

BAD FAITH DEVELOPMENTS IN THE WEST: AN UPDATE

Joyce C. Wang
Charles M. Clark, Esq.
Carlson, Calladine & Peterson LLP
353 Sacramento Street, 16th Floor
San Francisco, California 94111
Tel: (415) 391-3911
Fax: (415) 391-3898
jwang@ccplaw.com
cclark@ccplaw.com

Rina Carmel
Carlson, Calladine & Peterson LLP
333 South Grand Avenue, Suite 3500
Los Angeles, California 90071
Tel: (213) 613-1191
Fax: (213) 617-1191
rcarmel@ccplaw.com

I. INTRODUCTION

Over 145 years ago, the United States Supreme Court declared the regulation of insurance to be a state, rather than a federal, function. *Paul v. Virginia*, 75 U.S. 168, 183 (1869). Seventy-one years later, the Supreme Court confirmed that states are allowed to regulate those insurers that operate within their borders, but Congress has the power under the Commerce Clause to regulate insurers that engage in transactions across state lines. *United States v. South-Eastern Underwriters Ass'n*, 322 U.S. 533 (1944). In response, Congress enacted the McCarran-Ferguson Act, which declares that states remain free to regulate insurance. 15 U.S.C. §§ 1011, 1012(b) (exempting “business of insurance” from federal antitrust laws to the extent such business is regulated by state law); *American Int’l Group, Inc. v. Superior Court*, 234 Cal.App.3d 749, 756-758 (1991) (reviewing history of federal versus state regulation of insurance).

In response to terrorism and domestic social and economic issues, Congress has enacted some federal insurance legislation, such as the Terrorism Risk Insurance Act. Similarly, Congress is considering whether to amend the McCarran-Ferguson Act to allow for greater federal regulation of insurance. *See Insurance Industry Competition Act of 2007*, S. 618, H.R. 1081, 110th Cong. (2007).

Still, state law continues to govern the overwhelming majority of insurance questions. The states exhibit great disparity in their treatment of insurance law, and in the availability of, defense to, and remedies for an insurer’s alleged breach of the implied covenant of good faith and fair dealing. This article will summarize the general principles of bad faith law, and discuss recent developments, in Arizona, California, Nevada, Oregon and Washington State. The duty to defend and duty to indemnify are more or less settled in these states. Interestingly, the duty to investigate and duty to settle are becoming hot topics. Likewise, the scope of the genuine dispute doctrine as an

affirmative defense, and an insured's entitlement (if any) to punitive damages, are now key issues in most of these states.

II. ARIZONA

Arizona has a significant body of bad faith law, including a category of jury instructions devoted exclusively to bad faith. In the past few years, Arizona courts have considered numerous novel issues of bad faith law.

A. General Principles

1. Statutory And Common Law Bad Faith

With respect to statutory bad faith law, the Arizona Unfair Claims Settlement Act ("AUCSA") prohibits specified practices in connection with claims handling, investigation, settlement, and communication with insureds. Ariz. Rev. Stat. §§ 20-442, 20-461. No private right of action exists under the AUCSA. Ariz. Rev. Stat. § 20-461(D) ("It is, however, the specific intent of this section to provide solely an administrative remedy to the director for any violation of this section or rule related to this section."); *Leal v. Allstate Ins. Co.*, 199 Ariz. 250, 255, 17 P.3d 95, 100 (Ariz. Ct. App. 2000). Rather, only the Director of Insurance can enforce the AUCSA. Ariz. Rev. Stat. § 20-142.

Insureds may sue for violation of Arizona Revised Section § 20-443, which prohibits misrepresentations by insurers in connection with advertising practices. *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 541, 647 P.2d 1127, 1139 (Ariz. 1982), *cert. denied*, 459 U.S. 1070 (1982). The attorney general may sue for violations of the Consumer Fraud Act, Ariz. Rev. Stat. § 44-1521, *et seq.*, which creates a private cause of action for challenging deceptive practices. Arizona courts have additionally implied a private right of action for violations of this, as well as other, consumer protection statutes. *Transamerica Fin. Corp. v. Superior Court*, 158 Ariz. 115, 116, 761 P.2d 1019, 1020 (Ariz. 1988); *Sellinger v. Freeway Mobile Home Sales*, 110 Ariz. 573, 575-576, 521 P.2d 1119, 1121-1122 (Ariz. 1994).

Arizona recognized the tort of bad faith, and allowed a common cause of action for bad faith, in *Noble v. National American Life Insurance Co.*, 128 Ariz. 188, 190, 624 P.2d 866, 868 (Ariz. 1981). *Noble* defines bad faith "the absence of a reasonable basis for denying benefits of the policy and the [insurer's] knowledge or reckless disregard of the lack of a reasonable basis for denying the claim." *Id.*

Bad faith requires intentional conduct on the part of the insurer, and is evaluated under an "objective standard," in other words, whether "a reasonable insurer under the circumstances have denied or delayed payment of the claim under the facts and circumstances." *Id.*; see *Brown v. Superior Court*, 137 Ariz. 327, 336, 670 P.2d 725, 734 (Ariz. 1983). An insurer's failure to pay undisputed funds promptly constitutes bad faith *per se*. *Borland v. Safeco Ins. Co. of America*, 147 Ariz. 195, 200, 709 P.2d 552, 557

(Ariz. Ct. App. 1985). An insurer must give “equal consideration” to the interests of its insured. *Fulton v. Woodford*, 26 Ariz. App. 17, 20-21, 545 P.2d 979, 982-983 (1976).

Arizona is among a minority of jurisdictions that appear to hold that “[t]he covenant of good faith and fair dealing can be breached even if the policy does not provide coverage.” *Lloyd v. State Farm Mut. Auto. Ins. Co.*, 189 Ariz. 369, 377, 943 P.2d 729, 737 (Ariz. Ct. App. 1996), *rev. denied* (Ariz. Sept. 16, 1997); *Deese v. State Farm Mut. Auto. Ins. Co.*, 172 Ariz. 504, 509, 838 P.2d 1265, 1270 (Ariz. 1992) (“We hold that a plaintiff may simultaneously bring an action both for breach of contract and for bad faith, and need not prevail on the contract claim in order to prevail on the bad faith claim, provided plaintiff proves a breach of the implied covenant of good faith and fair dealing.”). As the Arizona Court of Appeals has observed, however, “[a]lthough the pertinent Arizona decisions clearly have rejected the notion that a contractual breach or even policy coverage is a necessary element of all bad faith claims, none of the cases suggests that a carrier may be held liable for bad faith denial of coverage in the face of a final judicial determination that there was no coverage.” *Manterola v. Farmers Ins. Exch.*, 200 Ariz. 572, 579, 30 P.3d 639, 646 (Ariz. Ct. App. 2001).

The insured bears the burden of proving that the insurer acted in bad faith. *Noble*, 128 Ariz. at 190, 624 P.2d at 868. In first-party claims, the insured must show, among other things, that the insurer (1) intentionally denied the claim, failed to pay the claim, or delayed payment of the claim without a reasonable basis; and (2) knew that it acted without a reasonable basis, or “failed to perform an investigation or evaluation adequate to determine whether its action was supported by a reasonable basis.” Rev. Ariz. Jury Instructions (4th) Bad Faith, No. 1. In third-party claims, the insured must show that the insurer “has given equal consideration to the interests of its insured,” defined as “whether a prudent insurer without policy limits would have accepted the settlement offer.” Rev. Ariz. Jury Instructions (4th) Bad Faith, No. 8.

2. *Damron/Morris* Agreements

“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.” *Himes v. Safeway Ins. Co.*, 205 Ariz. 31, 34 n.2, 66 P.3d 74, 77 n.2 (Ariz. Ct. App. 2003); *Safeway Ins. Co. v. Guerrero*, 210 Ariz. 5, 7 n.1, 106 P.3d 1020, 1022 n.1 (Ariz. 2005) (although case law uses terms interchangeably, *Damron* agreements involve insurer’s refusal to defend, while *Morris* agreements do not involve refusal to defend); *see 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).

Damron/Morris agreements have long been enforceable against insurers in Arizona. Insurers have always been able to challenge *Damron/Morris* agreements on the basis of fraud or collusion. *See, e.g., Damron*, 105 Ariz. at 153, 460 P.2d 997, 999. In addition, recent case law and newly-promulgated jury instructions have expanded the

insured's burden of proof to show that the settlement was "fair and reasonable under the circumstances," meaning "what a reasonably prudent person in the insured's position would have settled for on the merits of [the third party claimant's] case against [the insured]." Rev. Ariz. Jury Instructions (4th) Bad Faith, No. 13; *see Himes*, 205 Ariz. at 39, 66 P.3d at 82 (quoting *Morris*, 154 Ariz. at 121, 741 P.2d at 254). *Himes* requires the insured to prove that the dollar amount of the *Damron/Morris* agreement is reasonable. *Id.* Furthermore, a negotiated settlement between the insured and third party claimant does not raise an evidentiary presumption that the insured was liable to the third party claimant for the amount of the settlement. *Himes*, 205 Ariz. at 37, 66 P.3d at 80.

