

## **BAD FAITH AND PUNITIVE DAMAGES IN LIABILITY INSURANCE**

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### **I. INTRODUCTION**

As the state of the national economy worsens, many insureds find themselves looking for additional sources of revenue. As a result, they may be more likely than ever to assert – and litigate – claims against insurers. Legislatures and courts have made it all too easy to sue insurers, by legislating new causes of action and imposing more stringent standards of conduct on insurers. This is especially true in the area of the duty to investigate, where increasingly, insurers can be held liable even in the absence of coverage.

It seems likely that the insurance industry will continue to face lawsuits seeking contractual and extracontractual<sup>1</sup> damages arising out of coverage decisions and claims handling. Thus, insurers are wise to understand the risks they face in the states where they do business. All states allow claims for breach of contract against insurers, and most states allow extracontractual claims against insurers. While the law varies from state to state – sometimes considerably – there are some general principles that apply nationwide (or at least in most jurisdictions).

The first step, therefore, is to evaluate which states' laws may apply to coverage issues, because choice of law may determine the outcome. The next step is to thoroughly research the relevant states' statutes, regulations and case law to understand the controlling standards. The stakes for not doing so can be high, because an adverse verdict can subject an insurer to extracontractual damages that include consequential damages, emotional distress damages, treble damages, attorneys' fees – and, in egregious cases, punitive damages. Although the United States Supreme Court limited the multipliers for punitive damages in *State Farm Mutual Insurance Company v. Campbell*, 538 U.S. 408 (2003), and some state supreme courts and legislatures have done likewise, juries remain eager to impose punitive damages.

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<sup>1</sup> As a terminology note, the terms “extracontractual,” “breach of the implied covenant of good faith and fair dealing” and “bad faith” are often used interchangeably.

This article introduces the general concepts of bad faith liability in third-party cases. This article discusses how claims can arise in the context of an insurer's duties to defend, investigate, settle and indemnify, and what steps are likely to prevent bad faith liability. This article also discusses the elements of the tort of bad faith, damages, punitive damages, and affirmative defenses available to the defendant insurer. Finally, this article reports on recent developments regarding the scope of the duty to investigate and the standard for punitive damages.<sup>2</sup>

## II. THIRD-PARTY BAD FAITH

Terminology in the liability context varies from property terminology in some important respects. In particular, the term "third-party" is frequently used in a variety of ways.

- Third-Party Claim a/k/a Liability Claim: In the coverage context, these terms refer to a situation in which a third party makes a claim against the insured, and the insured seeks coverage for that claim from its insurer. That third party is known as the "third-party claimant" or the "underlying plaintiff." A claim might develop into a lawsuit, known as an "underlying action," which is usually captioned *Third-Party Claimant vs. Insured*.
  - In this sense, the term "third-party claim" is distinguished from a "first-party claim" made by the insured under a property policy, in which the insured seeks coverage for damage it has sustained to its own property interests. *See, e.g., Port Authority of New York and New Jersey v. Affiliated FM Ins. Co.*, 311 F.3d 226, 233 (3d Cir. 2002) (New Jersey law); *Garvey v. State Farm Fire & Cas. Co.*, 48 Cal.3d 395, 399 n.2 (1989).
- Third-Party Bad Faith Suit a/k/a Coverage Action: These cases are usually captioned *Insurer vs. Insured*. In the bad faith context, a third-party bad faith suit stems from an underlying action (as described above). In such situations, the insured may file suit against the insurer to require payment to the third party, on the insured's behalf, for the underlying action. Alternatively, the insured may file suit against the insurer based on the insurer's alleged improper evaluation or handling of the underlying action. This article discusses that scenario.
- Third Party Direct Actions: To add to the confusion, some states allow a third party to file a coverage action directly against the insurer, without involving the insured in the lawsuit. Such cases are usually captioned *Third-Party Claimant vs. Insurer*. This issue is discussed in Section V, below.

Most liability policies agree to defend and indemnify the insured against suits (underlying

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<sup>2</sup> Because policy terms and the law vary, and depend on the specific facts presented, this survey is not intended as legal advice and readers should not rely on it without actual consultation with a lawyer.

actions) that fall within the policy's coverage provisions. Liability policies often expressly provide that the insurer has discretion to settle claims or suits – but even if they do not, state law often reads a duty to settle into these policies.

The most common type of liability policy is a commercial general liability (or “CGL”) policy. They contain coverage parts agreeing to provide a defense and indemnity for covered suits for “property damage,” “bodily injury,” “personal injury” and “advertising injury,” as those terms are defined in the policy. Other common types of liability policies are errors and omissions policies (which cover a professional's malpractice) and directors and officers policies (which cover certain types of corporate misconduct). Many first-party policies, such as auto and homeowners policies, also contain liability coverage parts – for example, for bodily injury sustained in an auto accident, or for a guest's slip and fall at the insured's home.

Liability insurers typically have the following duties:

- The duty to defend;
- The duty to investigate;
- The duty to indemnify; and
- The duty to settle.

Some states, such as California, allow bad faith claims on any of these bases. *See, e.g., Comunale v. Traders & Gen. Ins. Co.*, 50 Cal.2d 654, 659-660 (1958); *Crisci v. Security Ins. Co.*, 66 Cal.2d 425, 431 (1967). Other states, such as New York, limit tort liability for bad faith claims to wrongful failure to settle claims made against the insured. *AFIA v. Continental Ins. Co.*, 140 A.D.2d 167, 168, 527 N.Y.S.2d 420, 421 (1988). Still other states, such as Washington State, have recently imposed bad faith liability on yet another basis, for “procedural bad faith” in failing to follow the state's insurance regulations. *St. Paul Fire & Marine Ins. Co. v. Onvia, Inc.*, 165 Wash.2d 122, 196 P.3d 664 (2008)

In today's landscape, an insurer may find itself liable for bad faith even if it settles and pays the claim. In most states, insurers are liable only if they have acted “unreasonably.” The problem, of course, is that this is a nebulous term subject to manipulation and interpretation. An equally serious problem is that the use of the term “unreasonable” may be confused with the lower standard for mere negligence. *See, e.g., Cal. Civ. Jury Instr. 2331* (“unreasonable” conduct required for finding of bad faith).

#### **A. The Duty to Defend**

The duty to defend is usually based on the policy's insuring clause, which typically provides that the insurer has the “right and duty to defend” potentially covered claims. Unlike the duty to indemnify, which arises only when the insured's liability in the underlying action has been established, the duty to defend must usually be analyzed at the inception of the underlying action.

