states have recognized a private right of action by third-party claims for breach of the state's Unfair Insurance Practices Act, even in the absence of legislative approval. (*Elmore v. State Farm Mut. Auto. Ins. Co.* (1998) 202 W. Va. 430, 504 S.E.2d 893, 901-902; *State Farm Mut. Auto. Ins. Co. v. Reeder* (Ky. 1988) 763 S.W.2d 116, 118.)

Once upon a time in California, third party claimants were allowed to pursue claims of bad faith against insurance companies for their conduct in handling the claims made against insureds by the third party claimants. The California Supreme Court eliminated this exposure in 1988 by holding that the unfair business practices act did not create a private right of action in favor of the third party claimant. Thus, in California, any

remedy for violation of the act is technically within the sole purview of the Department of Insurance. (*Moradi-Shalal v. Fireman's Fund Ins. Co.* (1988) 46 Cal.3d 287, 304-305, 758 P.2d 58, 68-69, 250 Cal.Rptr. 116, 127.)

Today, *Moradi-Shalal* represents the majority rule. It is critical, though, to keep in mind that the inability of a claimant or insured to sue directly under a state's UCPA does not render the UCPA less relevant or important. Even though a given UCPA may not provide the basis for a private right of action, such regulations will most certainly become relevant in an action for bad faith when the plaintiff's expert is asked to opine on whether or not the claims handling was reasonable. See *Gray v. North Carolina Insurance Underwriting Association* (N.C. 2000) 529 S.E.2d 676; *Spray, Gould & Bowers v. Associated Int'l Ins. Co.* (1999) 71 Cal.App.4th 1260.

B. THE UNAUTHORIZED PRACTICE OF LAW AS IMPACTING BAD FAITH LIABILITY

Alleged Unauthorized Practice of Law, or UPL, by insurance companies appears to be the theory du jour for the policyholder's bar. Essentially, the argument presented is that by directing litigation decisions, implementing billing guidelines, and/or using staff counsel to defend insureds, insurers are engaged in the unauthorized practice of law which is in and of itself evidence of unreasonable or bad faith conduct. Awareness of the issues is therefore very important.

1. Out-of-State Attorneys Engaging in the "Unauthorized Practice of Law"

The question of whether an insurer has engaged in the "unauthorized practice of law" can arise in several different contexts. Once such instant occurs when an attorney admitted in one state is asked to advise a client (usually an insurer client) concerning a matter in a state where the attorney is not licensed.

The exact parameters constituting the practice of law in any particular state are ill-defined. While many states provide a specific list of which actions amount to practicing law, most jurisdictions simply provide a skeletal sketch of the law, thus leaving the question to be applied on a case-by-case basis.

For example, in California a lawyer is found to have practiced law in the state when it is established that the lawyer has sufficient contact with the California client to render the legal service a clear representation. (*Birbrower, Montalbano, Condon & Frank v. Superior Court* (1998) 17 Cal.4th 119.) The Court, in *Birbrower*, explained that the nature of activities must be examined on a case-by-case basis, and that mere casual or attenuated contacts will not be considered practicing law. The focus, according to the Court, is on whether the lawyer's actions create a continuing relationship with the California client that includes legal duties and obligations. Also, the Court made clear that physical presence in the state is only a factor in analyzing whether a lawyer has

engaged in the unauthorized practice, thereby indicating that a lawyer who never sets foot in California can violate the state's unauthorized practice of law rules.

Nevada Courts are even less clear, choosing to focus on the client's reliance rather than the lawyer's actions. Again, however, Nevada Courts make all determinations on a case-by-case basis. According to the head of the Nevada State Bar Ethics Committee, a lawyer is practicing law in Nevada when a Nevada client relies on an out-of-state lawyer's independent judgment, and the judgment affects the client's legal rights. For example, an out-of-state lawyer is not practicing law in Nevada when the lawyer prepares forms for a Nevada client; but the lawyer is practicing law if the lawyer chooses which forms to prepare. Similarly, when a lawyer chooses boilerplate language to include in such forms, the lawyer is practicing law.