3. Affirmative Defenses

Insurers may assert several affirmative defenses to allegations of bad faith. An insurer's "mere negligence" or "honest mistake, oversight, or carelessness" – even though unreasonable – does not give rise to bad faith. *See, e.g., Rawlings v. Apodaca*, 151 Ariz. 149, 160, 726 P.2d 565, 576 (Ariz. 1986); *Trus Joist Corp. v. Safeco Ins. Co. of America*, 153 Ariz. 95, 104, 735 P.2d 125, 134 (Ariz. Ct. App. 1986). "Advice of counsel" is a viable defense to bad faith claims in Arizona. *Walter v. Simmons*, 169 Ariz. 229, 238, 818 P.2d 214, 223 (Ariz. Ct. App. 1991). Insurers may also raise "any factors tending to establish or negate bad faith on the part of the insurer." *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 259, 792 P.2d 719, 722 (Ariz. 1990). Arizona has rejected industry custom as a defense to bad faith. *Sparks*, 132 Ariz. at 537, 647 P.2d at 1135; *but see Rawlings*, 151 Ariz. at 158, 726 P.2d at 574 (industry custom may be relevant to determination of whether insurer acted in bad faith).

4. Damages

Assuming that the insured can prove breach of the implied covenant of good faith and fair dealing, the insured may recover consequential damages, including all losses caused by the insurer's conduct, damages for pain, humiliation and inconvenience, and pecuniary losses. *Rawlings*, 151 Ariz. at 161, 762 P.2d at 577. The insured may also recover damages for emotional distress. *Farr v. Transamerica Occidental Life Ins. Co.*, 145 Ariz. 1, 7, 699 P.2d 376, 382 (Ariz. Ct. App. 1984); *Bates v. Superior Court*, 156 Ariz. 46, 49, 749 P.2d 1367, 1370 (Ariz. 1988). Punitive damages are available only where the insured proves by "clear and convincing" evidence that the insurer's "evil hand was guided by an evil mind," or that the "facts establish that [the insurer's] conduct was aggravated, outrageous, malicious or fraudulent." *Rawlings*, 151 Ariz. at 162-163, 726 P.2d at 578-579; *Linthicum v. Nationwide Ins. Co.*, 150 Ariz. 326, 332, 723 P.2d 675, 681 (Ariz. 1986).

The prevailing party is entitled to reimbursement for costs and attorneys' fees incurred in the coverage action. Ariz. Rev. Stat. §§ 12-341, 12-341.01. The prevailing party is entitled to reimbursement for costs and attorneys' fees incurred in the coverage action. Ariz. Rev. Stat. §§ 12-341, 12-341.01.

B. Recent Developments

1. Claims Professionals May Be Liable For Bad Faith

A federal court has recently suggested that claims professionals, and not just insurers, may be liable for bad faith. *Ballesteros v. American Standard Insurance Company of Wisconsin*, 436 F. Supp. 2d 1070 (D. Ariz. 2006). In *Ballesteros*, the insured, who spoke only Spanish, purchased auto insurance and signed forms rejected uninsured and underinsured motorist coverage, which forms were written only in English.¹ Subsequently, the insured's mother-in-law, who was covered under the policy, was killed by an uninsured driver in an auto accident. The insurer, American Standard, disclaimed coverage on the basis of the insured's waiver of uninsured motorist coverage.

The insured sued American Standard in Arizona state court, alleging that the waiver was invalid as it was provided in English only. The insured also named the insurance agent and an insurance adjuster as defendants, on the grounds that they "were motivated to engage in this practice as UM/UIM coverage is less profitable than other forms of insurance," and because agents "were compensated based on the profitability generated for the company." *Id.* at 1073.

Although the agent and adjuster were Arizona residents, the insurer removed the case to federal court. At issue on the insured's motion to remand the case to state court was whether the agent and adjuster had been fraudulently joined for the purpose of destroying diversity jurisdiction – or, from a substantive standpoint, whether insurance agents and adjusters can be held liable for bad faith. The insurer argued that adjusters cannot be liable for bad faith, because they are not in contractual privity with the insured. The court disagreed, on the grounds that "the Arizona case law pertaining to the precise issue before the Court is ambiguous, and any ambiguities must be resolved in Plaintiff's favor at this stage of the litigation." *Id.* at 1077. Instead, *Ballesteros* relied on case law holding that insurers and their *agents* are jointly and severally liable for bad faith to conclude that in the instant case, and concluded that it was not clear whether *adjusters* (as "agents" of the insurer) could be liable for bad faith. *Id.* at 1079 (relying on *Sparks v. Republic National Life Ins. Co.*, 132 Ariz. 529, 647 P.2d 1127 (Ariz. 1982) and *Farr v. Transamerica Occidental Life Ins. Co. of California*, 145 Ariz. 1, 699 P.2d 376 (Ariz. App. 1984)). Accordingly, the court remanded the case to state court, since the adjuster was an Arizona citizen. *Id.* at 1079. The court did not, however, analyze the claims against the *agent* in making its ruling.

2. "Fairly Debatable" Standard Requires That Insurer Perform Proper Investigation, And Can Be Measured Against Other Insurers' Conduct In Claims Handling

¹ The court's analysis indicates that availability of Spanish insurance documents is an important and emerging area of law in Arizona.

Arizona courts have continued to develop the concept of what constitutes a “fairly debatable” claim. Where a question of fact exists as to whether the insurer owes policy benefits, the claim is fairly debatable, and the insurer may raise this as an affirmative defense to a bad faith claim. Where a claim is fairly debatable, as a matter of law, the insurer is not liable for bad faith for failing to pay the insured’s claim immediately. *Knoell v. Metro. Life Ins. Co.*, 163 F. Supp. 2d 1072, 1075 (D. Ariz. 2001); *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).

In the third-party context, “[w]hile it is clear that an insurer may defend a fairly debatable claim, all that means is that it may not defend one that is not fairly debatable. But in defending a fairly debatable claim, an insurer must exercise reasonable care and good faith.” *Zilisch*, 196 Ariz. at 237, 995 P.2d at 279.

In the first-party context, recent decisions confirm that the insurer must properly investigate the claim in order to assert that the claim was fairly debatable. *See, e.g., Lerch v. Allstate Ins. Co.*, 2006 WL 1789061 (D. Ariz. June 27, 2006); *Young v. Allstate Ins. Co.*, 296 F. Supp. 2d 1111 (2003).

In *Lerch*, the court concluded that whether a claim is fairly debatable may be a question of fact, and that this determination can be measured according to (1) the conduct of other insurers in handling claims arising from the same forest fire, and (2) the insurer and insured’s disagreement as to whether damage existed.

In *Lerch*, the insureds made a claim for damage to their home and personal property under a first-party property policy, following a forest fire that burned for four weeks and approached within 300 feet of their home. The insureds were evacuated from their home, and upon their return fifteen days later, discovered that their electrical appliances no longer worked, the refrigerator and freezer were filled with rotting meat, the metal roof had faded in color, the house smelled like smoke, plants and trees outside the house had been killed, and the soil was apparently sterilized. The insurer’s adjuster visited the home three times to inspect the damage, but did not ask the insureds to prepare a list of damaged property or submit a proof of loss, and did not – unlike other insurers – take soil samples. The insurer paid a portion of the alleged claim.

In response to the insured’s assertions that the first adjuster had been “cursory” and unresponsive, the insurer sent a second adjuster to reinspect the property. Although the insureds asserted the house smelled like smoke, the second adjuster claimed not to smell any smoke inside the house (although he acknowledged the smell of smoke in the area), and refused to take pictures of alleged smoke damage on the walls, ultimately concluding that there was no further damage. The insurer took the insureds’ examination under oath, which revealed that the insureds had not fully inspected the electrical appliances prior to reporting, and that the appliances were partly or entirely functional. Accordingly, the insurer denied the remainder of the claim on the basis of material misrepresentation.

The insureds filed suit for bad faith, alleging that the value of their property was reduced due to the insurer's failure to pay for timely repairs. In its defense, the insurer asserted that the claim was fairly debatable and that it had conducted a "timely, objection, and thorough" investigation. *Lerch*, 2006 WL 1789061 at * 3. The court concluded that questions of fact existed, precluding summary judgment in favor of the insurer. The court premised its ruling on two main factors. First, the insurer did not take soil samples or replace the insureds' roof – although other insurers had done so in connection with the same fire. Second, "[a]fter observing that the smell of smoke had lingered in the area long after the fire, [the second adjuster] claimed not to smell any smoke in [the insureds'] home, in spite of [the insureds'] observations to the contrary." *Lerch*, 2006 WL 1789061 at * 5. Thus, "the reasonableness of Allstate's belief" was subject to "doubt." *Id.*

III. CALIFORNIA

As the most populous state in the union, California continues to lead the nation's development of bad faith law. The past year alone has seen significant developments and expansion of bad faith law in California.