It is well established that the duty to defend is broader than the duty to indemnify. *Allstate Ins. Co. v. Bowen*, 121 Wash. App. 879, 884, 91 P.3d 897, 900 (2004);

*Erdman v. Eagle Ins. Co.*, 239 A.D.2d 847, 849, 658 N.Y.S.2d 463, 466 (1997); *Crum & Forster Managers Corp. v. Resolution Trust Corp.*, 156 Ill.2d 384, 393-394, 620 N.E.2d 1073, 1079, 189 Ill. Dec. 756, 762 (1993). As a practical matter, this means that the insurer has a duty to defend claims that are only “potentially covered,” whereas the duty to indemnify is limited to claims that are actually covered. *Buss v. Superior Court*, 16 Cal.4<sup>th</sup> 35, 46 (1997). Most courts construe the duty to defend liberally, and require a defense of the entire underlying action even if only one claim is potentially covered. *Montrose Chemical Corp. v. Superior Court*, 6 Cal.4<sup>th</sup> 287, 295-296 (1993). Indeed, in an era of skyrocketing legal costs, the duty to defend may be a more valuable policy benefit to the insured. Thus, 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. *Employers Ins. of Wausau v. Ehlco Liquidating Trust*, 186 Ill.2d 127, 153, 708 N.E.2d 1122, 1136, 237 Ill. Dec. 82, 96 (1999); *Lawyers Title Ins. Corp. v. JDC (America) Corp.*, 52 F.3d 1575, 1580 (11<sup>th</sup> Cir. 1995) (Florida law); *A-Mark Fin. Corp. v. CIGNA Prop. & Cas. Cos.*, 34 Cal.App.4<sup>th</sup> 1179, 1185 n.2 (1995).

### **1. Is the Suit Potentially Covered? The Duty to Investigate**

Property insurers usually have wide latitude to investigate claims. With liability claims, however, the insurer’s duty – and ability – to investigate coverage is usually somewhat limited, for the reason that the insurer may not do anything to prejudice the insured’s defense of the underlying action. *Haskel, Inc. v. Superior Court*, 33 Cal.App.4<sup>th</sup> 963, 974-980 (1995). States are generally grouped into three categories, with respect to the scope of the duty to investigate.

- In “four corners” states, such as Maine and Florida, an insurer must look at the allegations in the four corners of the underlying complaint in order to determine whether a duty to defend exists. *Travelers Indem. Co. v. Dingwell*, 414 A.2d 220, 224 (Me. 1980); *Federal Ins. Co. v. Applestein*, 377 So.2d 229, 231 (Fla. Dist. Ct. App. 1979).
- In “eight corners” states, such as Texas and Illinois, an insurer must look to the factual allegations in the underlying complaint and the policy to determine whether a duty to defend exists. *St. Paul Ins. Co. v. Texas Dept. of Transportation*, 999 S.W.2d 881, 884 (Tex. App. - 3d Dist. 1999); *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 154 Ill.2d 90, 107-108, 607 N.E.2d 1204, 1212, 180 Ill. Dec. 691, 699 (1992).
- In “extrinsic evidence” states, such as Maryland and California, an insurer must look not only at the underlying complaint and policy, but must additionally consider any extrinsic evidence that gives rise to a duty to defend. *Chantel Assocs. v. Mt. Vernon Fire Ins. Co.*, 338 Md. 131, 141-142, 656 A.2d 779, 784 (1995); *Horace Mann Ins. Co. v. Barbara B.*, 4 Cal.4<sup>th</sup> 1076, 1081 (1993). Under this approach, insurers may, but are not required to, consider extrinsic evidence that eliminates any duty to defend.

In recent years, the scope of the duty to investigate has become a hot topic, especially in western states.

In *Wilson v. 21<sup>st</sup> Century Ins. Co.*, 42 Cal.4<sup>th</sup> 713 (2007), the California Supreme Court ruled that an insurer acted in bad faith when it denied coverage following an inadequate investigation. The insured made an underinsured motorist “bodily injury” claim, and the insurer disclaimed coverage solely on the basis of the insured’s medical records, without consulting the insured’s treating physician, and without having the insured examined by a doctor of the insurer’s own choice. The court stopped short, however, of finding that a “blanket duty” to investigate exists. Shortly before *Wilson* was decided, the California Supreme Court accepted review of *Delgado v. Interinsurance Exchange of the Automobile Club of Southern California*, in which the California Court of Appeal recently applied a distinction used in first-party property cases, whether a “factual” or “legal” dispute exists, to the third-party liability scenario. The California Supreme Court has accepted review of *Delgado* on a different issues (the distinction between negligent and intentional conduct), so the Court of Appeal’s decision cannot be cited. In light of the intervening decision in *Wilson*, it remains to be seen whether the court will comment further on the scope of the duty to investigate.

The Washington Supreme Court has recently extended the rule that an insurer can be liable for bad faith for failure to investigate a first-party claim, even when no coverage exists, to the third-party context. *St. Paul Fire & Marine Ins. Co. v. Onvia, Inc.*, 165 Wash.2d 122, 196 P.3d 664 (2008) (extending *Coventry Assocs. v. American States Ins. Co.*, 136 Wn.2d 269, 961 P.2d 933 (1998)). *Onvia* involved an underlying action against the insured for fax blasting; the insurer disclaimed coverage, and the insured filed a bad faith action in federal court. The federal court held that no coverage existed, and thus the insurer had no duty to defend, settle or indemnify for the underlying action. The federal court asked the Washington Supreme Court to rule on the issue of whether the insurer can be liable for “procedural bad faith,” even when there is no coverage. The Washington Supreme Court ruled that the answer is “yes.” Specifically, insurers can be liable for bad faith for failing to timely communicate with the insured, even if there is no coverage, but the insured must first prove it suffered actual damages.

## **2. Evaluating Potential Coverage to Determine Duty to Defend**

Where the allegations made against the insured are potentially covered under the policy, the insurer must defend the underlying action. *Hawaiian Holiday Macadamia Nut Co. v. Industrial Indem. Co.*, 76 Hawai’i 166, 169, 872 P.2d 230, 233 (1994). In contrast, “[w]here pleadings fail to allege any basis for recovery within the coverage clause, the insurer has no obligation to defend.” *Id.*; see *Novak v. Insurance Admin. Unlimited, Inc.*, 91 Ill.App.3d 148, 150, 414 N.E.2d 258, 260, 46 Ill. Dec. 536, 538 (1980).

The duty to defend, although broad, is not without limitations. An insurer must defend a suit against its insured if, but only if, any of the allegations against the insured could result in a judgment that the insurer would be obligated to pay (*i.e.*, would have a duty to indemnify). *Waller v. Truck Ins. Exch.*, 11 Cal.4<sup>th</sup> 1, 18 (1995) (“Where there is no potential for the third party to recover on a covered claim, there is no duty to defend.”); *McCostis v. Home Ins. Co. of Indiana*, 31 F.3d 110, 112 (2d Cir. 1994) (under New York law, “[a]n insurer can escape the duty to defend only if there is no legal or factual basis in the complaint upon which the insurer might eventually have to indemnify the insured.”); *Doyle v. Engelke*, 219 Wis.2d 277, 284-285, 580 N.W.2d 245, 248 (1998) (“An insurer has a duty to defend a suit where the complaint alleges facts which, if proven at trial, would give rise

to the insurer's liability under the terms of the policy.'').

