When Actions Speak Louder than Words: Procedural Bad Faith in the Absence of Coverage

March 2009

Certain states have recognized a common law tort often referred to as procedural (as opposed to substantive) bad faith. Unlike substantive bad faith, which is, in basic terms, the failure by an insurer to pay a *meritorious* claim[1], procedural bad faith is a vehicle for an insured to seek damages based on an insurer's bad faith handling of *any* claim, meritorious or otherwise. Simply stated, an insurer can be required to pay bad faith damages for a claim for which the insurer has no coverage obligations under an insurance policy, if the insurer handled the investigation or denial of the non-covered claim in an unfair manner.

Recently, the viability of procedural bad faith was reviewed, and upheld, by the Washington Supreme Court in *St. Paul Fire and Marine Ins. Co. v. Onvia, Inc.*, 196 P.3d 664 (Wash. 2008) (en banc). The plaintiff/insured involved in the *Onvia* case was served with a lawsuit which it tendered to its liability insurer. The insured reportedly resubmitted its tender letter six months later and, shortly thereafter, submitted to its insurer an amended version of the complaint. Approximately nine months after the original tender, the insurer responded for the first time, denying coverage and defense. Subsequently, in a bad faith and breach of contract lawsuit against the insurer, a federal district court found that the insurer's coverage determination was correct.[2]

Nonetheless, the Washington Supreme Court, reviewing the issue on certification from the district court,[3] held that, in the third-party context, an insured has available to it a cause of action for bad faith claims handling that is not dependent on the duty to indemnify, settle, or defend. The court reasoned that, under Washington law, insurers have not only a general duty of good faith, but also a specific duty to act with reasonable promptness in investigation and communication with their insureds following notice of a claim and tender of defense. The court further reasoned that the duty of good faith is broad and all-encompassing, and is not limited to an insurer's duty to pay, settle, or defend.[4]

Previously, the Washington Supreme Court had already adopted the tort in the first-party context in *Coventry Associates v. American States Ins. Co.*, 136 Wash.2d 269, 961 P.2d 933 (1998), in which case the court held "[t]he implied covenant of good faith and fair dealing in the policy should necessarily require the insurer to conduct any necessary investigation in a timely fashion and to conduct a reasonable investigation before denying coverage. In the event the insurer fails in either regard, it will have breached the covenant and, therefore, the policy." [5]

Washington is by no means the first state to adopt the tort of procedural bad faith and, although the Connecticut Supreme Court has not yet spoken on the issue, the district court in that state has predicted a similar outcome. In *United Technologies Corp. v. Am. Home Assurance Co.*, 118 F.Supp.2d 181, 188-89 (D.Conn. 2000), *mod. after recon. on other grounds*, 237 F.Supp.2d 168 (D.Conn. 2001), the district court was asked to determine whether the Connecticut Supreme Court would likely recognize a common law action for procedural bad faith not involving wrongful withholding of payment due under an insurance policy. Although the defendant insurer argued that a claim for bad faith is not actionable without a showing of a failure to pay a meritorious claim (substantive bad faith), the court concluded, after carefully analyzing existing state court precedent, that the Connecticut Supreme Court would not limit the tort of bad faith to claims of unreasonable or wrongful denial of claims. The court reasoned that an insurer's duty of good faith can be breached not only when coverage is unquesionted, but also when there is no coverage. [6]

The tort of procedural bad faith has similarly been reviewed and adopted by the Wyoming Supreme Court. The issue was first considered by that court in the first-party context, when it considered whether the investigatory procedures utilized by an insurer can amount to bad faith when the insurer is entitled to debate the underlying merits of the insured's claim. *See Hatch v. State Farm Fire and Cas. Co.*, 842 P.2d 1089 (Wyo. 1992). The court recognized the tort of procedural bad faith where the insurer (under circumstances later described as "rather egregious")[7] required the insured, who sought coverage after a house fire, to file a detailed inventory of items in the house at the time of the fire, including how many cornflakes were left in the cereal box before the fire and how much salt was in the salt shaker. The Wyoming Supreme Court later recognized procedural bad faith where the claim was not only debatable, but was ultimately determined to be outside the scope of coverage. *State Farm Mut. Auto Ins. v. Shrader*, 882 P.2d 813 (Wyo. 1994) ("while an insured may state causes of action for breach of contract and breach of the duty of good faith and fair dealing, the insured does not need to prevail on the contract claim to prevail on the claim for breach of the duty of good faith and fair dealing."). That rationale was adopted from the Arizona Supreme Court, which also recognized procedural bad faith in the absence of coverage. *Deese v. State Farm Mut. Auto. Ins. Co.*, 172 Ariz. 504, 509 (1992) ("breach of an express covenant is not a necessary prerequisite to an action for bad faith ... 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.").