Arizona does not have a general statute prohibiting the unauthorized practice of law. The State Bar of Arizona Ethics Committee, however, released an official opinion in October 2000 stating that lawyers not authorized to practice law in Arizona must not hold themselves out as being able to practice in Arizona, and must make clear on any letterhead used within the state that the lawyer is not admitted to the Arizona State Bar. Additionally, the letterhead must affirmatively disclose that out-of-state lawyers are only admitted to practice where admitted to a state bar, and that any practice in Arizona is limited to federal matters only.

The state of Utah has recently defined practicing law as the appearance as an advocate in any criminal proceeding or before any court of record in the state of Utah in a representative capacity on behalf of another person. The state's intent in adopting such a narrow definition of practicing law was to improve access to the Courts for the middle class. The members of the Utah State Bar, however, felt the narrowness of this definition was an intrusion on the constitutional rights of the Utah Supreme Court, and therefore lobbied successfully for an amended definition (which should be approved soon).

In September 2001, the Washington Supreme Court approved a new definition of practicing law, which characterized the practice of law as the application of legal principles and judgment with regard to the circumstances or objectives of another entity or person(s), which requires the knowledge of a person trained in the law. The Washington Supreme Court also defined a number of specific acts that constitute practicing law, including, but not limited to: (1) Giving advice or counsel to others as to their legal rights for a fee or consideration; (2) Selection, drafting, or completion of legal documents or agreements that affect an entity or person's legal rights; (3) Representation of another entity or person(s) in Court or other formal proceeding; and (4) Negotiation of legal rights or responsibilities on behalf of another entity or person.

Although Hawaii does not have a statute defining the authorized practice of law, the Hawaii Supreme Court has emphasized that physical presence in the state of Hawaii is critical. (*See Fought & Company v. Engineering and Erection, Inc.* (1998) 951 P.2d 487.) In *Fought* an Oregon law firm represented an Oregon client and performed all services in the state Oregon, where all of the firm's attorneys were licensed. (*Ibid.*) The Oregon firm did not file any papers with Hawaii Courts, did not appear in a Hawaii

Court, did not communicate with opposing counsel on the client's belief, and never set foot in Hawaii. (*Ibid.*) The Hawaii Supreme Court was convinced that the Oregon client's Hawaii counsel was actually "in charge" of the suit in Hawaii, and that the Oregon law firm's role was merely that of consultant to the client and the client's Hawaii counsel. (*Ibid.*) Finally, the Court held that because it could not say with certainty that the Oregon law firm rendered legal services "within [Hawaii]," the Oregon law firm could not be penalized for unauthorized practice of law in Hawaii. (*Ibid.*)

In the decision, the Hawaii Supreme Court cited the California case of *Birbrower, Montalbano, Condon & Frank v. Superior Court* (1998) 17 Cal.4th 119. The Court, however, seemed to dismiss the idea set forth by the California Supreme Court that an out-of-state lawyer could be found to have practiced law in Hawaii without actually setting foot in the state. (*Fought & Company v. Engineering and Erection, Inc., supra*, 951 P.2d at p. 487.) The Hawaii Supreme Court's focus was on the physical presence of the out-of-state attorney's actions, as well as the client's location.

Oregon's unauthorized practice of law statute provides that a lawyer is practicing law if the lawyer: (1) Holds himself out as an attorney or lawyer authorized to practice law in the state of Oregon; (2) Appears on behalf of another in any judicial or administrative proceeding; or (3) Provides legal advice or services to another involving the application of legal rights, duties, obligations or liabilities. Further, the statute makes clear that the Oregon Supreme Court has the right to interpret this rule on a case-by-case basis, and to expand it, if necessary.

The Oregon statute goes on to define certain practices subject to investigation by the Oregon State Bar, including, but not limited to: appearance on behalf of another in a judicial proceeding; negotiation on behalf of another for the settlement of pending or possible legal actions; drafting or selection of documents for another or giving of advice to another when informed or trained discretion must be used; and exercising any use of intelligent choice or informed discretion in advising another of his legal rights.

In Michigan, the rule is set forth in *Shapiro v. Steinberg* (1989) 176 Mich. App. 683, 440 N.W.2d 9. In *Shapiro*, the personal friend of an attorney licensed in Massachusetts died in a plane crash in Michigan. The attorney contacted a local attorney in Michigan to pursue any possible claims against the airline. The local counsel agreed to share the contingency fee agreement with the attorney, in exchange for his assistance. This consisted of research, investigation of the claim and preparation of certain documents, such as a lost employment benefits report and a day-in-the life booklet. The Court found that this did not constitute the unauthorized practice of law as the out-of-state attorney was only doing preparatory work such as research and investigation, such as a law clerk would perform.