This holds true even if the claims are frivolous and without merit. *Lawyers Title Ins. Corp. v. JDC (America) Corp.*, 52 F.3d 1575, 1580 (11<sup>th</sup> Cir. 1995) (Florida law) (“[T]he 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 Fin. Corp. v. CIGNA Prop. & Cas. Cos.*, 34 Cal.App.4<sup>th</sup> 1179, 1190 n.3 (1995) (“Thus, the fact that it was ultimately established in the underlying ... litigation that [the insured] did not advertise its products and services to the general public [a prerequisite to coverage] is not ... dispositive since plaintiffs claimed, and sought to prove, that it did.”).

In analyzing whether or not a defense is owed, the insurer should not focus on the labels the underlying plaintiff places on his or her claims. *Hurley Constr. Co. v. State Farm Fire & Cas. Co.*, 10 Cal.App.4<sup>th</sup> 533, 538 (1992) (“a third party is not the arbiter of the policy's coverage.”). “A corollary to this rule is that the insured may not speculate about unpled third party claims to manufacture coverage.” *Id.* For example, a cause of action may be labeled “intentional interference with contractual relations,” which does not qualify as an enumerated “personal injury” or “advertising injury” offense (and as such is not covered) – but contain facts that allege the elements of defamation, which is an enumerated “personal injury” and “advertising injury” offense, and is potentially covered.

As noted above, in many states, the insurer must consider extrinsic facts made known to the insurer. In these states, where the insurer obtains information from which it appears that there might be coverage for any of the damages sought from the insured, the insurer has a duty to defend, even if the allegations of the complaint themselves would not give rise to such a duty. *Perkins v. Allstate Ins. Co.*, 63 F.Supp.2d 1164, 1174 (C.D. Cal. 1999); *Fitzpatrick v. American Honda Motor Co., Inc.*, 78 N.Y.2d 61, 66, 575 N.E.2d 90, 92, 571 N.Y.S.2d 672, 674 (1991) (even though New York is a “four corners” state, insurers cannot ignore known facts that would implicate coverage, even if the pleadings are themselves inadequate to trigger a duty to defend).

This rule is usually applicable only if the insurer was aware, or should have been aware, of such extrinsic evidence when it refused to defend. *Gunderson v. Fire Ins. Exch.*, 37 Cal.App.4<sup>th</sup> 1106, 1114 (1995) (“The issues here are what facts [the insurer] knew at the time [the insureds] tendered the defense of the [underlying action] ... and whether these known facts created a potential for coverage under the terms of the Policy.”); *Controlled Blasting, Inc. v. Ranger Ins. Co.*, 225 Ga. App. 373, 375, 484 S.E.2d 47, 49 (1997) (“[T]he 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.”). In other words, the existence of a duty to defend usually cannot be determined based upon hindsight. *Aetna Cas. & Sur. Co. v. Dow Chem. Co.*, 44 F.Supp.2d 847, 856 (E.D. Mich. 1997); *Amato v. Mercury Cas. Co.*, 53 Cal.App.4<sup>th</sup> 825, 833 (1997).

Once the duty to defend is triggered, it can extend to all of the claims made against the insured, not just those that may be potentially covered under the policy. *Buss v. Superior Court*, 16 Cal.4<sup>th</sup> 35 (1997); *Matsushita Elec. Corp. of Am. v. Home Indem. Co.*, 907 F.Supp. 1193, 1196 (N.D. Ill. 1995). In a very few states, and only in the rare case where defense costs can be readily

apportioned between covered and non-covered claims, the insurer may limit its defense to the covered claims only. *Enron Corp. v. Lawyers Title Ins. Co.*, 940 F.2d 307, 311 (8<sup>th</sup> Cir. 1991) (Virgin Islands law). Where the insurer is required to defend all claims made against the insured, some states allow the insurer to reserve the right to later seek reimbursement from the insured for defense costs attributable to defending the non-covered claims. *Capitol Indem. Corp. v. Blazer*, 51 F.Supp.2d 1080, 1090 (D. Nev. 1999); *Buss*, 16 Cal.4<sup>th</sup> at 65. California recently extended this principle to allow the insurer to reserve its right to recover all defense costs, if the court later determines that none of the underlying claims was potentially covered. *Scottsdale Ins. Co. v. MV Transportation*, 36 Cal.4<sup>th</sup> 643 (2005).

Most policies provide that the insured has a duty to defend “suits” against the insured. Jurisdictions differ as to whether this term requires an actual lawsuit, or whether it encompasses administrative actions, such as an order from an environmental agency to clean up pollution. Compare *Foster-Gardner, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 18 Cal.4<sup>th</sup> 857 (1998) (duty to defend is limited to actual lawsuits filed in court); *Lapham-Hickey Steel Corp. v. Protection Mut. Ins. Co.*, 166 Ill.2d 520, 531, 655 N.E.2d 842, 847, 211 Ill. Dec. 459, 464 (1995) (same); *Reisner v. Vigilant Ins. Co.*, 138 Misc.2d 542, 544, 524 N.Y.S.2d 602, 604 (1987) (same) with *Hi-Mill Mfg. Co. v. Aetna Cas. & Sur. Co.*, 884 F.Supp. 1109, 1116-1117 (E.D. Mich. 1995) (requiring insurer to defend administrative action by Environmental Protection Agency).

With respect to the requirement of “damages,” some states have limited the duty to defend to suits seeking compensatory monetary damages, while other states require insurers to defend actions seeking equitable relief. Compare *Bank of the West v. Superior Court*, 2 Cal.4<sup>th</sup> 1254 (1992) (insurer has no duty to defend claims for equitable relief); *School Dist. No. 1, Multnomah County v. Mission Ins. Co.*, 58 Or. App. 692, 704 (1982) (suggesting no duty to defend suits seeking purely equitable relief) with *Outboard Marine Corp. v. Liberty Mut. Ins. Co.*, 154 Ill.2d 90, 115-117, 607 N.E.2d 1204, 1215-1216, 180 Ill. Dec. 691, 702-703 (1992) (prayers for equitable relief fall within policy definition of “damages”); *Home Indem. Co. v. City of Marianna*, 291 Ark. 610, 613, 727 S.W.2d 375, 376 (1987) (insurers may be required to defend claims for equitable relief in select circumstances).