It should be noted that, even in California, where it has been determined that "a bad faith claim cannot be maintained unless policy benefits are due,"[8] courts have acknowledged the validity of a procedural bad faith claim under unusual or "highly extraordinary" circumstances when benefits are not due under the policy. *See Avery Dennison Corp. v. Allendale Mutual Ins. Co.*, 310 F.3d 1114, 1117 (9th Cir. 2002) (*"[e]xcept perhaps in highly extraordinary circumstances*, California does not permit recovery on a bad faith claim unless insurance benefits are due under the policy") (emphasis added); *see also Murray v. State Farm Fire & Cas. Co.*, 219 Cal.App.3d 58, 268 Cal.Rptr. 33, 37 (1990) *("[w]hile 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*, no such circumstances are presented here.") (emphasis added).

Despite the fact that procedural bad faith in the absence of coverage has only been recognized by a handful of states,[9] insurers across the board should be mindful of its existence and cautious to avoid falling prey to such a claim. A bad faith action can be filed in, or litigated under, the laws of any number of different jurisdictions, regardless of the venue of the underlying claim for which coverage is sought or the location of the insured to whom the policy was issued. What may start out as an ordinary insurance claim in an insurer-friendly state could eventually result in a bad faith lawsuit in a state recognizing the tort.

Moreover, insurers should be cognizant that the common law tort of procedural bad faith opens the door to the possibility of much greater liability to the insurer than seemingly-similar statutory protections. Although several states offer statutory protections against unfair claims handling,[10] certain states do not allow individual insureds to bring a claim for a violation of the statute,[11] while others do not allow the statutory protections to be invoked for a single violation.[12] In those states recognizing the tort of procedural bad faith, however, insurers can be liable to individual insureds for isolated instances of unfair claims handling.

Additionally, insurers should be mindful of seemingly innocent setbacks in the handling of claims. Although an insured will often have to prove "extraordinary" or "egregious" conduct to prevail on a procedural bad faith claim,[13] it can also be found as a result of something as innocuous as a delayed notification of a proper denial of coverage, as demonstrated by St. Paul v. Onvia. Even non-meritorious procedural bad faith claims based on nothing more than sloppy claims handling can result in lengthy and expensive litigation until a conclusion regarding the insurer's good faith can be reached.

Given the appealing nature of this tort to insureds who are otherwise unable to prove breach of contract or violations of unfair claims handling statutes, and the recent attention paid to the tort by the Washington Supreme Court, insurers face the possibility that similar claims will soon emerge in states currently silent on the issue. Insurers should always be mindful of the tort of procedural bad faith, regardless of the merits of the underlying claim and the confidence with which the insurer denies coverage. This topic should be monitored as courts continue to render decisions on this issue.

[1] *See United Technologies Corp. v. Am. Home Assurance Co.*, 118 F.Supp.2d 181, 188-89 (D.Conn. 2000), *mod. after recon. on other grounds*, 237 F.Supp.2d 168 (D.Conn. 2001).

[2] *See St. Paul Fire & Marine Ins. Co. v. Onvia*, Inc., 2007 WL 2005536, *2 (W.D.Wash. 2007).

[3] The United States District Court for the Western District of Washington certified the following question to the Washington Supreme Court: "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?" *St. Paul Fire & Marine Ins. Co. v. Onvia*, Inc., 2007 WL 2005536, 1 (W.D.Wash. 2007).