In New York, an attorney licensed in Federal court but not in state court was found to have engaged in the unauthorized practice of law by entering into a retainer agreement with a corporation and providing legal services, even though the attorney never appeared in court and other admitted attorneys handled the case. *law Sevidone Constr. Corp. v. St. Paul Fire & Marine Ins. Co.* (N.D.N.Y. 1995) 911 F. Supp. 560,

Finally, Illinois has held an offer to provide prospective legal services may be considered the unauthorized practice of law. Such conduct would be improper, if an out-of-state attorney sends letters to Illinois residents soliciting personal injury cases. This conduct may be considered at least a tentative offer to provide legal services within the state. (*ISBA Advisory Opinion on Professional Conduct*, Op. (1994) (1994 WL 904175))

Other state rules in this area are somewhat relaxed, when the question involved whether an out of state lawyer may properly accept an in-house counsel position, without becoming admitted in the state where the employer is located. (*Fla. Ct. R. ch. 17*; *Kan. Ct. R. 706*; *Ky. Ct. R. 2.111*; *Mich. Bd. of L. Examiners R. 5*; *Minn Ct. Admission to Bar R. VI*; *Mo. Ct. R. 8.105*; *Ohio Gov. Bar R. VI § 4*; *S.C. Ct. R. 405.*)

2. Insurance Claims Adjusters Engaging in the Unauthorized Practice of Law

The question of whether an insurer has engaged in the unauthorized practice of law can also arise when an insurance claims adjuster directs legal strategies of the defense, either indirectly through imposition of “billing guidelines” or directly by telling retained counsel how to litigate the case.

For example, in *In Re Rules of Professional Conduct* (2000 Mont.) 2 P.3d 806, a group of frustrated insurance defense attorneys filed a motion with the Montana Supreme Court seeking a declaratory judgment on how much control insurance companies may exercise over how lawyers defend cases filed against their insureds. The attorneys named several specific insurance companies that required outside counsel to get the company’s pre-approval for all legal services performed and then subjected their bills to outside auditors.

The resulting decision was the first time that any Court (much less a State’s Supreme Court) had ruled on the issues surrounding the relationship between insurance companies and the outside lawyers who represent their policyholders. After hearing the case, the Court ruled that the requirements placed upon defense counsel were impermissible because requiring prior approval before an attorney performs legal services unduly restricts the attorney’s ability to represent his or her clients, and the use of outside auditors, without obtaining the insured’s informed waiver, violated the attorney-client privilege.

At this point no jurisdiction has fully embraced the rule of the Montana Supreme Court. However, several have found that an insurer does not become part of the attorney-client relationship when it provides defense counsel for its insured. (*Higgins v. Karp* (1997 Conn.) 687 A.2d 539, 543; *Atlanta Int’l Ins. Co. v. Bell* (Mich. 1991) 475 N.W.2d 294, 295, 296; *First Am. Carriers, Inc. v. Kroger Co.* (1990 Ark.) 787 S.W.2d 669, 671.), and at least one State Supreme Court has directly criticized *In Re Rules of Professional Conduct*: “we have never gone so far to find that defense counsel cannot have an attorney-client relationship with both the insured and insurer. (*Pine Island Farmers Coop v. Erstad & Riemer, P.A.* (2002 Minn.) 649 N.W.2d 444, 449.)

Direction of the defense by adjusters also results in UPL claims. (*Merritt v. Reserve Ins. Co.* (1973) 34 Cal.App.3d 858, 880-881.) In *Merritt v. Reserve Ins. Co.*, liability was sought against the insurer for not only bad faith, but the negligent provision of the defense against the underlying claim brought against the insured. (*Id.*, at p. 866.) The negligent provision of defense claim was based upon the allegation that defense counsel's investigation and case preparation and presentation of evidence at trial was inadequate in view of the potential liability to which the insured was exposed. (*Id.*, at p. 867.)

The Court in *Merritt* held that such authorization did not entitle the insurer or its representatives to practice law. Specifically, the Court found that where settlement or defense requires a lawyer's services, the insurer must engage the services of competent counsel. However, the Court found that so long as competent counsel was provided, the insurer could not be held vicariously liable for the negligence of that counsel.