### **3. Disclaimer of Duty to Defend**

If the underlying action does not appear to be even potentially covered, the insurer may disclaim a duty to defend. In some situations, the insurer’s decision may be erroneous, or the insured may simply disagree with the decision. Either way, the insurer faces a number of risks. First and foremost, the insurer waives its right to control the defense. *Hartford Accident & Indem. Co. v. Civil Service Emp. Ins. Co.*, 33 Cal.App.3d 26, 35 (1973). As a corollary, the insurer is not entitled to notice of any legal proceedings. Second, the insurer may lose the right to require the insured’s compliance with policy conditions, such as the duty to cooperate and to provide timely notice. *Employers Ins. of Wausau v. Ehlco Liquidating Trust*, 186 Ill.2d 127, 151, 708 N.E.2d 1122, 1135-1136, 237 Ill. Dec. 82, 96 (1999) (insurer that improperly declines to defend is estopped from raising coverage defenses). Third, the insurer may lose its right to control settlement, and the insured will not be required to obtain the insurer’s approval prior to settling the case. *Guillen v. Potomac Ins. Co. of Illinois*, 323 Ill.App.3d 121, 135-136, 751 N.E.2d 104, 117, 256 Ill. Dec. 51, 64 (2001)

Fourth, and more seriously, in a subsequent coverage action, the insurer typically cannot challenge matters expressly or impliedly adjudicated in the underlying action. *Pruyn v. Agricultural Ins. Co.*, 36 Cal.App.4<sup>th</sup> 500, 514-516 (1995). Fifth, and most crucially, an insurer's "bad call" will almost certainly be met with a coverage lawsuit for, at a minimum, breach of contract – and in a worst-case scenario, for bad faith.

By itself, an insurer's disclaimer of a duty to defend a potentially covered underlying action is simply a breach of contract. For the insurer to be additionally liable for bad faith, other elements must be present. In California, the insurer must have *actual* notice of facts giving rise to a duty to defend. *California Shoppers, Inc. v. Royal Globe Ins. Co.*, 175 Cal.App.3d 1, 37-38 (1985). In contrast, only *constructive* notice is required for a breach of contract claim. *Id.*

The key to the analysis is whether the insurer acted "unreasonably" under the circumstances; did the insurer disclaim a defense "without proper cause"? *California Shoppers*, 175 Cal.App.3d at 54. After all, "declining to perform a contractual duty under the policy with proper cause is not a breach of the implied covenant." *Id.* The reasonableness of the insurer's decision is evaluated as of the time it was made, rather than on the basis of later developments. *See Filippo Industries, Inc. v. Sun Ins. Co. of New York*, 74 Cal.App.4<sup>th</sup> 1429, 1441 (1999). On the other hand, an insurer facing a bad faith suit may raise any coverage defense. *State Farm Fire & Cas. Co. v. Jioras*, 24 Cal.App.4<sup>th</sup> 1619 (1994); *Love v. Fire Ins. Exch.*, 221 Cal.App.3d 1136, 1151-1153 (1990) (where no policy benefits are due, insured cannot maintain claim for bad faith).

In some states, an insurer's mere negligence is insufficient to subject it to liability for bad faith. *Congleton v. National Union Fire Ins. Co.*, 189 Cal.App.3d 51, 59 (1987). In contrast, Washington State recently enacted amendments to the Insurance Fair Conduct Act, which significantly broaden the insured's rights to sue for bad faith. Wash. Rev. Code §§ 48.30.010(7), 48.30.015. As originally proposed, the amendments would have prohibited insurers from "unreasonably or *negligently* deny[ing] a claim for coverage or payment of benefits to *any insured*" and allowed insureds to recover damages, including treble damages, based on an insurer's unreasonable or *negligent* conduct. S.B. 5726(3)(7), 5726(4), 60<sup>th</sup> Leg. (Wash. Jan. 29, 2007) (emphasis added). Although these new rights extend to "first-party claimants," the statutory definition of this term is arguably broad enough to encompass third-party claimants as well. *St. Paul Fire & Marine Ins. Co. v. Onvia, Inc.*, 165 Wash.2d 122, 196 P.3d 664 (2008) appears to have ruled that this statute applies to third-party claims as well as first-party claims (or at least paved the way for future cases to do so more definitively).

#### **4. Damages for Breach of the Duty to Defend**

The available damages vary significantly depending on whether the breach of the duty to defend constitutes a breach of contract or bad faith and, of course, on the jurisdiction.

If the underlying action was covered under the policy, then the insurer may be liable, at a minimum, for breach of contract damages. Under this measure of damages, an insured can recover only amounts due under the policy, plus any other “consequential” damages that were foreseeable when the policy was entered into. *Amato v. Mercury Cas. Co.*, 53 Cal.App.4<sup>th</sup> 825, 831 (1997). Such damages are ordinarily limited to attorneys’ fees and costs incurred by the insured in defending the underlying action. *Hogan v. Midland Nat’l Ins. Co.*, 3 Cal.3d 553, 564 (1970). If the insured had to pay a judgment or to settle the case, such amounts may be recoverable under a duty to settle or duty to indemnify analysis.

If the insurer is found liable for bad faith, the damages exposure becomes far worse. Extracontractual liability may be imposed in such instances. The measure of extracontractual damages can include treble damages, damages for emotional distress, attorneys’ fees incurred in pursuit of coverage, and even punitive damages. These issues are discussed in detail in Section III.A, below.

#### **B. The Duty to Settle**

##### **1. The Nature of the Duty to Settle**

The duty to settle refers to whether an insurer has a duty to pay to resolve the underlying action before a court enters a judgment against the insured. Most liability policies make settlement discretionary with the insurer. However, courts in many states have imposed a duty to settle on insurers, especially where the settlement is within policy limits, but a risk of an excess verdict exists. Thus, many states require the insurer to give the insured’s interests “at least equal consideration” to the interests of the insurer. *Jessen v. O’Daniel*, 210 F.Supp. 317, 325-326 (D. Mont. 1962) (enumerating six factors to consider in evaluating insurer’s response to policy limits demand), *aff’d*, *National Farmers Union Prop. & Cas. Co. v. O’Daniel*, 329 F.2d 60, 65 (9<sup>th</sup> Cir. 1964). An additional reason for this requirement is that, in most states, the insurer controls settlement. *See, e.g., Western Polymer Technology, Inc. v. Reliance Ins. Co.*, 32 Cal.App.4<sup>th</sup> 14, 24 (1995).