A. General Principles

1. Statutory And Common Law Bad Faith

California statute and regulations prohibit the commission of various specified unfair claims practices. Ins. Code § 790.03(h); Cal. Code Regs. tit. 10, § 2695.1, *et seq.* No private right of action exists for violation of the unfair claims practices statute. *Shade Foods v. Innovative Prods. Sales & Mktg.*, 78 Cal.App.4th 847, 916 (citing *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 46 Cal.3d 287, 304-305 (1988)). However, violation of Section 790.03(h) may constitute evidence of a breach of the implied covenant of good faith and fair dealing. *Id.*

A covenant of good faith and fair dealing is implied in every California insurance policy. *See, e.g., Waller v. Truck Ins. Exch., Inc.*, 11 Cal.4th 1, 36 (1995). An insured may maintain a common law bad faith action in connection with first-party claims as well as third-party claims. *See, e.g., Gray v. Zurich Ins. Co.*, 65 Cal. d 263 (1966) (third-party claim stemming from underlying suit alleging assault); *Chateau Chamberay v. Associated Int'l Ins. Co.*, 90 Cal.App.4th 335 (2001) (first-party claim based on earthquake damage to property).

As a general matter, no cause of action for bad faith exists in the absence of coverage. *Waller*, 11 Cal. 4th at 35; *Dynamic Concepts, Inc. v. Truck Ins. Exch.*, 61 Cal. App. 4th 999, 1010 (1998) ("A carrier is subject to tort liability for bad faith only where it unreasonably fails to provide benefits due under the policy or the law."). Some courts have articulated this concept to require the insured to prove breach of contract before liability for bad faith can exist. *See, e.g., Love v. Fire Ins. Exch.*, 221 Cal. App. 3d 1136, 1153 (1990). This principle is not clear-cut under California law, however, as courts

have occasionally found a breach of the implied covenant of good faith and fair dealing despite the lack of coverage. *Murray v. State Farm Fire & Cas. Co.*, 219 Cal. App. 3d 58, 65-66 n.5 (1990) (observing that “there may be unusual circumstances in which an insurance company could be liable to its insured for tortious bad faith despite the fact that the insurance contract did not provide for coverage,” such as “unreasonabl[e] delay[] in performing an investigation of a claim before concluding there was no coverage and the insured suffered consequential loss as a result of the delay.”).

2. Affirmative Defenses

Mere negligence on the part of the insurer is insufficient to support a finding of bad faith. *See, e.g., State Farm Fire & Cas. Co. v. Superior Court*, 45 Cal.App.4th 1093, 1105 (1996) (plaintiff must show insurer failed to refused to discharge its contractual duties, “prompted not by an honest mistake, bad judgment or negligence but rather by a conscious and deliberate act.”). The insured’s conduct may serve as a defense to coverage as well as to a bad faith claim. *Kransco v. American Empire Surplus Lines Ins. Co.*, 23 Cal.4th 390, 410-411 (2000). The insurer may assert “advice of counsel” as a defense, although doing so waives the insurer’s attorney-client privilege. *Stewart v. Truck Ins. Exch.*, 17 Cal.App.4th 468, 483-484 (1993); *State Farm Mut. Auto. Ins. Co. v. Superior Court*, 228 Cal.App.3d 721, 725-726 (1991); *Merritt v. Reserve Ins. Co.*, 34 Cal.App.3d 858, 872 (1973).

A “genuine dispute” as to whether coverage exists has traditionally been a defense to a bad faith claim. *Chateau Chamberay*, 90 Cal.App.4th at 345-346. To assert this defense, the insurer must have conducted a proper investigation of the claim; if the insurer did so, it could assert this defense even if its coverage decision was erroneous. *Opsal v. United Services Auto. Ass’n*, 2 Cal.App.4th 1197, 1205 (1991). Recent decisions have touched upon the scope of this defense, and this emerging issue is discussed in detail below.

In the third-party context, where another insurer undertakes to defend the insured, the insurer that did not defend cannot be liable for bad faith. *Ringler Assocs. Inc. v. Maryland Cas. Co.*, 80 Cal. App. 4th 1165, 1187 (2000).

3. Damages

An insured may recover consequential damages, so long as the consequential damages were foreseeable. Cal. Civ. Code §§ 3300 (breach of contract), 3333 (wrongs other than breach of contract). Economic losses are generally not recoverable. *California Shoppers, Inc. v. Royal Globe*, 175 Cal.App.3d 1, 59 (1985). If the court finds that the insurer acted in bad faith, the insured may recover attorneys’ fees incurred to compel payment of policy benefits; however, the insured cannot recover fees attributable to bringing the bad faith action itself. *Brandt v. Superior Court*, 37 Cal.3d 813 (1985). In other words, where the insurer has committed bad faith, the insured can recover attorneys’ fees allocable to the cause of action for breach of contract, but not those fees allocable to the cause of action for bad faith. Individual insureds can recover for

intentional infliction of emotional distress. *Fletcher v. Western Nat'l Life Ins. Co.*, 10 Cal.App.3d 376, 401 (1970). Punitive damages may be awarded upon a “clear and convincing” showing that the insurer acted with “oppression, fraud, or malice.” Cal. Civ. Code § 3294(a); *Walker v. Farmers Ins. Exch.*, 153 Cal.App.4th 965 (2007).

The prevailing party may recover costs. Cal. Code Civ. Pro. §§ 1033, 1033.5.

B. Recent Developments

1. California Supreme Court Accepts Review Of Case Involving Scope Of Coverage For Allegations Of Intentional Conduct

California has long held that an insurer has no duty to *indemnify* “for a loss caused by the wilful act of the insured.” Cal. Ins. Code § 533; *Gray*, 65 Cal.2d 263 (where underlying claims for assault could implicate negligent conduct, as well as intentional conduct, insurer had duty to *defend* underlying action). The courts have wrestled with the scope of this principle in underlying actions where it is not clear whether the insured could have acted negligently (so as to trigger coverage) or only intentionally (such that there could be a duty to defend, but not to indemnify). *See, e.g., J.C. Penney Cas. Co. v. M.K.*, 52 Cal.3d 1009 (1991) (no coverage exists for sexual molestation of a child because no reasonable person could believe that such conduct is negligent, rather than intentional); *Downey Venture v. LMI Ins. Co.*, 66 Cal.App.4th 478 (1998) (where policy promised coverage for malicious prosecution, insurer had duty to defend such claim, even though “malice” is element of cause of action for malicious prosecution, but not to indemnify).

The California Supreme Court has just accepted review of a case involving the distinction between intentional and negligent conduct. *Delgado v. Interinsurance Exchange of the Automobile Club of Southern California*, 152 Cal.App.4th 671, 61 Cal.Rptr.3d 826 (2007), *review granted* (Sept. 25, 2007).² In *Delgado*, the insured, Craig Reid, allegedly kicked and struck the third party claimant, Jonathan Delgado, in the nose, causing physical injury to Delgado. The underlying complaint alleged both intentional and negligent conduct. Specifically, the first cause of action alleged that Reid “in an unprovoked fashion and without any justification physically struck, battered and kicked ... Delgado repeatedly causing serious and permanent injuries.” *Delgado*, 61 Cal.Rptr.3d at 831. The second cause of action alleged that Reid “negligently and unreasonably believed and [sic] that [Reid] was engaging in self defense and unreasonably acted in self defense when [Reid] negligently and unreasonably physically and violently struck and kicked ... Delgado repeatedly causing serious and permanent injuries.” *Id.* Finally, the

² California Rules of Court, Rule 8.1115(a) provides that unpublished opinions “must not be cited or relied on by a court or a party in any other action.” *See* Cal. Rules of Court 8.1105(d)(1).

complaint alleged that Reid acted “intentionally [sic] and with malice and oppression,” in order to allege a claim for punitive damages. *Id.* at n.2; *see* Cal. Civ. Code § 3294(a).

Delgado and Reid subsequently entered into a settlement, and Reid assigned his claim against the insurer pursuant to a covenant not to execute. The parties stipulated that “Reid’s use of force constituted a negligent use of excessive force in the exercise of his right of self-defense,” and the underlying claims for intentional conduct were dismissed. *Delgado*, 61 Cal.Rptr.3d at 831.

In the resulting direct coverage action by Delgado, the insurer argued that coverage was excluded, on the basis of an exclusion for “bodily injury” arising out of “[i]ntentional acts or omissions committed by or at the direction of any insured that are: [¶] (a) of a willful and malicious nature; or [¶] (b) grossly negligent or reckless; and which could reasonably be expected to result in bodily injury This applies whether or not the insured forms the intent or has the mental capacity to form the intent to cause bodily injury” *Id.* at 835. Following the reasoning of *Gray*, the court concluded that the underlying complaint pled facts showing that a potential for coverage existed, as it alleged that the insured, Reid, had acted in self-defense. *Id.* at 836-837.

The California Supreme Court has accepted review, framing the issue as follows:

When a liability policy covers injury from an ‘occurrence,’ which is defined as an ‘accident,’ does the insurer have a duty to defend an action for assault if the complaint alleges the insured was acting under an unreasonable and negligent belief that he was acting in self-defense?

