



Legal Beat

By MICHAEL SEAN QUINN

Insurance Bad Faith: The Basic Tenets and More

Insurance, as we know it, rests upon ten simple truths. (1) Bad stuff happens. (2) Things break. (3) People value wealth. No one doubts any of these truths.

They imply others. (4) Disasters ruin things. (5) Because accidents can hurt, people plan against them. This involves avoidance, control and payment. (6) Risk management, broadly understood, is absolutely necessary to a modern economy.

Savings is one way to pay for disasters. But, bad stuff may happen before you've saved enough. Besides, lots of pesky mini-disasters affect us. (7) Dealing with bad stuff takes time.

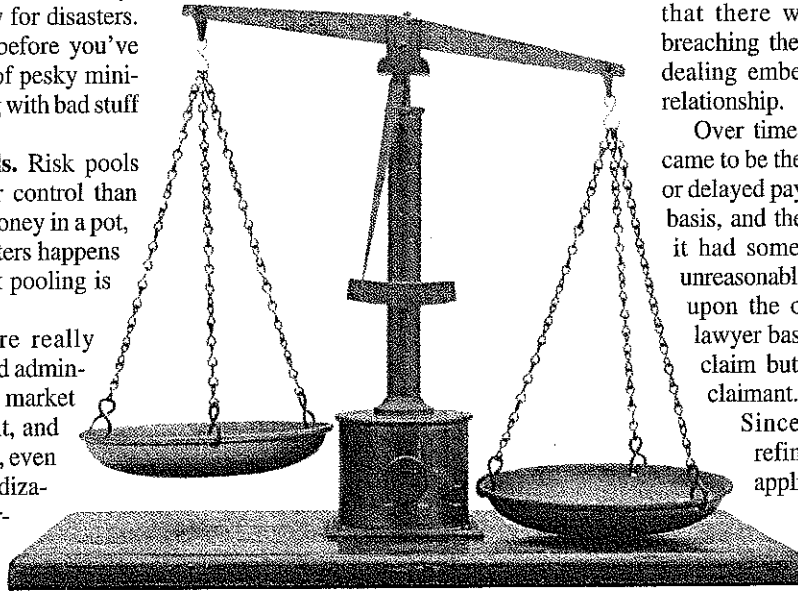
Insurance Fundamentals. Risk pools are a better form of disaster control than savings. Lots of people put money in a pot, and those few to whom disasters happens draw from the pool. (8) Risk pooling is a crucial economic function.

Insurance companies are really agencies for the formation and administration of risk pools. In a market economy, they do it for profit, and good ones innovate over time, even though considerable standardization is necessary. Thus, insurance is the business of conceiving what to cover, pricing and selling the coverage, investing premium dollars and paying covered claims promptly.

Insurance Temptations. Every insurance company suffers the temptation of taking the premium and not paying the claims. Truth (3) entails that this is so. As some law and many economics professors

point out (following Justice Holmes), sometimes it makes economic sense to breach a contract. Sometimes it is cheaper to breach and pay damages than it is to perform.

This kind of economically efficient, but morally suspect, conduct is especially tempting for repeat players—entities which enter into lots and lots of contracts and many, many lawsuits.



Insurance companies are paradigmatic repeat players. Breach is also tempting when the main exposure to big damages is "consequential" or indirect damages, like lost profits. These are hard to prove.

Truth (9): Deliberate, economically efficient contract breaches by insurers are

morally outrageous and legally intolerable. Truth (9) follows truths (7) and (8). The very essence of insurance is to pay covered claims quickly. If an insurer breaches simply to save money, it is violating the essence of its mission. This the law cannot countenance. Contract jurisprudence, however, not only tolerates it, but the ideology of "law-and-economics," so much in vogue today, encourages it.

IBF: Texas Style. Consequently, in the last 30 years or so, courts around the country invented insurance bad faith (IBF). This free-wheeling tort is designed to deter insurers from arbitrarily denying or delaying claims. In 1987, things came to a head in the Texas Supreme Court. The case was *Arnold v. National County Mutual*. It was an uninsured motorist case. The court held that there was a tort for an insurer's breaching the duty of good faith and fair dealing embedded in the insurer-insured relationship.

Over time, the elements of Texas IBF came to be these: the insurer denied a claim or delayed paying it without any reasonable basis, and the insurer's determination that it had some legitimate basis was itself unreasonable. (In *Arnold*, the insurer relied upon the opinion of an inexperienced lawyer based not upon the merits of the claim but upon the scruffiness of the claimant.)

Since 1987, Texas courts have refined this tort considerably. It applies to workers' compensation claims. It does not apply to liability insurance claims.

Only insurance companies can be liable for IBF. Independent adjusters cannot. Insurance agents cannot. An insurer can be liable for IBF only when it acts as an insurer: an insurer acting as a landlord, a judgment-debtor, or a contracting party cannot. Arguably, an insurer as a litigant—even in a bad faith suit—cannot commit IBF. If so, insurers in

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lawsuits cannot be IBF-liable for (even sanctionable) conduct in those lawsuits. That is what court ordered sanctions are for.

IBF claims are not merely negligence claims. Most significantly, IBF recoveries can be predicated upon economic losses only, whereas negligence claims, in general, cannot. IBF claims resemble legal and accounting malpractice claims in that regard, but IBF is not merely adjuster malpractice. At the same time, if IBF is committed recklessly, policyholders can recover exemplary damages. This makes IBF somewhat like gross negligence and therefore somewhat like gross malpractice. On the other hand, IBF claims are assignable, whereas legal malpractice claims are not.