Although insurers are entitled to consider the likelihood of an adverse verdict against the insured in the underlying action, an insurer usually should not decline to settle on that basis. In *Crisci v. Security Ins. Co.*, 66 Cal.2d 425, 431-432 (1967), the court held that an insurer’s decision not to settle was unreasonable where it placed blind faith in the expectation that expert testimony would defeat the underlying plaintiff’s claims. The insurer turned down a \$10,000 demand while recognizing that a \$100,000 award might follow if the jury rejected the expert’s testimony. *Id.* In another case, an insurer declined a \$100,000 policy limit demand because the insurer unquestioningly relied on the insured’s statement regarding liability, despite mounting evidence to the contrary; this decision was held to be unreasonable. *Betts v. Allstate Ins. Co.*, 154 Cal.App.3d

688, 707 (1984). In *O'Neill v. Gallant Ins. Co.*, 329 Ill.App.3d 1166, 1168, 769 N.E.2d 100, 103, 263 Ill. Dec. 898, 901 (2002), the insurer decided not to settle a catastrophic injury case within policy limits. The appellate court characterized that decision as a “remarkable wizardry” that turned a \$20,000 contractual duty into a judgment of over \$3 million for bad faith refusal to settle.

In contrast, Massachusetts requires insurers to consider whether liability is “reasonably certain” when evaluating a third-party claimant’s settlement demand, and may even require insurers to extend settlement offers on behalf of the insured where liability is “reasonably certain.” See generally *Bobick v. United States Fid. & Guar. Co.*, 439 Mass. 652, 790 N.E.2d 653 (2003). The court articulated a nebulous standard for the insurer’s evaluation – “in light of the situation as a whole” and under the “over-all circumstances.”

A decision not to settle that forces the insured into bankruptcy can lead to bad faith liability. *Larraburu Brothers, Inc. v. Royal Indem. Co.*, 604 F.2d 1208, 1215 (9<sup>th</sup> Cir. 1979) (California law). In that case, the insurer declined a policy limits demand, exposing the insured to excess liability. When the insured’s creditors learned of this risk, they refused to extend further credit to the insured, forcing it into bankruptcy. Even though the insurer promptly paid the full amount of the excess verdict before entry of the judgment, the court ruled that the insured could still maintain a claim for bad faith.

An insurer may also be subject to bad faith liability when the settlement prevents the insured from seeking damages against the third party claimant. *Barney v. Aetna Cas. & Sur. Co.*, 185 Cal.App.3d 966, 976 (1986). Where there is more than one insured, the insurer should not enter into a settlement agreement with the third party which releases only one insured defendant but not the others. *Kinder v. Western Pioneer Ins. Co.*, 231 Cal.App.2d 894, 902 (1965).

An insurer may also be liable for bad faith if it asks an insured to contribute to the settlement. *J.B. Aguerre, Inc. v. American Guar. & Liab. Ins. Co.*, 59 Cal.App.4<sup>th</sup> 6, 15 (1997). The insured may independently offer to do so, however.

Notwithstanding the above, the duty to settle is not an unqualified duty. The insurer usually has a duty to settle only if, based on facts that are or should have been known to the insurer, there is a reasonable possibility of an excess verdict, and only if, in that situation, the insurer can settle within policy limits. *Dairyland Ins. Co. v. Herman*, 124 N.M. 624, 629, 954 P.2d 56, 61 (1997) (insurer has duty to settle when there is a substantial likelihood of recovery in excess of policy limits); *Riske v. Truck Ins. Exch.*, 490 F.2d 1079, 1082-1083 (8<sup>th</sup> Cir. 1974) (Minnesota law) (when determining whether insurer breached duty to settle, the company will be deemed to have knowledge of those facts which a proper investigation would have disclosed); *Boston Old Colony Ins. Co. v. Gutierrez*, 386 So.2d 783, 785 (Fla. 1980). Consequently, an insurer is liable only if its refusal to settle was unreasonable.

Typically, bad faith liability can attach only if the insurer had an opportunity to settle. An intermediate appellate court in Illinois recently noted that an insurer is not liable for bad faith where it rejects an offer to settle within policy limits that is made after an excess judgment against the insured in the underlying action. *Chandler v. American Fire & Cas. Co.*, 377 Ill.App.3d 253, 879 N.E.2d 396, 400, 316 Ill. Dec. 329, 333 (2007).

Similarly, where an insurer is defending the underlying action, the insured should not attempt to settle the underlying action without the insurer's consent. In *Mercado v. Allstate Ins. Co.*, 340 F.3d 824 (9<sup>th</sup> Cir. 2003) (California law), the underlying plaintiff rejected a settlement offer within policy limits, and the insured proceeded to enter into a stipulated judgment with the underlying plaintiff, in exchange for an assignment of rights against the insurer – despite the insurer's statement that it did not consent to the proposed transaction. The court held that the insurer was not liable for bad faith, because a cause of action for breach of duty to settle does not accrue until “after a litigated excess judgment is obtained” against the insured. *Id.* at 827. Similarly, where the policy contains a provision that the insurer need not reimburse the insured for voluntary payments made by the insured, the insured cannot obtain reimbursement for its voluntary settlement payment. *Low v. Golden Eagle Ins. Co.*, 110 Cal.App.4<sup>th</sup> 1532 (2003).

Insurers are unlikely to face liability for settlements that were allegedly harmful to the insured's reputation, especially when dealing with a non-“consent to settle” policy. *Hurvitz v. St. Paul Fire & Marine Insurance Company*, 109 Cal.App.4<sup>th</sup> 918, 929 (2003); *Western Polymer Technology, Inc. v. Reliance Ins. Co.*, 32 Cal.App.4<sup>th</sup> 14, 27 (1995). Consent to settle provisions are sometimes part of errors and omissions policies. Where such a policy is at issue, the insurer should keep in mind the insured's interest in having all the necessary information to make an informed decision to consent to a settlement. In *Mullen v. Physicians Ins.*, 130 Wash. App. 1031, 2005 WL 3105630 (Nov. 21, 2005) (unpublished opinion), the Washington Court of Appeals reversed summary judgment in favor of the insurer, highlighting that the insured physician was not provided with various critical information during the litigation, such as the mediator's evaluation and defense counsel's evaluation of the case.

Where the underlying action consists of both covered and non-covered claims, the insurer's duty to settle is arguably limited to the reasonable value of the covered claims only. *Camelot by the Bay Condo. Owners' Ass'n, Inc. v. Scottsdale Ins. Co.*, 27 Cal.App.4<sup>th</sup> 33, 53 (1994) (“The insurer does not, however, insure the entire range of an insured's well-being, outside the scope of and unrelated to the insurance policy, with respect to paying third party claims. It is an insurer, not a guardian angel.”). Alternatively, the insurer can settle and unilaterally reserve the right to seek reimbursement for the portion of the payment that is allocable to non-covered claims. *Blue Ridge Ins. Co. v. Jacobsen*, 25 Cal.4<sup>th</sup> 489 (2001). Most states do not allow this approach, however, instead requiring the insurer first to resolve the underlying action and then resolve settlement reimbursement with the insured. *Magnum Foods, Inc. v. Continental Cas. Co.*, 36 F.3d 1491, 1504-1505 (10<sup>th</sup> Cir. 1994) (Oklahoma law).