California Supreme Court, Release No. S.C. 39/07, Summary of Cases Accepted During the Week of September 24, 2007, Release Date October 1, 2007, viewed at <http://www.courtinfo.ca.gov/courts/supreme/summaries/WS092407.PDF>.

a. Application Of The Genuine Dispute Doctrine To Third-Party Claims

Delgado is arguably the first case to apply the genuine dispute doctrine to third-party insurance disputes. *Delgado*, 61 Cal.Rptr.3d at 843-844. In *Delgado*, the California Court of Appeal extensively analyzed the scope of the genuine dispute doctrine as a defense to a bad faith claim. The court articulated a new framework for determining whether the genuine dispute doctrine constitutes an affirmative defense: whether the dispute is “factual” or “legal.” *Id.* at 842-844 (drawing on established case law to articulate distinction). A “factual” dispute exists where “the determination of coverage turns on disputed facts.” *Id.* at 842 n.14. Where the dispute is “*factual* in nature, the *potential* for coverage arises and exists *until* that dispute is *conclusively* resolved.” *Id.* at 842 (emphasis in original). In other words, if a factual dispute exists as to coverage, the insurer has a duty to defend. Because there can be no “reasonable”

dispute as coverage when a factual dispute exists, *Delgado* concluded that insurers cannot rely on the genuine dispute doctrine in claims involving factual disputes.

A “legal” dispute, on the other hand, arises “when there is a question whether the undisputed facts constitute an ‘occurrence’ under the policy.” *Id.* at 842 n.14. So long as the insurer has performed a reasonable investigation, and so long as its coverage position is “objectively reasonable and legitimate,” the insurer may assert the genuine dispute doctrine where a legal dispute as to coverage exists. *Id.* at 844 & n.16.

Although the insurer did not identify the California Court of Appeal’s ruling on the genuine dispute doctrine as an issue for review, the California Supreme Court could still address the genuine dispute doctrine.³

2. **Insurers Must Investigate “All” Bases Of Coverage In First-Party Claims, Even While Coverage Litigation Is Pending, In Order To Assert The Genuine Dispute Doctrine As A Defense; If No Coverage Exists, The Insured Cannot Have Suffered Damages Based On The Insurer’s Alleged Failure To Investigate**

The California Court of Appeal has recently reaffirmed that insurers may not assert the genuine dispute doctrine as a defense to bad faith unless they have investigated “all” bases of coverage – but that liability for bad faith exists only if the insured’s claim is covered. *Jordan v. Allstate Ins. Co.*, 148 Cal.App.4th 1062 (2007) (“*Jordan II*”).

In *Jordan II*, the insured discovered that a window had fallen out of the wall of her living room and floorboards in the corner of a living room were “giving way.” She retained an expert, who concluded that the damage was caused by a water conducting fungus, *Meruliporia Incrassata* (*Poria*). She reported the claim to her insurer, Allstate, whose expert came to the same conclusion.

The policy at issue contained exclusions for “wet or dry rot” and “collapse,” but the “collapse” exclusion contained an exception for

- a) the *entire* collapse of a covered building structure;
 - b) the *entire* collapse of a part of a covered building structure;
- and

³ Even though the California Supreme Court did not state that it will review this portion of the decision, the California Court of Appeal’s analysis of the genuine dispute doctrine cannot be cited as precedent in California state courts. Cal. Rules of Court 8.1105(d)(1), 8.1115(a).

- c) direct physical loss to covered property caused by (a) or (b) above.

Id. at 1067 (emphasis in original). The definition of the term “collapse” did not include “hidden decay” or “settling, cracking, shrinking, bulging or expansion.” *Id.*

Allstate disclaimed coverage on the basis of the policy’s exclusion for “wet or dry rot.” The insured contested the insurer’s position, arguing that Poria was not “wet or dry rot,” and that it was “hidden decay,” so as to fall within the exception to the “collapse” exclusion. In the resulting coverage action, the California Court of Appeal concluded that the policy language was ambiguous, and resolved the ambiguity in favor of the insured, but concluded that Allstate’s denial of coverage had been reasonable. *Jordan v. Allstate Ins. Co.*, 116 Cal.App.4th 1206, 1219-1220 (2004) (“*Jordan I*”). The *Jordan I* court remanded for further proceedings as to the actual cause of the damage.

At issue in *Jordan II* was whether Allstate could be liable for bad faith in denying coverage for the insured’s claim, or whether the genuine dispute doctrine shielded Allstate from liability. To assert the genuine dispute doctrine as an affirmative defense, the insurer must have conducted a proper investigation of the claim. *See, e.g., Chateau Chamberay*, 90 Cal.App.4th at 345-346. *Jordan II* held that “an insurer owes a duty to its insured to investigate *all* of the possible bases of an insured’s claim.” *Jordan II*, 148 Cal.App.4th at 1073 (emphasis in original). Here, although Allstate had investigated the insured’s claim, the court ruled that issues of fact existed as to whether Allstate had investigated “*all* of the possible bases” of the claim, because Allstate:

- did not retain a structural engineer or evaluate structural engineering issues (and indeed Allstate’s adjuster simply disregarded recommendations of its and the insured’s experts to do so);
- did not communicate to the insured about collapse coverage until the insured’s attorney finally received a copy of the policy, despite internal correspondence about the possibility that “collapse” coverage might apply;
- did not inspect the inner walls or subflooring of the insured’s home for “hidden decay”;
- did not interview the insured regarding her awareness that parts of her home were collapsing;
- refused to interview the insured’s expert for the sole reason that the expert had been hired by the insured;
- left it completely up to its adjuster to determine if there was collapse, even though the adjuster had no credentials or background to make structural engineering decisions;

- conducted no further investigation because the insured did not make any claim for damages, even though the insured had previously sent a letter stating that “damage is now spreading at an alarming pace,” and asking what Allstate was going to do to prevent “further damage”;
- did nothing further to investigate coverage for “collapse” after the court’s decision in *Jordan I*.

Jordan II, 148 Cal.App.4th at 1074-1076.

Based on these factors, the Court of Appeal concluded:

If found to be true at trial and not countered or satisfactorily explained by Allstate, such facts would constitute evidence sufficient to support the conclusion that Allstate did indeed fail to conduct a full, fair, thorough and timely investigation of Jordan’s claim as it related to and relied on the “entire collapse” provisions of the Allstate policy. On the other hand, Allstate may well be able to produce evidence that all or part of Jordan’s factual assertions are false, or that Allstate’s acts or omission as claimed by Jordan were justified or reasonable in the circumstances.

Id. at 1076. The court noted that the fact that coverage litigation “had commenced did not excuse Allstate from the continuing responsibility to fully investigate [the insured’s] claim. *Id.* at 1076 n.7. The court also held that the expert opinion was admissible regarding Allstate’s failure to comply with California’s air claims settlement practices statute and regulations. *Id.* at 1077-1078.

Crucially, the court stated: “[I]t is important to make clear that in order for [the insured] to recover on her remaining claim of bad faith, it will be necessary for her to first establish a basis for coverage.” *Id.* at 1078. California courts have wrestled with the issue of whether insurers can be liable for bad faith in the absence of coverage, and the *Jordan II* court reaffirmed that in the context of an alleged breach of the duty to investigate, no bad faith liability exists unless the claim was covered.

[The insured’s] coverage claim rests upon the proposition that there was an “entire collapse” of all or a part of her home. This claim is disputed by Allstate. Before [the insured] can successfully assert her claim for damages arising from Allstate’s alleged bad faith claims handling activities, she must first demonstrate that there is in fact coverage under the policy. [Footnote.] An insurer’s failure to investigate, upon which [the insured’s] claim of bad faith entirely rests, is *not* separately actionable if there is no coverage. If there is no coverage, then any failure by Allstate to properly investigate would not have caused [the insured] any damage.

Id. (citing *Waller v. Truck Ins. Exch., Inc.*, 11 Cal.4th 1, 36 (1995) and *Love v. Fire Ins. Exch.*, 221 Cal.App.3d 1136, 1151 (1990)) (emphasis in original).

3. Insureds Cannot Assert Causes Of Action Against Insurers Under The Consumer Legal Remedies Act

In California, insureds can, under limited circumstances, maintain claims against insurers for unfair competition or unfair business trade practices. *See* Cal. Bus. & Prof. Code § 17200, *et seq.* (prohibiting “unfair competition,” defined in pertinent part as “any unlawful, unfair or fraudulent business act or practice and unfair, deceptive, untrue or misleading advertising”); *see, e.g., State Farm Fire & Cas. Co. v. Superior Court*, 45 Cal.App.4th 1093, 1098 (1996) (“We find that a cause of action limited to a request for injunctive or restitutive relief can be prosecuted under Business and Professions Code section 17200 based upon an insurer's alleged fraudulent misconduct and breach of the covenant of good faith implied in every policy of insurance ...”). In a case of first impression, the California Court of Appeal recently held that insureds cannot maintain claims against insurers under the analogous Consumer Legal Remedies Act (“CLRA”), a pro-consumer statute that prohibits specified deceptive or unfair acts in the sale or lease of goods and services. *Fairbanks v. Superior Court*, 154 Cal.App.4th 435 (2007); Cal. Civ. Code § 1750, *et seq.*

The insurer in *Fairbanks* was a provider of interest-sensitive universal life insurance policies, policies whose premiums and value depend on the interest and risk rates set for the policies by the insurer over time. *Fairbanks*, 154 Cal.App.4th at 439 & n.2. The insurer advised the plaintiffs/insureds that they “could keep the policy in full force indefinitely by paying a stated premium amount,” but the “premium amount was insufficient to keep the policy in force to maturity.” *Id.* Plaintiffs sued, alleging that the insurer had committed unfair and deceptive practices in the design and marketing of the policies, and had fraudulently failed to warn insureds that the policies were systematically underfunded.