The question of whether counsel is acting in the best interest of the insured was addressed in *Mosier v. Southern Cal. Physicians Ins. Exchange* (SCPIE) (1998) 63 Cal.App.4th 1022. In *Mosier*, the Court held that an insurer could subject itself to liability when it dictates to defense counsel the manner in which the underlying defense is conducted. This includes litigation strategies, such as which experts to call at the time of trial. (*Id.*, at pp. 1030, 1037, 1045-1046.) The *Mosier* Court suggested that the best way for the insurer (and defense counsel) to remain protected from such liability is to obtain the informed consent from the client for any important defense decisions. (*Id.*, at pp. 1045-1046.)

The Washington Supreme Court has also addressed this situation, interpreting the practice of law rather strictly. It maintained that a person is practicing law when performing services in a formal court setting, as well as giving legal advice and counsel and preparing legal instruments and contracts. (*Jones v. Allstate Insurance Co.* (2002) 45 P.3d 1068.)

In *Jones*, the Washington Supreme Court held that an insurance company's claims representative had engaged in the practice of law when the representative completed claims forms, advised claimants regarding the settlement process and recommended that claimants sign a complete settlement and release -- all without advising the claimants of potential consequences or securing the advice of independent counsel.

3. Use of Staff or "In-House" Counsel

The use of "staff counsel," (in-house salaried attorney employees) to defend claims against insureds is the hottest UPL area today.

Use of staff counsel is prohibited in only two states today, Kentucky, (*American Ins. Ass'n v. Kentucky Bar Ass'n.* (Ky. 1996) 917 S.W.2d 568,) and North Carolina (*Gardner v. North Carolina State Bar* (N.C. 1986) 341 S.E.2d 517). Many other states asked to consider the question have ruled an insurer may properly discharge its duty to defend by appointing an in-house attorney to defend claims and suits against its insureds. (*See In re Allstate Ins. Co.* (Mo. 1987) 722 S.W.2d 947 [The Court determined that the

representation of an insured by the insurer's in-house counsel did not constitute the unauthorized practice of law.]; *Coscia v. Cunningham* (Ga. 1983) 299 S.E.2d 880 [The Court found that the use of staff counsel to represent insureds is not prohibited, as such conduct is within the insurer's "immediate affairs."]; *Kittay v. Allstate Ins. Co.* (Ill. 1979) 397 N.E.2d 200 [The Court found that Illinois statutory law did not prohibit in-house counsel from defending insureds.]

However, recent decisions show that the issue is by no means settled.

For example, in California, a trial court recently found that a claims department's alleged control of staff counsel amounted to unauthorized practice of law by non-attorneys and subjected the company to an award of punitive damages. *Ricketts v. Farmers Group, Inc.* (LASC Case No. BC 165 961.) Although not an insurance bad faith action, *Ricketts* involved allegations that insurance claims personnel were wrongfully controlling staff counsel assigned to defend insureds.

Attorney Donald Ricketts was a long time insurance defense attorney who was hired by Farmers in 1993 to work as staff counsel defending suits against Farmers' insureds. Ricketts complained to his supervisors about what he perceived as undue interference by claims personnel into his professional judgment. He was later terminated and filed suit against Farmers claiming he was terminated in retaliation for essentially complaining about unauthorized practice of law by adjusters. Following a bench trial, a verdict was rendered in favor of Ricketts for \$140,000 in compensatory damages and \$2.5 million in punitive damages. The trial court ruled that Farmers' control over Ricketts defense of insureds was so extreme it constituted an unauthorized practice of law.

Ricketts was subsequently reversed on appeal in an unpublished opinion, without the Court reaching the issue of whether Farmers' control of the defense of its insureds constituted the unauthorized practice of law. (*Ricketts v. Farmers Group, Inc.* (2001) B 140852.), and in what may be a judicial comment on the staff counsel/UPL issue left unaddressed in the *Ricketts* appellate decision, a California Appellate court has ruled that an insurance company's use of salaried employee attorneys working within a "law division" to represent insureds is not improper, as long as the attorneys within the law division do not permit the division to "become a front or subterfuge for lay adjusters or other unlicensed personnel to practice law" or control the defense of claims against insureds. (*Gafcon, Inc. v. Ponsor & Associates* (2002) 98 Cal.App.4th 1388, 1413.)