Texas IBF: Some Problems. IBF is now just over ten years old. Consequently, much is still obscure. If both the insurer and the policyholder misbehave, is there such a thing as comparative bad faith to reduce an award against the insurer? (Probably: Yes) What if the policyholder creates the problem through his misconduct? Does a policyholder owe an insurance company a duty of good faith and fair dealing? Does the insurance company have a cause of action for reverse bad faith? (Probably: No.) But how can these two answers be consistent?

Texas IBF is not in peak health. Plaintiffs have worn it out. They have sought (and occasionally obtained) massive punitive damages for minor—or, at least, contestable—screw-ups. They have filed bad faith cases on behalf of giant businesses, which it was, philosophically, never meant to protect. And they have engaged in clever, but cynical, venue manipulation. The Texas Supreme Court has lost patience with this nonsense. Moreover, judicial insurance regulation has become a crowded field. It includes at least one other common law tort and several statutes.

Stowers. An IBF-related tort is a complicated species of service negligence. A liability carrier is negligent if it defends its insured, receives a settlement offer for covered claims within policy limits, unreasonably refrains from settling, and a judgment comes in against the insured on covered claims in excess of policy limits. This tort is called "Stowers" in honor of the venerable 1929 case which spawned it.

Stowers is extremely important. It requires liability insurers to be quasi-fiduciaries of the insureds they defend and prevents defending insurers from gambling with the insured's money. At the same time, *Stowers* remains semi-opaque.

Consider an insurer defending under a reservation of rights which has genuine doubts about which claims are covered, if any. Over time, those doubts should be dispelled. Perhaps the insurer will file a declara-


tory judgment action. Early in the underlying tort suit, however, the insurer will not have sufficient information to know which claims are covered. What if a *Stowers* offer is made then and has a short fuse? What if the underlying tort case involves both covered and uncovered claims?

Further, excess liability insurers sue primary carriers on *Stowers* theories, since they are subrogated to the rights of the insured. Courts have not yet indicated how *Stowers* applies to excess carriers, when an offer to settle comes in above the limits of the primary carrier but within the limits

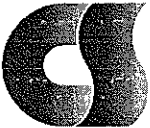
of the excess insurer. What if a verdict is returned above even that limit? In part, the result will depend upon the excess insurance contract. It's hard to see how an excess carrier, without a duty to defend, could have *Stowers* liability. This point is especially cogent when the insured is running the defense and does not wish to settle.

The Texas Supreme Court used *Stowers* to remove liability carriers from the scope of IBF. It said holders of liability policies don't need IBF. They have contract remedies plus *Stowers*, instead. Is this right? Isn't

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the duty to defend a first-party duty? If so, shouldn't IBF apply, even if there is no judgment above policy limits?

Statutory Bad Faith. Statutes specifying private remedies also regulate insurers. Significantly, the legislature recently made insurers—and potentially others—subject to damages if they fail “to attempt in good faith to effectuate a prompt, fair and equitable settlement of a claim with respect to

which the insurer's liability has become reasonably clear[.]” If an insurer violates this section of the Insurance Code, it is liable for attorneys' fees. If it violates this section knowingly, it is exposed to treble damages. Furthermore, agents and brokers are subject to the same statute. Thus, an agent or broker who somehow assisted an insurer in arbitrarily refraining from paying a claim could be directly liable to the insured.

In any case, insurers have faced two different standards when they denied or hesitated over a claim. There was IBF, and there was the standard just quoted, which is Insur-

ance Code Art. 21.21 § (4)(10)(a)(ii).

Last year, the Texas Supreme Court brought IBF into conformity with Art. 21.21 in *Universe Life v. Giles*. Now, a first-party insurer commits IBF only if it fails to make prompt, fair and equitable payment to its insured upon a claim once the insurer's liability upon that claim has become reasonably clear.

Although *Giles* was unanimous in some respects, the Justices filed three separate, divergent opinions. Probably, the court intended to make it harder for plaintiffs to win IBF cases. It may not have succeeded. The new standard looks more like negligence than ever. The more a standard looks like negligence, the easier it is for the policyholder to get a jury and therefore win. Truth (10): Juries don't trust insurance companies.

Nicolau. Shortly after the court decided *Giles*, it decided *State Farm v. Nicolau*. This case involved foundation damage and plumbing leaks. The insurer retained Haag Engineering which examined the property. Haag has an institutional philosophy that plumbing leaks never—well, hardly ever—cause foundation damage. State Farm denied ostensibly on Haag's say-so.

The plaintiffs argued that Haag's philosophy was nothing but rank bias and that State Farm knew of Haag's dogmatism. State Farm argued that Haag was a reputable and experienced engineering company, so that its reliance was reasonable. For its part, Haag filed an amicus brief in the Supreme Court defending itself. Such filings are very, very rare.

In the end, the results in *Nicolau* were a mixed bag. The insurer lost, but just barely. There was a well-reasoned dissent, and the plaintiffs were stripped of many of their damages. Consequently, the plaintiffs' lawyers lost much of their contingency fees. Conclusion. So where are we? The Supreme Court is agonizing over IBF. It may even abolish it at some point, since art. 21.21 can do virtually everything IBF can do. There is a medieval adage, “Occam's Razor.” Applied to the law, it goes like this: Don't multiply causes of action beyond necessity.

What would abolition mean? It would eliminate punitive damages from the legal regulation of first-party insurance. “So what. Big deal. Who cares?” The present court is hard on such awards anyway. Things wouldn't change much, really, if the court abolish IBF, with one exception. Agents can have liability under art. 21.21, though they can't under IBF. □

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