At issue was whether insurance constitutes a “good” or “service,” so as to fall within the provisions of the CLRA. The court determined that insurance cannot be a “good,” since the CLRA defines “goods” to mean “tangible chattels bought or leased for personal, family or household use.” *Id.* at 441; Cal. Civ. Code § 1761(a)). With respect to services, the court contrasted the definition of “service” under the CLRA (“work, labor, and services for other than a commercial or business use, including services furnished in connection with the sale or repair of goods”) with the statutory definition of “insurance” (“a contract, whereby one undertakes to indemnify another against loss, damage, or liability arising from a contingent or unknown event.”). *Fairbanks*, 154 Cal.App.4th at 441 (citing Cal. Civ. Code § 1761(b) and Cal. Ins. Code § 22). Based on the legislative history of the CLRA, which omitted “insurance” from the definition of “services,” and the fact that the Unfair Insurance Practices Act, Cal. Ins. Code § 790.03(h), had been in effect when the CLRA was enacted, the court concluded that the legislature did not intend to include insurance within the CLRA. *Id.* at 443-447. Accordingly, insureds cannot maintain claims against insurers under the CLRA.

IV. NEVADA

Compared to other states, Nevada's bad faith law is relatively undeveloped and fairly limited. Nevada does, however, expressly provide for a bad faith cause of action based on unreasonable denial and for unfair practices based on the insurer's processing of a claim. This allows insureds to assert two distinct causes of action.

A. General Principles

1. Statutory And Common Law Bad Faith

The Nevada Unfair Practices in Settling Claims Act ("NUPSCA"), Nev. Rev. Stat. § 686A.310(1), sets forth standards for processing claims and provides insureds with a private right of action.

In addition, Nevada common law recognizes an implied covenant of good faith and fair dealing in every contract under Nevada law, including insurance policies. *Pemberton v. Farmers Ins. Exch.*, 109 Nev. 789, 792-793, 858 P.2d 380, 382 (1993). The elements of "bad faith" in the insurance context are (1) an insurer's denial of (or refusal to pay) an insured's claim (2) without any reasonable basis, and (3) the insurer's knowledge or awareness of the lack of any reasonable basis to deny coverage, or the insurer's reckless disregard as to the unreasonableness of the denial. *Pioneer Chlor Alkali Co., Inc. v. National Union Fire Ins. Co.*, 863 F. Supp. 1237, 1247 (D. Nev. 1994). Consequently, to prevail, the insured must demonstrate knowledge on the part of the insurer, not simply unreasonable denial. *Id.* Although Nevada recognizes an implied covenant in all contracts, no such covenant exists between insurers and third parties. *Gunny v. Allstate Ins. Co.*, 108 Nev. 344, 345, 830 P.2d 1335, 1335-1336 (1992) (third-party claimant who lacks contractual relationship with insurer has no standing to sue for bad faith). As such, third-party claimants may not sue insurers for bad faith. *Id.*

Causes of action under NUPSCA and for common law "bad faith" are legally and analytically distinct causes of action. *Schumacher v. State Farm Fire & Cas. Co.*, 467 F. Supp. 2d 1090, 1095-1096 D. Nev. 2006) (citing *Pioneer*, 863 F. Supp. at 1244). "Bad faith and NRS 686A.310 involve different legal analyses, and a violation of a provision of NRS 686A.310 is not per se an act of bad faith." *Id.* The statute directly addresses the manner in which an insurer processes a claim, while bad faith "exists where an insurer denies a claim without any reasonable basis and with knowledge that no reasonable basis exists to deny the claim." *Id.* Thus, an insured can pursue both distinct claims for unfair practices under NUPSCA and common law bad faith denial of a claim. *United States Fid. & Guar. Co. v. Peterson*, 91 Nev. 617, 540 P.2d 1070 (1975).

2. Affirmative Defenses

An insurer in Nevada can assert many affirmative defenses to a bad faith cause of action based on the reasonableness of the insurer's actions. In sum, an insurer can defend

against bad faith by demonstrating that it acted reasonably and/or the insured acted unreasonably.

As noted above, to demonstrate bad faith, the insured must show that the insurer had no reasonable basis for denial and had knowledge of a lack of reasonable basis, yet still chose to deny the claim. *Pioneer*, 863 F. Supp. at 1247. Therefore, 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). The insurer must show that it relied on and acted in compliance with the "advice of counsel." *Mann v. Glens Falls Ins. Co.*, 418 F. Supp. 237, 249 (D. Nev. 1974), *rev'd on other grounds*, 541 F. 2d 819 (9th Cir. 1976). In addition, an insurer can assert the unreasonableness of the insured's actions.

An insured's late notice of the claim defeats coverage, even without a showing of prejudice to the insurer. *Las Vegas Star Taxi, Inc. v. St. Paul Fire & Marine Ins. Co.*, 102 Nev. 11, 714 P.2d 562 (1986). Further, an insurer may defend a bad faith suit if the insured has made a "material misrepresentation," meaning that the insurer's investigation would have proceeded differently had the insured told the truth. *Powers v. United Services Auto Ass'n*, 115 Nev. 38, 42, 979 P.2d 1286, 1288 (Nev. 1999).

3. Damages

The plaintiff may recover consequential damages where the insurer has acted in bad faith. *Peterson*, 91 Nev. at 619-620, 540 P.2d at 1071.

Attorneys' fees may be awarded if the insurance policy so provides. *See Great West Cas. Co. v. See*, 185 F. Supp. 2d 1164, 1173 (D. Nev. 2002) (policy language stating insurer "will pay ... [a]ll reasonable expenses incurred by the 'insured' at our request" allowed insured to recover fees incurred in defending declaratory relief action brought by insurer). The court noted that "an award of fees is required in any legal action where the insurer compels the insured to assume the burden of legal action, to obtain the full benefit of his insurance contract." *Id.* The court did not address whether this broad language permits an award of attorneys' fees where the insured sues the insurer to compel payment of policy benefits. *Cf. Brandt v. Superior Court*, 37 Cal.3d 813 (1985).

Plaintiffs can recover compensatory damages for emotional distress suffered between the date of denial of the claim until the date of judgment. *Farmers Home Mut. Ins. Co. v. Fiscus*, 102 Nev. 371, 374-375, 725 P.2d 234, 236 (1986).

Punitive damages may be awarded only if the insured can show by "clear and convincing evidence" that the insurer acted with oppression, fraud or malice. Nev. Rev. Stat. § 42.005.

B. Recent Developments

1. Nevada Insurers Are Not Liable For Bad Faith Where Coverage Language Is Ambiguous And The Case Presents A Novel Issue

A federal court has apparently determined that where the coverage language is ambiguous, the insurer cannot be liable for bad faith if its interpretation is “nominally reasonable.” *Hummel v. Continental Cas. Ins. Co.*, 254 F. Supp. 2d 1183, 1191 (D. Nev. 2003). In *Hummel*, the insured under an accidental death/dismemberment policy died of an overdose of painkillers prescribed by her physician. The insurer denied coverage based on policy exclusions “for any loss caused by or resulting from ... influence of drugs unless taken as prescribed by a physician.” However, Nevada statute provides that following language supersedes any policy language that is less favorable to the insured: “The insurer is not liable for any loss sustained or contracted in consequence of the insured’s being ... under the influence of any narcotic unless administered on the advice of a physician.” *Id.* (discussing applicability of Nev. Rev. Stat. §§ 689A.280, 689A.340(2)).

The court determined that the statutory language “administered on the advice of” was ambiguous, especially when read in conjunction with the policy language “taken as prescribed by,” and concluded that the exclusion did not bar coverage in this case. Because the insurer had reasonably interpreted the exclusion, however, it was not liable for bad faith. The court continued, “*and* because this is a case of first impression in Nevada, as a matter of law, [the insurer] cannot be liable for bad faith.” *Id.* (emphasis added). The court’s decision has not been clarified or distinguished. Rather, it appears to hold that when an ambiguous statute creates ambiguity in an insurance policy, the insurer will not be held liable for bad faith, so long as its interpretation was nominally reasonable.

2. Insureds Are Preempted From Bringing State Law Claims Against Insurers Of ERISA Policies

In two recent cases, Nevada federal courts have held that insureds who have attempted to collect benefits under ERISA have no state law causes of action against the insurers who allegedly denied or mishandled such benefits. *Medford v. Metropolitan Life Ins. Co.*, 244 F. Supp. 2d 1120 (2003); *Brandner v. Unum Life Ins. Co. of America*, 152 F. Supp. 2d 1219 (2001). Instead, state law claims are preempted by ERISA when insured attempts to apply such state laws to a valid ERISA plan. *Medford*, 244 F. Supp. 2d at 1123.