The national debate over the ethical obligations of defense counsel and the role of the insurer in providing defense was most recently addressed by the Court in *Am. Home Assurance Co. v. Unauthorized Practice of Law Committee* (November 12, 2003) 2003 Tex. App. LEXIS 9507.) In *Am. Home Assurance Co.*, the Texas Unauthorized Practice of Law Committee ("UPLC") argued that insurance companies' right to control and direct staff counsel violated a lawyer's professional code of ethics because the lawyer cannot exercise independent judgment, which created an irreconcilable conflict. The UPLC further argued that a corporation cannot practice law, and staff attorneys, whose sole client is the insured, are agents of the insurance company and therefore, the insurance company is practicing law. A trial court agreed.

However, the Appellate Court rejected UPLC's arguments finding that an insurance staff attorney's status as an employee is not an irreconcilable conflict because an insurance company is not organized to practice law. Instead, the purpose of an insurance company is to indemnify its insureds, and when either a staff or outside attorney represents his or her corporation's interest in a matter, the corporation is not practicing law because it is not acting through its agent on behalf of the client. This decision has been appealed to the Texas Supreme Court, and so once again, all eyes will be on Texas in the coming year.

Finally, the flip side to the UPL by adjusters is use of staff or outside counsel as extensions of the claims handling arm of the company. Though assertion of attorney client privilege or work product privileges to block in inquiry into attorney created but claims related correspondence, adjusters should be very careful to make sure that the line between claims adjustment and traditional legal services (defending suits, providing coverage advice) is not blurred.

In *2,022 Ranch LLC v. Chicago Title Insurance Company* (2003) 113 Cal.App.4th 1377, a title insurer retained a licensed attorney to handle the factual investigation of the insured's claim. When the insured subsequently brought suit against the insurer for the handling of the underlying claim, the insurer objected to the production of the relevant claim file based upon the attorney-client privilege, asserting that any factual information contained in the file was generated with the assistance of counsel.

The Court in *2,022 Ranch* rejected this argument finding that employing attorneys to conduct routine claims investigations does not make their factual investigations subject to the attorney-client privilege. The Court reasoned that factual insurance claims investigations are not protected by the attorney-client privilege. The only matters that are protected by privilege are those communications that constitute the actual requesting or rendering of legal advice.

C. EXPOSURE RELATING TO INDEPENDENT ADJUSTERS

Claimants and their attorneys routinely attempt to impose liability upon independent adjusters for their conduct in handling a claim. These attempts are usually unsuccessful, as the majority rule holds that no liability may exist on behalf of independent adjusters for their claims handling activities. (*Sanchez v. Lindsey Morden Claims Services, Inc.* (1999) 72 Cal.App.4th 249, 253 [California law.]; *Charleston Dry Cleaners & Laundry, Inc. v. Zurich Ins. Co.* (S.C. 2003) 586 S.W.2d 614, 618 [South Carolina law.]; *Velastequi v. Exchange Ins. Co.* (1986) 505 N.Y.S.2d 779, 782 [New York law.]) A minority of jurisdictions have imposed liability against independent adjusting firms. (*Brown v. State Farm Fire & Cas. Co.* (Okla. Ct. App. 2002) 58 P.3d 217, 220-221 [Oklahoma law.]; *Morvay v. Hanover Ins. Co.* (N.H. 1986) 506 A.2d 333, 335 [New Hampshire law.])

The Courts that have declined to impose direct liability against adjusters have rationalized that policy considerations preclude such extension of liability, as liability

still exists directly against the insurer as the principal of the adjusters. (*Sanchez v. Lindsey Morden Claims Services, Inc.* (1999) 72 Cal.App.4th 249, 254-256.) As such, the conduct of an independent adjuster may be used by a claimant to prove bad faith liability against the insurer.

While most states do not recognize independent liability on the part of the claims professional for the adjustment of a claim, this does not mean that an independent adjuster is insulated from liability, as a matter of course. Employee adjusters, loss executives and independent adjusters can still be found liable for independent torts such as fraud, intentional infliction of emotional distress, slander/libel, invasion of privacy, conspiracy or tortious interference with economic advantage, to name a few.