[4] The court concluded, however, that no rebuttable presumption of harm can arise in this context, and declined to recognize coverage by estoppel. The court held that an insured must prove actual harm, and its damages are limited to the amounts its has incurred as a result of the bad faith, as well as general tort damages.

[5] *Id.*, citing 1 Allan D. Windt, Insurance Claims & Disputes: Representation of Insurance Companies and Insureds § 2.05, at 38 (3d ed.1995).

[6] The *United Technologies* holding has been acknowledged numerous times in Connecticut since that decision, including at the state trial court level. *See Joseph Fortin et al. v. Hartford Underwriters Ins. Co. et al.*, 2006 WL 3524562, 42 Conn. L. Rptr. 353 (Conn. Super. 2006) (insurer claimed that tort was only available when insurer breached its contract; court noted that such expansive reading of case law does not withstand scrutiny in light of United Technologies careful review of Connecticut case law and conclusion that Connecticut courts have recognized an independent common law tort for such conduct.)

[7] *International Surplus Lines Ins. Co. v. University of Wyoming Research Corp.*, 850 F. Supp. 1509, 1527 n. 20 (D. Wyoming 1994), aff'd, 52 F.3d 901 (10th Cir. 1995), citing Hatch, supra, 842 P.2d at 1098.

[8] *Love v. Fire Ins. Exchange*, 221 Cal. App. 3d 1136 (1990); *see also Young v. Illinois Union Ins. Co.*, 2008 WL 5234052, 2 (N.D.Cal. 2008), *citing Love, supra*, 221 Cal. App. 3d at 1153 ("[i]n the absence of any underlying coverage, there is no conceivable liability that Young could allege against [the insurer] on any theory of 'bad faith;'" *see also Brown v. State Farm Mut. Auto. Ins. Co.*, 2008 WL 5234255, 13 (N.D.Cal. 2008), citing Love, supra ("[a]bsent an entitlement to policy benefits, a plaintiff may not recover on a bad faith claim, as a matter of law.")

[9] Certain states have explicitly held that they do not recognize the tort of procedural bad faith in circumstances where there is no coverage owed under the policy. *See, e.g., Zurich Ins. Co. v. Texasgulf, Inc.*, 233 A.D.2d 180, 181 649 N.Y.S.2d 153, 154 (N.Y. App. Div. 1996) (granting insurer's motion to dismiss insured's bad faith claim because the claim was not covered upon the insurance policy); *Republic Ins. Co. v. Stoker*, 903 S.W.2d 338, 341 (Tex. 1995) (finding that as a general rule, a claim for bad faith cannot exist without first establishing that a claim is covered); *Love v. Fire Ins. Exchange*, 221 Cal. App. 3d 1136 (1990) ("a bad faith claim cannot be maintained unless policy benefits are due"). But *see Avery Dennison Corp. v. Allendale Mutual Ins. Co.*, 310 F.3d 1114 (9th Cir. 2002) and *Murray v. State Farm Fire & Cas. Co.*, 219 Cal.App.3d 58, 268 Cal.Rptr. 33, 37 (1990), discussed above.

[10] *See, e.g.*, the Connecticut Unfair Insurance Practices Act, which includes a section specifically regarding "unfair claim settlement practices." Conn. Gen. Stat. Section 38a-816(6).

[11] The Supreme Court of California, for example, has held that section 790.03 of the California Insurance Code, addressing unfair claim settlement practices, was not intended to create a private civil cause of action against an insurer that commits one of the various acts listed in that section. *Moradi-Shalal v. Fireman's Fund Ins. Cos.*, 46 Cal.3d 287, 304, 758 P.2d 58, 250 Cal.Rptr. 116 (1988) (*en banc*).

[12] For example, in Connecticut, unfair claim settlement practices must be committed or performed "with such frequency as to indicate a general business practice." Conn. Gen. Stat. Section 38a-816(6).

[13] *See, e.g., Avery Dennison Corp. v. Allendale Mutual Ins. Co., supra*, 310 F.3d 1117; *International Surplus Lines Ins. Co. v. University of Wyoming Research Corp., supra*, 850 F. Supp. at 1527 n. 20.