Medford involved termination of the employee/participant’s long-term disability benefits. The participant subsequently brought an action in state court against the plan’s insurer, asserting both state law tort claims and claims under ERISA. *Id.* The defendants removed the action to federal court and sought a stay of discovery on all state law claims. *Id.* The federal court relied on Ninth Circuit precedent that “ERISA contains one of the

broadest preemption clauses ever enacted by Congress.” *Id.* at 1125 (citing *PM Group Life Ins. v. Western Growers Assur. Trust*, 953 F. 2d 543, 545 (9th Cir. 1992)). “ERISA preempts state law causes of action that offer remedies for the violation of rights expressly guaranteed by ERISA and exclusively enforced by ERISA’s civil enforcement mechanism.” *Id.* (citing *Ingersoll-Rand Co. v. McClendon*, 498 U.S. 133 (1990)). Therefore, the court concluded that an insured under an ERISA plan cannot maintain state law causes of action against the insurer. *Id.* at 1126.

In *Brandner*, an insured brought action against a disability insurer, alleging state law claims of unfair insurance practices, bad faith, and breach of fiduciary duty in connection with calculation of his benefits under an ERISA long-term disability policy. *Brandner*, 152 F. Supp. 2d at 1222. As in *Medford*, the insurer removed the case to federal court, invoking both federal question jurisdiction and diversity jurisdiction. *Id.* The court held that federal jurisdiction was proper because the insured’s claims involved his ERISA policy/benefit plan. Even if the insured’s causes of action were brought under Nevada law regulating insurance, the court held that federal ERISA law preempted the state law causes of action, and granted summary judgment. *Id.* at 1225, 1227.

V. OREGON

Oregon has traditionally not allowed bad faith claims against insurers, essentially restricting insureds to contract claims, and allowing tort-based claims for negligence in rare circumstances only. Recently, Oregon has expanded the availability of tort-based remedies against insurers.

A. General Principles

1. Statutory And Common Law Claims

The Oregon Unfair Claims Settlement Practices Act (“OUCSPA”) prohibits misrepresentations and other conduct that constitutes an unfair claims practice, including specified settlement, claims handling, investigation and communications practices. Or. Rev. Stat. § 746.230 (2005). The Director of the Department of Consumer and Business Services has authority to enforce the Oregon Insurance Code and to investigate and remedy violations of the OUCSPA. Or. Rev. Stat. § 746.240. Insureds have no right of action to sue for violations of the OUCSPA. *Richardson v. Guardian Life Ins. Co. of America*, 161 Or. App. 615, 623-624, 984 P.2d 917, 923 (1999) (affirming summary judgment for insurer), *rev. denied*, 329 Or. 553, 994 P.2d 129 (1999).

With respect to common law claims, Oregon has generally not recognized the tort of bad faith against insurers. Insureds can sue only in contract and, in rare circumstances, under limited tort theories, discussed below. Insureds may state a cause of action for breach of contract arising out of first-party or third-party claims; however, under principles of contract law, only the insured – and not the third-party claimant – may file suit. An insured may, however, assign its claims against the insurer. *See, e.g., Stumpf v. Continental Cas. Co.*, 102 Or. App. 302, 794 P.2d 1228 (1990).

“[A]n insurer’s bad faith refusal to pay policy benefits to its insured sounds in contract and is not an actionable tort in Oregon.” *Employers’ Fire Ins. Co. v. Love It Ice Cream Co.*, 64 Or. App. 784, 791, 670 P.2d 160, 165 (1983). Because the insured-insurer relationship is grounded in contract, an insured can assert only contract-based causes of action, even if the alleged breach of contract is “negligent, intentional, or otherwise.” *Georgetown Realty, Inc. v. Home Ins. Co.*, 313 Or. 97, 106, 831 P.2d 7, 12 (1992).

Liability insurers have a “special relationship” with their insureds; courts have declined to create an independent fiduciary duty on the part of insurers. *Gorodetzer v. Massachusetts Cas. Ins. Co.*, 201 F. 3d 444, 1999 WL 993651 * 7 (9th Cir. 1999) (limiting holding to disability insurers); see *Maine Bonding & Cas. Co. v. Centennial Ins. Co.*, 298 Or. 514, 517, 693 P.2d 1296, 1298 (1985) (“The right of the insurer to control the defense of the litigation carries with it the duty to exercise diligence and care toward the insured.”).

Liability insurers have a duty to defend covered claims. *Georgetown*, 313 Or. at 110-111, 831 P.2d at 913-914. Where an insurer undertakes to defend its insured against a third-party claim, and then fails to defend with reasonable care, the insurer may be liable in tort, because it owes an independent duty of care to the insured in this situation. *Id.* The duty to defend includes a duty to settle the case within policy limits, if it would be reasonable to do so. *Maine Bonding*, 298 Or. at 519, 623 P.2d at 1299.

2. Affirmative Defenses

An insured’s “willful” non-cooperation is a complete bar to recovery against the insured. *Stumpf*, 102 Or. App. at 309-310, 794 P.2d at 1232-1233. Oregon recognizes “advice of counsel” as a defense in contract litigation, *Rose v. Rose*, 144 Or. 683, 685, 25 P.2d 1051, 1051 (1933), but not in the specific context of insurance policies. Policy exclusions that may preclude coverage qualify as affirmative defenses. *Porter*, 58 Or. App. at 736-738, 659 P.2d at 134-135.

3. Damages

Violation of the OUCSPA may lead to civil penalties of up to \$10,000 per offense. Or. Rev. Stat. § 731.988 (2005).

In contract-based actions, the insured may recover contract damages and consequential damages, including settlement payments and any costs of defense paid by the insured. *Northwest Pump & Equip. Co. v. American States Ins. Co.*, 144 Or. App. 222, 229-230, 925 P.2d 1241, 1245 (1996). Only foreseeable damages are recoverable; foreseeability is determined as of the time of execution of the contract, not the time of breach. *Id.*, 144 Or. App. at 226, 925 P.2d at 1243. In the third-party context, the insurer may be liable for the entire amount of an excess verdict if it did not reasonably attempt to settle within policy limits, or otherwise conducted the defense in a negligent manner. *Maine Bonding*, 298 Or. at 518-519, 623 P.2d at 1299. Neither damages for emotional

distress nor punitive damages are available in contract-based actions. *Farris v. United States Fid. & Guar. Co.*, 284 Or. 453, 456, 587 P.2d 1015, 1017 (1979).

The availability of attorneys' fees and punitive damages is discussed further below.

B. Recent Developments

1. Insureds May Recover The Cost Of Prosecuting Coverage Actions

Pursuant to statute enacted in 2005, an insured may recover the cost of prosecuting a coverage action "if settlement is not made within six months from the date proof of loss is filed with an insurer ... and the plaintiff's recovery exceeds the amount of any tender made by the defendant in such action, a reasonable amount to be fixed by the court as attorney fees shall be taxed as part of the costs of the action and any appeal thereon." Or. Rev. Stat. § 742.061 (2005). This statute carves out exceptions for personal injury protection ("PIP") benefits and uninsured or underinsured motorist benefits, where the insurer accepts coverage in writing within six months, the only issue is the amount of benefits, and the insurer has consented to submit the case to binding arbitration. Or. Rev. Stat. §§ 742.061(2), (3).

The Oregon Supreme Court has enforced this statute. In *Grisby v. Progressive Preferred Insurance Co.*, 343 Or. 175, 166 P.3d 519 (2007), the insured was involved in an automobile accident. His insurer accepted coverage for PIP benefits that were "reasonable and necessary medical expenses directly related to the accident," and agreed to arbitrate in case of any dispute as to the amount of benefits owed. *Grisby*, 343 Or. at 177, 166 P.3d at 520. The insurer denied the insured's claim for chiropractic treatment, asserting that it was not related to the accident. The parties arbitrated the claim, and the arbitrator ruled in the insurer's favor. The insured then filed suit, seeking a trial *de novo* on the issue of coverage, and seeking attorneys' fees under Section 742.061.

At issue was whether chiropractic benefits concerned an amount of benefits or "coverage" under the policy. The court concluded that the term "coverage," in the insurance context, means "inclusion within the scope of a protective or beneficial plan." *Grisby*, 343 Or. at 180, 166 P.3d at 522. With this understanding, the court determined that the legislature intended the term "accepting coverage" to have a broad meaning, requiring the insurer to evaluate separately each claim for services rendered by a provider, as opposed to evaluating the accident as an indivisible claim. *Grisby*, 343 Or. at 181, 166 P.3d at 523.

The court further concluded that the insurer had not simply disputed the "amount" of the chiropractic benefits, as provided in Section 742.061, but whether such benefits were covered under the policy at all. Accordingly, the insurer had not complied with the terms of the statute, and the insured was entitled to recover attorneys' fees. *Grisby*, 343 Or. at 182-183, 166 P.3d at 523-524.