In *Jacques Interiors v. Petrak* (1987) 188 Cal.App.3d 1363, 1370, an insurer, Sentry Insurance Co., hired an independent claims adjuster, Edwin Petrak, to investigate a fire in a building owned by its insured but occupied by a commercial tenant, Jacques Interiors. The adjuster concealed and distorted evidence to make it appear that the tenant caused the fire. Apparently, Petrak was attempting to shift the blame away from the insured, so as to avoid liability claims from other tenants who also suffered fire losses. Relying on Petrak's report, Sentry paid its insured for the fire loss and then brought a subrogation action against Jacques Interiors. Sentry dismissed its claim after this discovery and Jacques Interiors then sued Petrak for malicious prosecution on the theory that Petrak was instrumental in causing the subrogation action to be filed. The jury found Petrak liable for malicious prosecution, concluding that the adjuster had acted with malice in withholding photographs that would have exonerated Jacques Interiors and in filing his report to Sentry. (*Id.*, at p.1371; see *Henry v. Associated Indemnity Corp.* (1990) 217 Cal.App.3d 1405 [Holding that although adjusters could not be sued for unfair claims and settlement practices, it could be sued for intentional infliction of emotional distress.])

Other courts have had occasion to find liability on the part of the claims professional for causes of action other than breach of the policy and breach of the implied covenant of good faith and fair dealing. For example, in *Bass v. California Life Ins. Co.* (1991) 581 So.2d 1087, a Mississippi Court found that, although the administrator of a group health insurance policy could not be held liable for simple negligence in determining a claim, it could incur independent liability if its conduct constituted gross negligence, malice or reckless disregard for the rights of the insured. Likewise, in *Porter v. Crawford & Co.* (Mo.App. W.Dist. 1980), 611 S.W.2d 865, an insured's complaint based on intentional actions of insurer and adjuster in stopping payment of a settlement check was held by a Missouri court to state a cause of action against insurer and adjuster under theory of "prima facie tort doctrine."

Moreover, a Florida appellate court upheld a fraud and deceit cause of action against an adjuster where plaintiffs incurred legal expenses to set aside a settlement procured by such fraud and deceit. (*Howard v. Crawford & Co.* (Fla.App.1 Dist.1980) 384 So.2d 1326.) And in Wisconsin, a Complaint filed by a property owner sufficiently alleged a cause of action for negligence against an insurance adjuster for injuries sustained when the property owner drove stakes into the ground at adjusters direction, in order to brace

trees that were damaged when a motorist drove his automobile onto the property owner's lawn. (*Morgan v. Pennsylvania General Ins. Co.* (Wis. 1979) 275 N. W.2d 660.)

One theory that has been disapproved in the context of suits against adjusters is conspiracy to commit bad faith by treating the insured in an unreasonable manner. (*The Doctors' Company v. Superior Court* (1989) 49 Cal.3d 39; *Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566.) In *Doctors' Company*, the Supreme Court of California held that, under *Gruenberg*, an insurer's adjusters and attorneys are not liable for conspiracy. In *Gruenberg*, the plaintiff alleged that his insurers, and their adjusters and attorneys, conspired to deny benefits for an insured fire loss. In furtherance of the conspiracy, the adjusters and attorneys had (1) encouraged criminal charges by falsely implying to an official investigator and at a preliminary hearing that the plaintiff had a motive to commit arson, (2) used the plaintiff's failure to appear at an examination under oath as a pretext for denying the claim even though they knew plaintiff would not appear during the pendency of the criminal charges, and (3) refused to accept plaintiff's offer to appear for an examination under oath after the charges were dropped.

The Court held that these allegations stated a cause of action against the insurers for breach of the implied covenant of good faith and fair dealing. The attorneys and adjusters, however, could not be liable for conspiracy because (1) they were not parties to the insurance contracts and therefore not subject to the implied covenant of good faith and fair dealing, (2) as agents and employees of the corporate insurers, the attorneys and adjusters could not conspire with the insurers where they were acting in their official capacities on behalf of the corporation and not as individuals for their individual advantage. (*Gruenberg v. Aetna Ins. Co.*, *supra*, 9 Cal.3d at p. 576; *see The Doctors' Company v. Superior Court*, *supra*, 49 Cal.3d at pp.44-45.)