Finally, the duty to settle does not require the insurer to settle claims for punitive damages against the insured, for the reason that punitive damages are uninsurable in most states. Cal. Ins. Code § 533; *Home Ins. Co. v. American Home Prods. Corp.*, 75 N.Y.2d 196, 200, 550 N.E.2d 930, 932 (1990); *Beaver v. Country Mut. Ins. Co.*, 95 Ill. App.3d 1122 (1981) (punitive damages are not insurable where liability is based on insured's direct misconduct, but may be insurable if awarded pursuant to theory of vicarious liability or based on insured's "reckless indifference"). In such cases, the insurer must be prepared to put forth settlement amounts that will cover the reasonable value of the non-punitive claims. Although the insurer cannot ask the insured to contribute to settlement, the insured may independently offer to pay some amount allocable to claims for punitive damages.

In jurisdictions where punitive damages are insurable, however, an insurer may have a duty to settle claims for punitive damages. The Texas Supreme Court recently issued a long-awaited decision regarding the insurability of punitive damages. In *Fairfield Insurance Company v. Stephen Martins Paving LP*, 246 S.W.3d 653 (Tex. 2008), the court held that an insurer is required to indemnify an insured for an award of punitive damages based on the insured's gross negligence, in the context of specific types of workers compensation and employer's liability policies. Although this case did not address insurability of punitive damages in the context of an insurer's duty to settle, it remains to be seen whether courts will extend the *Stephen Martins* ruling in that direction.

## **2. Damages for Breach of the Duty to Settle**

Bad faith plaintiffs generally contend that where an insurer has not accepted a settlement demand within policy limits, it should be required to pay any judgment later entered, even if the judgment exceeds policy limits. Jurisdictions are split as to whether such damages are available. In some states, the insurer may be liable for the entire amount of an excess verdict. *Newhouse v. Citizens Sec. Mut. Ins. Co.*, 176 Wis.2d 824, 838, 501 N.W.2d 1, 6-7 (1993); *Crisci v. Security Ins. Co.*, 66 Cal.2d 425, 430 (1967). In other states, recovery is limited to amounts up to the policy limits. *United States Fid. & Guar. Co. v. Copfer*, 48 N.Y.2d 871, 873, 400 N.E.2d 298, 298, 424 N.Y.S.2d 356, 357 (1979) (insurer required only to reimburse insured in an amount up to the coverage limits absent a showing of bad faith).

In those states where an insurer may be liable for an excess verdict, the insurer may also be liable for all of the insured's damages proximately caused by breach of the duty to settle, regardless of policy limits. See, e.g., *Hamilton v. Marlyand Cas. Co.*, 27 Cal.4<sup>th</sup> 718, 725 (2002). Insureds may argue that the insurer's unreasonable failure to settle may have caused other harm to the insured, such as injury to business reputation, emotional distress, damage to credit, attorneys' fees and the like. See *Larraburu Brothers, Inc. v. Royal Indem. Co.*, 604 F.2d 1208, 1215 (9<sup>th</sup> Cir. 1979) (California law); *Gibson v. Western Fire Ins. Company*, 210 Mont. 267, 290-292, 682 P.2d 725, 738-739 (1984).

An insurer is not liable, however, for an award of punitive damages against the insured, in states that prohibit indemnification for punitive damages. “If we were to allow the intentional wrongdoer, here the insured, to shift responsibility for its morally culpable behavior to the insurance company, which surely will pass to the public its higher cost of doing business, we would defeat the public policies of punishing the intentional wrongdoer for its own outrageous conduct and deterring it and others from engaging in such conduct in the future.” *PPG Industries, Inc. v. Transamerica Ins. Co.*, 20 Cal.4<sup>th</sup> 310, 317 (1999). This holds true even though the punitive damages would not have been awarded but for the insurer’s decision not to settle prior to verdict.

### **III. STANDARDS FOR PROVING BAD FAITH**

Although most states have unique definitions for “bad faith,” the general inquiry is whether the insurer has struck an improper balance between its own and the insured’s interests. The following summarizes factors that many courts consider:

[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 insured 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 any other factors tending to establish or negate bad faith on the part of the insurer.

*Allen v. Allstate Ins. Co.*, 656 F.2d 487, 489 (9<sup>th</sup> Cir. 1981) (California law).

Traditionally, bad faith has required something more than mere negligence or mistakes in claims handling. The insured must show unreasonable conduct. However, some states allow for bad faith liability based on the lower standard of negligence. *Boston Old Colony Ins. Co. v. Gutierrez*, 386 So.2d 783, 785 (1980) (“Because the duty of good faith involves diligence and care in the investigation and evaluation of the claim against the insured, negligence is relevant to the question of good faith.”). It is therefore crucial for insurers to be award of the applicable standard in the jurisdiction at issue.

New York’s highest court recently recognized, for the first time, an independent tort cause of action for an insurer’s alleged failure to perform contractual obligations under the policy. *Bi-Economy Market, Inc. v. Harleystown Ins. Co. of New York*, 10 N.Y.3d 187, 886 N.E.2d 127, 856 N.Y.S.2d 505 (2008), *reargument denied*, 10 N.Y.3d 890, 891 N.E.2d 295, 861 N.Y.S.2d 262 (2008); *Panasia Estates, Inc. v. Hudson Ins. Co.*, 10 N.Y.3d 200, 886 N.E.2d 135, 856 N.Y.S.2d 513 (2008). Although both cases involve first-party claims for bad faith, they have potential implications for third-party bad faith claims. These cases overturned the prior standard articulated in *Rocanova v. Equitable Life Assur. Soc.*, 83 N.Y.2d 603, 613, 634 N.E.2d 940, 944, 612 N.Y.S.2d 339, 343

(1994), which had limited insureds to contractual recovery unless the insurer engaged in fraud or “egregious tortious conduct.” *Bi-Economy* and *Panasia* have not only lowered the standard for bad faith conduct, but have expanded the availability of punitive damages, under the guise of “consequential damages.”

### **A. Damages for Bad Faith**

Damages for bad faith typically include all damages proximately caused by the breach, although the measure of damages varies by state. In many states, insureds may recover for emotional distress. *Bates v. Superior Court*, 156 Ariz. 46, 49, 749 P.2d 1367, 1370 (Ariz. 1988).

Some states allow the insured to recover treble damages. Wash. Rev. Code § 19.86.090. Currently, Washington State limits recovery of treble damages to an amount not to exceed \$10,000. This statute is pending amendment under two competing bills as to the maximum dollar amount of the treble damages. S.B. 5531, 61<sup>st</sup> Leg. (Wash. Jan. 26, 2009) (proposing maximum of \$75,000); H.B. 1493, 61<sup>st</sup> Leg. (Wash. Jan. 21, 2009) (proposing maximum of “the greater of three thousand dollars or three times the actual damages sustained.”).