2. Contract vs. Tort Claims; Standard And Procedure For Pleading Punitive Damages

A federal court sitting in Oregon has recently elucidated the contract/tort distinction under Oregon law, as well as the standards and procedure for pleading punitive damages. *Eastwood v. American Family Mut. Ins. Co.*, 2006 WL 2934260 (D. Or. Oct. 12, 2006). In *Eastwood*, the insured caused an automobile accident that injured a pedestrian, requiring amputation of the pedestrian's leg. The insurer evaluated the claim as potentially presenting excess exposure, but did not initially offer the policy limits because of questions regarding hospital liens. The third party claimant/pedestrian demanded policy limits. The insurer did not respond, and the third party claimant filed suit against the insured, resulting in an excess verdict of over \$1 million. The insured paid its policy limits of \$100,000, leaving the remainder of the judgment uncollected.

The insured subsequently filed a coverage action against the insurer, asserting claims of breach of contract, negligence, and breach of fiduciary duty, and seeking attorneys' fees under Oregon Revised Statutes Section 742.061.

With respect to contract versus tort claims, *Eastwood* recognizes that where an insurer agrees to defend, "it agrees to provide legal representation and to stand in the shoes of the party that has been sued. The insured relinquishes control over the defense of the claim asserted." *Eastwood*, 2006 WL 2934260 at * 4 (quoting *Georgetown Realty*, 313 Or. 97, 831 P.2d 7, 14). Consequently, a tort standard of care exists, "independent of the contract and without reference to the specific terms of the contract." *Id.* (quoting *Georgetown Realty*, 313 Or. 97, 831 P.2d 7, 14). Even though the insured may have a tort claim, however, the insured is not restricted to bringing tort claims against the insurer; the insured may also pursue contractual claims. *Id.*

In that connection, the insured driver asserted claims for negligent infliction of emotional distress, and sought economic damages for past and future medical care, as well as lost wages, based on the insurer's alleged improper claims handling. To succeed on a claim for negligent infliction of emotional distress where no physical injury is alleged, an Oregon plaintiff must show that the defendant's conduct infringed on a legally protected interest, and that infringement of that interest is of sufficient importance to warrant an award of damages. *Eastwood*, 2006 WL 2934260 at * 3 (citing *McCulloch v. Price Waterhouse, LLP*, 157 Or. App. 237, 971 P.2d 414, 422 (Or. App. 1998)). The insurer did not dispute that its relationship with the insured gives rise to a "legally protected interest." The court concluded, however, that because the relationship is "primarily economic in nature," the insured could not recover against the insured for negligent infliction of emotional distress. *Id.*

Punitive damages are available if plaintiffs prove "by clear and convincing evidence that the party against whom punitive damages are sought has acted with malice or has shown a reckless and outrageous indifference to a highly unreasonable risk of harm and has acted with a conscious indifference to the health, safety and welfare of others." Or. Rev. Stat. § 31.730(1); *Eastwood*, 2006 WL 2934260 at * 5. A plaintiff

cannot plead punitive damages in the original complaint; instead, the plaintiff must request leave to amend the complaint, with supporting affidavits and documentation, to add a claim for punitive damages. *Id.* *Eastwood* clarifies that where the coverage action is pending in federal court, the party seeking to allege punitive damages must follow federal standards for amending pleadings. *Id.* (citing *Pruett v. Erickson Air-Crane Co.*, 183 F.R.D. 248 (D. Or. 1998)).

VI. WASHINGTON STATE

Washington State expanded the availability of statutory-based bad faith claims in the past few months. The Washington Supreme Court has been asked to decide whether insurers may be liable for “procedural” bad faith even in the absence of coverage; its decision is likely to have a significant impact on bad faith law.

A. General Principles

1. Statutory And Common Law Bad Faith

Washington State recognizes the tort of bad faith, and first-party claimants and third-party beneficiaries (but not third-party claimants) may maintain claims for violations. Washington State law imposes a statutory duty on all parties to the insurance contract to act in good faith.

The business of insurance is one affected by the public interest, requiring that all persons be actuated by good faith, abstain from deception, and practice honesty and equity in all insurance matters. Upon the insurer, the insured, their providers, and their representatives rests the duty of preserving inviolate the integrity of insurance.

Wash. Rev. Code § 48.01.030. The Insurance Fair Conduct Act (“IFCA”), codified at Washington Revised Code Section 48.030.010, *et seq.*, requires insurers to act in good faith in dealing with insureds. *Pruit v. Alaska Pac. Assur. Co.*, 28 Wash. App. 802, 804 (1981). The insurer’s duty to act in good faith is “fairly broad and may be breached by conduct short of intentional bad faith or fraud.” *Griffin v. Allstate Ins. Co.*, 108 Wash. App. 133, 143, 29 P.3d 777, 783 (2001), *opinion modified on denial of reconsideration*, 36 P.3d 552 (2001), *rev. denied*, 146 Wash. 1005, 45 P.3d 551 (2002); *Industrial Indem. Co. of Northwest, Inc. v. Kallevig*, 114 Wash. 2d 907, 916 (1990). Therefore, an insurer that merely denies coverage without reasonable justification has acted in bad faith. *Whistman v. West American of Ohio Casualty Group of Ins. Co.*, 38 Wash. App. 580, 584-585 (1984); *Safeco Ins. Co. of Am. v. JMG Restaurants, Inc.*, 37 Wash. App. 1, 11 (1984).

Effective July 22, 2007, Washington State enacted amendments to the IFCA which significantly broaden the rights of first-party claimants to sue for bad faith. *See, e.g.*, Wash. Rev. Code §§ 48.030.010(7), 48.030.015. 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), 60th Leg. (Wash. Jan. 29, 2007) (emphasis added).

As enacted, the IFCA amendments do not make negligent conduct actionable, and instead prohibit insurers from “unreasonably deny[ing] a claim for coverage or payment of benefits to any first party claimant.” Wash. Rev. Code § 48.030.010(7). “First party claimant,” defined as “an individual, corporation, association, partnership, or other legal entity asserting a right to payment as a covered person under an insurance policy or insurance contract arising out of the occurrence of the contingency or loss covered by such a policy or contract,” Wash. Rev. Code § 48.030.015(4), could arguably encompass third-party claimants. It remains to be seen how Washington State courts will construe this definition.

First-party claimants may file suit against insurers for unreasonable denial of a claim or violation of the IFCA. Wash. Rev. Code §§ 48.030.015(1), (2). First-party claimants may recover damages, including actual damages, costs, reasonable attorneys’ fees and litigation costs. Wash. Rev. Code § 48.030.015(1). If the court finds that the “insurer has acted unreasonably” or violated the IFCA, it may award treble damages, as well as reasonable attorneys’ fees and actual and statutory litigation costs, including expert witness fees. Wash. Rev. Code §§ 48.030.015(2).

Before filing suit, first-party claimants must provide written notice to the insurer and the office of the insurance commissioner, in order to allow the insurer time to resolve the coverage dispute informally. Wash. Rev. Code § 48.030.015(8). The statutory framework includes timelines for the insurer’s response and the filing of any suit. *Id.*

A violation of the statute IFCA is a *per se* violation of the Washington Consumer Protection Act (“WCPA”), codified at Washington Revenue Code Section 19.86.020. *Levy v. North American Co. for Life & Health Ins.*, 90 Wash. 2d 846, 850, 586 P.2d 845, 847 (1978). The WCPA creates a private cause of action against insurers. Wash. Rev. Code §§ 19.86.020, *et seq.* and 19.86.090, amended by 2007 Wash. Legis. Serv. Ch. 66 (S.S.B. 5228); *Leingang v. Pierce County Med. Bureau, Inc.*, 131 Wash. 2d 133, 143, 930 P.2d 288, 296 (1997). The provision declares that unfair or deceptive acts or practices in the conduct of any trade or commerce are unlawful. *Gould v. Mutual Life Ins. Co. of New York*, 735 F. 2d 1165 (9th Cir. 1984).

Washington State also recognizes a common law tort cause of action for bad faith. *Griffin*, 108 Wash. App. at 143, 29 P.3d at 783; *Tank v. State Farm Fire & Cas. Co.*, 105 Wash. 2d 381, 386, 715 P.2d 1133, 1136 (1986). “Liability insurers have a ‘heightened duty of good faith’ when a claim is presented against an insured.” *Griffin*, 108 Wash. App. at 143. “In order to establish bad faith, an insured is required to show the breach was unreasonable, frivolous, or unfounded.” *Kirk v. Mt. Airy Ins. Co.*, 134 Wash. 2d 558, 560, 951 P.2d 1124, 1126 (1998) (citing *Wolf v. League Gen. Ins. Co.*, 85 Wash. App.

113, 122, 931 P.2d 184 (1997)). Courts determine the “reasonableness” of the insurer’s actions “in light of all the facts and circumstances of the case.” *Griffin*, 108 Wash. App. at 143, 29 P.3d at 783.