It is still true, however, that under other circumstances, attorneys or adjusters may be liable for participation in tortuous acts with their client-insurers, and such liability may rest on a conspiracy theory. (*See, e.g., Barney v. Aetna Cas. & Sur. Co.* (1986) 185 Cal.App.3d 966.) In *Barney*, the car driven by the plaintiff collided with another car. Without notice to the insured, the insurer-retained attorneys settled the other driver's claim and filed a dismissal with prejudice, thus barring the insured's own action against the other driver. The insured's conspiracy cause of action against the insurer and attorneys was upheld, since the settlement clearly violated the attorney's own fiduciary duty to the insured. (*See Ivy v. Pacific Automobile Ins. Co.* (1958) 156 Cal.App.2d 652; *see also, Younan v. Equifax Inc.* (1980) 111 Cal.App.3d 498 [Insurer's agents held subject to liability for conspiracy to commit fraud, since they had a duty to abstain from injuring the plaintiff through express misrepresentation, independent of the insurer's implied covenant of good faith and fair dealing.]

The insured is not the only party that can recover against the claims adjuster. Since it is commonly believed the adjuster does owe a duty of care to the insurer, there have been cases where the insurer, or even a third party, recovered from the adjuster. In *Blackwell v. American Southern Ins. Co.* (Ga.App.1970) 175 S.E.2d 160, an insurer was entitled to recover from the adjuster the amount the adjuster, as part of a scheme to defraud the

insurer, overvalued a house damaged by fire, even though recovery was limited to the difference between actual value and the amount paid as a result of the misrepresentation. And in *Gay & Taylor, Inc. v. American Cas. Co. of Reading, Pa.* (Tenn.App. 1963) 381 S. W. 2d 304, an automobile liability insurer was entitled to recover damages for breach of contract on the part of an independent adjuster who failed to forward the claim file to the insurer's attorney, thus permitting default judgments to be entered against the insured.

If an adjuster exceeds his authority and causes damage to a third party, the adjuster may under certain circumstances incur independent liability to the third party. In *Miller v. Hartford Fire Ins. Co.* (Iowa 1960) 102 N. W.2d 368, an adjuster employed a repairman to make certain repairs to the insured property for an agreed price. The adjuster, however, lacked authority to bind the insurer, and was found liable to the repairman, who had acted in complete reliance upon the adjuster's representations.

Insurance coverage attorneys may also be sued for independent torts allegedly committed in connection with an insurance claim. The potential liability for independent adjusters and even the insurer's coverage counsel for non-derivative bad faith liability for other intentional torts was recently addressed in *Shafer v. Berger, Kahn, Shafton, Moss, Figler, Simon & Gladstone* (2003) 107 Cal.App.4th 54.

In *Shafer*, the insured was sued for various causes of action arising out of a construction dispute. The insurer issued an ROR that triggered a right to independent counsel. The insurer's coverage counsel then advised that because the allegations against the insured did not appear to involve intentional conduct, the ROR pertaining to intentional acts could be withdrawn and panel counsel appointed. The ROR was then withdrawn and panel counsel took over the defense of the insured. A judgment followed which incorporated a substantial fraud award, and the third party claimant, judgment in hand, brought a "direct action" (explained in the next section) against the insurer for payment.

Coverage counsel then advised the third party claimant that there was no coverage for the portions of the award that were based on intentional conduct, and payment issued for the non-intentional conduct portions of the award.

Years later *Shafer* (purportedly) discovered that the ROR pertaining to intentional acts had been withdrawn before the award had been entered, and brought suit against the coverage counsel and the insurer for fraud and other torts. Coverage counsel's demurrer was sustained without leave to amend, but the Court of Appeal, in a strongly worded opinion, reversed, holding that coverage counsel can be sued for fraud and conspiracy with the insurer to commit fraud in connection with statements made to the third party claimant turned judgment creditor

VII. ACTIONS AGAINST INSURERS BY NON-INSUREDS

A. BAD FAITH IN THE ABSENCE OF CONTRACTUAL PRIVACY

As set forth above, in many states third party claimants are precluded from bringing suit against insurers for conduct relating to the insurers' handling of the 3rd party's claims

against the insured. This is not to say that an insurer in those states may treat 3rd party claimants with impunity. Many states have so called “direct action” statutes that allow third party claimants to proceed directly against the insurer after obtaining a judgment against the insured. In many of those states, the 3rd party steps into the shoes of the insured, and can even assert claims for bad faith against the insured if the award is not immediately paid.