Where an insurer is found liable for bad faith, the insured may recover attorneys’ fees allocable to prosecuting the claim for breach of contract only. *Brandt v. Superior Court*, 37 Cal.3d 813 (1985) (allowing recovery where plaintiff’s counsel charged hourly fees); *Cassim v. Allstate Ins. Co.*, 33 Cal.4<sup>th</sup> 780 (2004) (same in contingent fee arrangement context); Or. Rev. Stat. § 742.061 (2005).

Crucially, a plaintiff is not necessarily entitled to punitive damages, even where a court finds that the insurer acted in bad faith. Standards for punitive damages vary, but most states require a heightened level of egregious, outrageous or evil conduct before imposing punitive damages. *See, e.g., Rawlings v. Apodaca*, 151 Ariz. 149, 162-163, 726 P.2d 565, 578-579 (Ariz. 1986) (requiring insured to prove by “clear and convincing” evidence that the insurer’s “evil hand was guided by an evil mind,” or that “facts establish that [the insurer’s] conduct was aggravated, outrageous, malicious or fraudulent.”); Mont. Code Ann. § 27-1-221 (requiring “clear and convincing evidence” of “actual malice” or “actual fraud”). Courts generally agree that punitive damages may not be awarded for breach of contract or “mere” or “ordinary” negligence. *Johnson & Higgins of Alaska Inc. v. Blomfield*, 907 P.2d 1371, 1376 (Alaska 1995); *Tri-Aspen Constr. Co. v. Johnson*, 714 P.2d 484, 488 (Colo. 1986). However, some states have relaxed the standard by finding that “gross negligence” or “reckless disregard” is sufficient for punitive damages. *Simbeck, Inc. v. Dodd Sisk Whitlock Corp.*, 257 Va. 53, 58, 508 S.E.2d 601, 604 (1999); *Cirrincione v. Johnson*, 184 Ill.2d 109, 115-116, 703 N.E.2d 67, 70, 234 Ill. Dec. 455, 458 (1998).

In June 2007, the California Court of Appeal issued a decision tying the amount of punitive damages to the reprehensibility of the insurer’s conduct. *Walker v. Farmers Ins. Exch.*, 153 Cal.App.4<sup>th</sup> 965 (2007). In that case, elderly residents in a condominium caused injury to another resident. The tortfeasors were not insured, but the homeowners association was. The insurer, through its claims adjuster, agreed to defend the homeowners association, but not the tortfeasors, in the resulting tort action, on the basis that the tortfeasors were individually liable rather than liable in

their capacity as members of the homeowners association. The tortfeasors retained their own counsel to defend the matter. The insurer subsequently authorized trial of the underlying action, and shortly before trial, the tortfeasors were able to settle, using borrowed funds. At issue, for the purpose of punitive damages, was whether the insurer had ratified the adjuster's decision to deny a defense to the tortfeasor. The California Court of Appeal concluded that the insurer's conduct showed a low level of reprehensibility, and affirmed reduction of the jury's award of punitive damages from \$8.3 million to \$1.5 million. The court explained that the following specific facts "indicated a relatively low level of reprehensibility":

Farmers' decision caused economic harm and emotional distress, and not physical harm; Farmers' conduct did not evince an indifference or reckless disregard for the health and safety of others; Farmers' conduct toward [the tortfeasors] was an isolated incident; and the harm to [the tortfeasors] was the result of oversight and a mistake.

*Walker*, 153 Cal.App.4<sup>th</sup> at 973.

In February 2008, the New York Court of Appeals lowered the standard for bad faith and, as part of the new framework, expanded the insured's ability to obtain punitive damages. *Bi-Economy Market, Inc. v. Harleystown Ins. Co. of New York*, 10 N.Y.3d 187, 886 N.E.2d 127, 856 N.Y.S.2d 505 (2008), *reargument denied*, 10 N.Y.3d 890, 891 N.E.2d 295, 861 N.Y.S.2d 262 (2008); *Panasia Estates, Inc. v. Hudson Ins. Co.*, 10 N.Y.3d 200, 886 N.E.2d 135, 856 N.Y.S.2d 513 (2008). Although these cases were decided in the first-party context, it remains to be seen whether New York courts will extend the new rulings to the third-party context.

#### **IV. DEFENSES TO BAD FAITH CLAIMS**

Insurers may assert a variety of defenses to claims of bad faith. This article discusses some of the key defenses that exist in most states.

##### **A. No Coverage Under the Policy**

A threshold inquiry is whether coverage exists for the underlying action. Where there is no coverage, there can be no bad faith. *Waller v. Truck Ins. Exch., Inc.*, 11 Cal.4<sup>th</sup> 1 (1995) (citing *Love v. Fire Ins. Exch.*, 221 Cal.App.3d 1136, 1136, 1151 (1990)). In some states, an insurer's reasonable interpretation of the policy serves as an affirmative defense to a bad faith claim. *Hart v. Prudential Prop. & Cas. Ins. Co.*, 848 F.Supp. 900, 902 (D. Nev. 1994). Similarly, where policy language is ambiguous and the underlying issues are novel, the insurer cannot be liable for bad faith. *Hummel v. Continental Cas. Ins. Co.*, 254 F.Supp.2d 1183, 1191 (D. Nev. 2003).

Thus, no matter how the insurer has handled the claim, there can be no liability for bad faith. *Federal Deposit Ins. Corp. v. Duffy*, 47 F.3d 146, 150 (5<sup>th</sup> Cir. 1995) (Louisiana law) (“Conduct in paying one claim under a policy does not prevent the insurer from raising defenses to the policy.”); *Downey Venture v. LMI Ins. Co.*, 66 Cal.App.4<sup>th</sup> 478, 510-511 (1998) (since public policy bars coverage for intentional wrongdoing, such coverage cannot be created by estoppel).

## **B. Genuine Dispute Doctrine**

Where there is a legitimate dispute as to the existence of coverage, **and** the insurer adequately investigated the claim, the genuine dispute doctrine is a strong defense. *Chateau Chamberay v. Associated Int’l Ins. Co.*, 90 Cal.App.4<sup>th</sup> 335 (2001); *Safeco Ins. Co. of Am. v. Guyton*, 692 F.2d 551, 557 (9<sup>th</sup> Cir. 1982) (California law) (“[S]ince the policy in dispute involved a genuine issue concerning legal liability, Safeco could not, as a matter of law, have been acting in bad faith by refusing to pay on the Policyholders’ claims.”); *Knoell v. Metro. Life Ins. Co.*, 163 F.Supp.2d 1072, 1075 (D. Ariz. 2001) (where claim is fairly debatable, as matter of law, insurer is not liable for bad faith for failing to pay insured’s claim immediately); *but see Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234, 237-239, 995 P.2d 276, 279-280 (Ariz. 2000) (if bad faith claim arises from conduct other than delay in payment of claimed funds, fair debatability is not necessarily sufficient to avoid bad faith liability).