A third-party claimant may not bring suit directly against an insurer for bad faith. *Tank*, 105 Wash. 2d at 391, 395, 715 P.2d at 1139, 1141; *Dussault ex rel. Walker-Van Buren v. American Int’l Group*, 123 Wash. App. 863, 867 (2004). However, if the insured assigns its rights to a bad faith claim, the third-party claimant may maintain an action against the insurer for bad faith. *Planet Ins. Co. v. Wong*, 74 Wash. App. 905, 909, 877 P.2d 198, 201 (1994), *rev. denied*, 125 Wash. 2d 1008, 889 P.2d 498 (1994). The court, however, treats third party claimants different from third party beneficiaries. *Gould*, 37 Wash. App. at 756. An intended beneficiary under a contract can bring a direct cause of action against an insurer for bad faith because the intended beneficiary is owed a direct contractual obligation by the and can sue to enforce the obligation. *Tank*, 105 Wash. 2d at 395.

2. Defenses

An insurer has an affirmative defense to a bad faith cause of action when the insurer acted reasonably or the insured acted unreasonably. Reasonable actions include good faith mistake, acting with honesty, basing the coverage decision on adequate information, not overemphasizing the insurer’s interests over the insured’s interests, and reasonable interpretation of the policy. *Griffin*, 108 Wash. App. at 143, 29 P.3d at 783; *Kirk*, 134 Wash. 2d at 560, 951 P.2d at 1126; *Transcontinental Ins. Co. v. Washington Pub. Utils. Dists.’ Util. Sys.*, 111 Wash. 2d 452, 470, 760 P.2d 337, 347 (1988). On the other hand, fraud perpetrated by the insured on the insurer is an absolute defense to a statutory or common law bad faith claim. *Tornetta v. Allstate Ins. Co.*, 94 Wash. App. 803, 810-811, 973 P.2d 8, 11-12 (1999). The court will not “punish [the insurer] when to do so would provide a windfall to one guilty of fraud.” *Mutual of Enumclaw Ins. Co. v. Cox*, 110 Wash. 2d 643, 652, 757 P.2d 499, 504 (1988).

3. Damages

The remedies for statutory bad faith include actual damages, attorneys’ fees and treble damages. Rev. Code Wash. § 19.86.090; *Levy*, 90 Wash. 2d at 850.

Because actionable bad faith is a tort, courts have held that plaintiffs are not limited to recovery of economic damages within the contemplation of the parties at the time the contract was made. *Safeco Ins. Co. of America v. Butler*, 118 Wash. 2d 383, 393-394, 823 P.2d 499, 505 (1992). An insured may recover consequential damages in the amount of the losses suffered as a result of the insurer’s breach of contractual and statutory obligations, and including expenses incurred as a “direct result” thereof. *Coventry v. American States Ins. Co.*, 136 Wash. 2d 269, 284, 961 P.2d 933, 939 (1998) (stating that consequential damages may include costs paid by insured for its own investigation where insurer’s investigation was inadequate).

Recovery of attorneys' fees depends on whether the insurer properly denied coverage, and whether or not the coverage action is based on statutory violations. *See* Rev. Code Wash. § 48.30.015; *Olympic S.S. Co. v. Centennial Ins. Co.*, 117 Wash. 2d 37, 52-53, 811 P.2d 673, 681 (1991) (allowing recovery of attorneys' fees where insurer refuses to defend or pay claim, regardless of whether suit is filed against insured).

A plaintiff may recover damages for emotional distress or personal injury in connection with a common law bad faith claim. *American Mfrs. Mut. Ins. Co. v. Osborn*, 104 Wash. App. 686, 697-698, 17 P.3d 1229, 1234 (2001) (common law bad faith claim), *rev. denied*, 144 Wash. 2d 1005, 29 P.3d 717 (2001); *Anderson v. State Farm Mut. Ins. Co.*, 101 Wash. App. 323, 333, 338, 2 P.3d 1029, 1035, 1037 (2000) (statutory bad faith claim), *rev. denied*, 142 Wash. 2d 1017, 20 P.3d 945 (2001); *cf. Kloepfel v. Bokor*, 149 Wash. 2d 192, 197-202, 66 P.3d 630, 633-635 (2003) (objective symptomatology not required to prove intentional infliction of emotional distress). The Consumer Protect Act permits treble damages of up to \$10,000 per claim for bad faith conduct. Rev. Code Wash. § 19.86.090 Washington courts generally do not permit punitive damages in civil case on the basis that such damages are akin to criminal sanctions. *Fluke Corp. v. Hartford Accid. & Indem. Co.*, 145 Wash. 2d 137, 148, 34 P.3d 809, 814 (2001)

B. Recent Developments

1. An Insurer Can Be Liable For Bad Faith As A Matter Of Law For Failure To Turn Over An Underwriting File In Connection With An Underlying Action

A Washington State appellate court recently held that an insurer acted in bad faith in failing to produce its underwriting file during mediation discussions, such that the plaintiff and insured did not know the extent of the available coverage. *Sharbono v. Universal Underwriters Ins. Co.*, 139 Wash. App. 383, 409 (2007). Before the third-party claimant filed suit, the insured's attorney requested that the insurer provide the underwriting files for all policies at issue. The insurer refused to do so. Both the insured and the third-party claimant reiterated their requests for the underwriting files, stating that they were attempting to settle the underlying case, but could not do so without the underwriting files because questions existed as to the amount of coverage provided. The insurer again refused to do so, on the grounds of privilege and that a genuine issue of fact existed as to what coverage was provided.

In the ensuing coverage action, the court framed the issue in terms of the insurer's duty of good faith, stating: "The issue here is whether the duty of good faith required Universal to disclose its underwriting files to its insured. *Sharbono*, 139 Wash. App. at 409. The court concluded: "[I]n the absence of a statute or rule requiring disclosure ... the insurer must disclose the insured's policy limits if a reasonable person in the same or similar circumstances would believe that disclosure is in the insured's ... best interests." *Id.* at 412 (citing *Smith v. Safeco Ins. Co.*, 112 Wash. App. 645, 653 (2002)). The court placed the burden of demonstrating that the file was not subject to production on the insurer, and appeared to apply a balancing test, stating that the insurer "failed to

demonstrate any significant need to protect the contents of its underwriting files and that such need weighed as heavily as the [insured's] interests." *Id.* Accordingly, the court affirmed summary judgment in favor of the insured, finding that the insurer had acted in bad faith.

2. **Federal Court Certifies Question Of Whether Insurers Can Be Liable For "Procedural" Bad Faith, Even In The Absence Of Coverage**

A federal district court has recently certified the issue of whether an insurer can be liable for bad faith for failing to comply with procedure requirements even though the insurer has been found to have no duty to defend, settle or indemnify. *St. Paul Fire & Marine Ins. Co. v. Onvia, Inc.*, 2007 WL 2005536 at * 2 (W.D. Wash. 2007). *Onvia* was based on an underlying action alleging that the insured, Onvia, engaged in "fax blasting" in violation of the Telephone Consumer Protection Act of 1991 ("TCPA"), 47 U.S.C. § 227 and equivalent Washington State statutes. Onvia settled with the third-party claimant settled in exchange for a stipulation to certify a class action, entry of judgment for \$17,515,000 and assignment of Onvia's rights against the insurer. The insurer, St. Paul Fire and Marine Insurance Company, subsequently filed a coverage action against Onvia.

In the coverage action, the district court granted summary judgment in favor of the insurer, ruling that it had no duty to defend, indemnify or settle the underlying action. However, the ruling did not dispose of the insured's counterclaim for common law procedural bad faith and for violation of the WCPA.

The insured's counterclaim alleged that the insurer's "claims handling violated a number of Washington insurance claims handling regulations, which include but are not limited to, allegations that [insurer] committed bad faith by failing to acknowledge notice of the claim and tender of defense for approximately nine months after the claim was tendered in violation of WAC 284-30-330 and WAC 284-30-360; failing to conduct an investigation in violation of WAC 284-30-330 and WAC 284-30-370; and failing to regularly report developments to the insured in violation of WAC 284-30-330(2)." *Id.* at * 2. The district court determined that these provisions were ambiguous, and certified the following questions to the Washington State Supreme Court:

- (1) Under Washington law, does an insured have a cause of action against its liability insurer for common law procedural bad faith for violation of the Washington Administrative Code and/or for violation of the Washington Consumer Protection Act, even though a court has held that the insurer had no contractual duty to defend, settle, or indemnify the insured?
- (2) If the answer to the first question is "yes," then:

- (a) Should the court require the insured to prove that the insurer's conduct caused actual harm, or should the court apply a presumption of harm? and
- (b) How should the insured's damages be measured?

Id. at * 1. The Washington State Supreme Court's ruling is likely to have a significant effect on insurers' potential liability for bad faith. Should the court decide that a bad faith cause of action exists as to the insurer's "procedural" conduct, insurers may be liable for bad faith even in the absence of coverage.

VII. CONCLUSION

It is clear that despite the states' geographic proximity, the bad faith law of Arizona, California, Nevada, Oregon and Washington State differs enormously. Insureds and insurers alike are wise to understand the bad faith law of the states in which they do business, so as to ensure compliance with the law and to avoid disputes.