For example, in California, the decision in *Hand v. Farmers Insurance Exchange* (1994) 23 Cal.App.4th 1847, provides that where a third party claimant had obtained a final judgment and became a judgment creditor under *Insurance Code § 11580*, the third party may properly bring a Bad Faith cause of action against an insurer who unreasonably fails to satisfy that judgment on behalf of its insured. (*Id.*, at p. 1858.)

A non-insured was allowed to pursue bad faith claims in *Mosier v. Southern Californian Physicians’ Insurance Exchange* (1998) 63 Cal.App.4th 1022. *Mosier* involved a unique fact situation where an insurer provided a courtesy defense to an uninsured physician for a medical malpractice action. (*Id.*, at pp. 1029, 1030.) After the trial concluded, the uninsured physician brought suit against the insurer alleging that it had improperly handled his defense. (*Id.*, at p. 1030.) On Appeal, the Court held that the physician could properly bring suit against the defending insurer, even though he lacked contractual privity with the insurer because once that insurer undertook the physician’s defense, it was obligated to conduct such a defense in accordance with the same duties it owed its insureds. (*Id.*, at p. 1040 [“One who voluntarily comes to the aid of another, having no initial duty to do so, becomes bound to exercise due care in the performance of the duties it undertakes to provide.”].)

In any event, a valid and enforceable judgment is generally a pre-requisite to bringing a direct action against an insurer. (*In re Lundberg* (ED Okla 1993) 152 B.R. 316, 318 [“[T]he liability of the insured must be determined prior to recovery against the insurer on the liability policy.”].)

Some states allow direct actions before judgment, (*La Rev. Stat Ann § 22:655* (West 1978); *Ga Code Ann § 68-612* (1980); *RI Gen. Laws § 27-7-2* (1979)). However, those states are a distinct minority.

Regardless of whether an actual judgment is required or not, an insurance company facing a direct action will ordinarily be able to assert against the injured party any coverage defense it would have against its own insured. (*United Servs. Auto Assn. v. Martin* (1981) 120 Cal.App.3d 963, 964-965, 174 Cal.Rptr. 835, 836 [If insured breached cooperation clause of policy and carrier was prejudiced thereby, injured party is barred from recovering directly against the insurer.]; *Mitchell v. Tatum* (1982) 104 Ill.App.3d 986, 433 NE.2d 978, 981 [If insured fails to give timely notice under insurance policy, injured party is barred from recovering directly from the insurer.].) Similarly, since the injured party will, in effect, stand in the shoes of the insured, the injured party should be able to assert any defenses that would have been available to the insured, including waiver and estoppel. (*Williams v. Community Drive-In Theatre, Inc.* (1979) 3

Kan.App.2d 352, 595 P.2d 724, 725 [Garnishor stands in the shoes of the insured, taking what the insured could personally enforce.]

But, the ability to use defenses it could have used against its insured against the 3rd party claimant often is coupled with an obligation to treat that third party claimant as one would treat one's insured. In other words, the party the claims professional is fighting with in trial one day could very well become that claim's professional's "insured" the next. The lesson to be learned is that whether a claim for insurance benefits is made by an insured, or by a third party alleging injury caused by the insured, it is important to keep the covenant of good faith and fair dealing in mind at all times

VIII. CONCLUSION

It is impossible to cover all of the various permutations and variations of first party and third party insurance claims handling and bad faith. The area remains year after year one of the most active, with decisions coming down in each state on a daily basis, each changing the rules ever-so-slightly in order to correct some past claimed transgression by either and insurer or policyholder.

The one thing it is possible to do is to impress upon the claims professional that his or her conduct in evaluating, investigating and otherwise responding to claims will, more likely than ever before, be placed under a bad faith microscope by some policyholder counsel or expert. If the claims handler has lived by the golden rules of claims handling (found in the unfair claims practices act of that adjuster's jurisdiction), the odds are he or she will never know that his or her claims handling was examined. If the claims professional broke one of the rules, even innocently, then it is a virtual certainty that he or she will be asked under oath to explain the claims handling decisions under oath. Though most bad faith suits in this author's experience do not involve "true" bad faith, the experience is one to be avoided, if possible. Hopefully, this article will help.