The scope of the genuine dispute doctrine is currently in flux. As discussed in Section II.A.1, above, the California Court of Appeal recently applied it in *Delgado v. Interinsurance Exchange of the Automobile Club of Southern California*, arguably for the first time, to a third-party liability case. That case cannot be cited, as it is on appeal to the California Supreme Court. The California Supreme Court accepted review of a different issue (coverage for intention versus negligent conduct), and it is not clear whether the court will speak to the issue of the genuine dispute doctrine.

## **C. Advice of Counsel**

Insurers often consult 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 they 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 elements of this defense are that the insurer (1) acted in good faith reliance on advice of counsel and in what it believed was a manner necessary to protect its interests, (2) was not so knowledgeable as to the legal standard involved that it knew the advice of counsel was erroneous, (3) made full disclosure of all relevant facts to counsel, and (4) was willing to reconsider, and act accordingly, when it determined that the attorney’s advice was incorrect. *Melovich Builders, Inc. v. Superior Court*, 160 Cal.App.3d 931, 936-937 (1984).

Jurisdictions are split as to whether an insurer may rely on erroneous advice, for purposes of this defense. In *Gordon v. Nationwide Mutual Insurance Co.*, 30 N.Y.2d 427, 433, 334 N.Y.S.2d 601 (1972), the New York Court of Appeals held that reliance on advice of counsel is an absolute defense, noting: “It would be an extraordinary result to hold a client guilty of breach of good faith, with large punitive damages, because it acts on advice of counsel – even mistaken advice...” In contrast, under Texas law, an insurer’s reliance on the advice of counsel was held irrelevant. “We do not hold to 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.” *Blakely v. American Emp. Ins. Co.*, 424 F.2d 728, 734 (5<sup>th</sup> Cir. 1970) (Texas law).

While asserting this defense has several advantages, it also has several disadvantages, chief of which is that it waives the attorney-client privilege as to communications between the insurer and its counsel. Thus, insurers choose to assert this defense in rare circumstances only.

## V. “DIRECT” ACTIONS AGAINST INSURERS BY NON-INSUREDS

The prototypical coverage suit involves a claim by the insured against its insurer. Most states prohibit third-party claimants from maintaining a coverage action against the insurer. *See, e.g., Moradi-Shalal v. Fireman’s Fund Ins. Co.*, 46 Cal.3d 287, 304-305 (1988) (overruling *Royal Globe Ins. Co. v. Superior Court*, 23 Cal.3d 880 (1979), which had allowed third-party claimant to maintain bad faith action against insurer). In a minority of states, the third-party claimant actually has greater rights than the insured to sue for bad faith. Mont. Code Ann. § 33-18-242 (1987) (statute is pending amendment); N.M. Stat. Ann. § 59A-16-30 (1984). The view of these states is that certain types of policies, such as auto policies, exist for the benefit of the third party claimant, not the insured. At least one state has recognized a limited private right of action by third-party claimants for breach of the state’s unfair practices act, even in the absence of legislative approval. *State Farm Mut. Auto. Ins. Co. v. Reeder*, 763 S.W.2d 116, 118 (Ky. 1988).

Many of the states that adhere to the majority rule nonetheless allow non-insureds to maintain coverage actions by way of a direct action statute or judicial creation of such a right. In the typical situation, the insured and third-party claimant enter into a stipulated judgment and covenant not to execute, in exchange for an assignment of the insured’s rights against the insurer to the third-party claimant. One direct action statute provides:

[W]henever judgment is secured against the insured or the executor or administrator of a deceased insured in an action based upon bodily injury, death, or property damage, then an action may be brought against the insurer on the policy and subject to its terms and limitations, by such judgment creditor to recover on the judgment.

Cal. Ins. Code § 11580(b)(2); *see also Himes v. Safeway Ins. Co.*, 205 Ariz. 31, 34 n.2, 66 P.3d 74, 77 n.2 (Ariz. Ct. App. 2003) (“The term ‘*Damron/Morris*’ agreement ... refer[s] to any agreement between a third-party claimant and insured whereby the insured consents in any fashion to liability and enters into an agreement providing the third-party claimant with the insured’s breach of contract

and bad faith claims against the insurer in exchange for a covenant not to execute against the insured.”) (citing *Damron v. Sledge*, 105 Ariz. 151, 460 P.2d 997 (Ariz. 1969); *United Svcs. Auto. Ass’n v. Morris*, 154 Ariz. 113, 741 P.2d 246 (Ariz. 1987)).

Courts have imposed stringent standards on third-party claimants seeking to maintain a direct action.

Under section 11580 a third party claimant bringing a direct action against an insurer should therefore plead and prove: 1) it obtained a judgment for bodily injury, death or property damage, 2) the judgment was against a person insured under a policy that insures against loss or damage resulting from liability for personal injury or insures against loss of or damage to property caused by a vehicle or draught animal, 3) the liability insurance policy was issued by the defendant insurer, 4) the policy covers the relief awarded in the judgment, 5) the policy either contains a clause that authorizes the claimant to bring an action directly against the insurer or the policy was issued or delivered in California and insures against loss or damage resulting from liability for personal injury or insures against loss of or damage to property caused by a vehicle or draught animal.

*People ex rel. City of Willits v. Certain Underwriters at Lloyd’s of London*, 97 Cal.App.4<sup>th</sup> 1125, 1130 n.2 (2002) (citing *Wright v. Fireman’s Fund Ins. Cos.*, 11 Cal.App.4<sup>th</sup> 998, 1015 (1992)).

Fortunately, courts recognize that the “potential for fraud and collusion is evident” where the insured and third-party claimant enter into these arrangements. *Wright v. Fireman’s Fund Ins. Cos.*, 11 Cal.App.4<sup>th</sup> 998, 1024 (1992). Several protective mechanisms exist. First, many courts are vigilant in refusing to enforce settlements that are collusive or the product of fraud. *See, e.g., Rose v. Royal Ins. Co.*, 2 Cal.App.4<sup>th</sup> 709, 716 (1992). No less important, the insurer can assert the same coverage defenses against the third-party claimant that it can assert against the insured. *Mitchell v. Tatum*, 104 Ill.App.3d 986, 990, 433 N.E.2d 978, 981, 60 Ill. Dec. 740, 743 (1982); *Williams v. Community Drive-In Theatre, Inc.*, 3 Kan.App.2d 352, 353, 595 P.2d 724, 725 (1979). Insurers should remain aware, however, that a court may prohibit the insurer from challenging an underlying settlement, especially where it did not defend the underlying action.

## **VI. CONCLUSION**

It appears that for the foreseeable future insurers will continue to face a large volume of contractual and extracontractual suits. Insurers are therefore wise to understand the law, particularly relating to claims handling standards, in the states in which they do business.