Insurance Bad Faith Claims


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This practice note provides an overview of insurance bad faith claims, including the insured’s right, claim triggers, and benefits of bringing a claim. The following discussion will not examine the statutory or jurisdictional aspect of the law.

For more information on bad faith claims, see Denial, Disclaimer, and Declination of Coverage, Bad Faith: First- and Third-Party Standards State Law Survey, Bad Faith Elements State Law Survey, Claims Handlers: Prevent and Mitigate Risk of Extracontractual Exposure, and Bad Faith Claims and Litigation Avoidance Checklist.

What Is an Insurance Bad Faith Claim?

Under the insurance contract or policy, insurance companies (insurer) have many duties to the person(s) they insure, the policyholder (insured). In performing their duties, insurers owe a duty to the insured to act in good faith and to deal fairly with the insured, particularly in the claim handling process. The insurer’s improper and often egregious handling of an insured’s claim can give rise to extra-contractual claims like bad faith claims. An insurance bad faith claim describes a claim that the insured may have against the insurance company for the insurer’s bad acts in not adhering to the implied covenant of good faith and fair dealing.

Some examples of insurer’s bad act:

- Unreasonable delay in handling, processing, or resolving claims
- Inadequate investigation or failure to investigate
- Unreasonable interpretations of an insurance policy
- Refusal to defend lawsuits or threats against the insured
- Unreasonable settlement offers
- Failure to settle third-party actions

In most jurisdictions, an insured cannot bring a bad faith claim against the insurer if the insurance policy does not cover the loss in the original action against the insured. The insured typically must first prove the policy covers the claimed loss before considering bad faith actions by the insurance company.

You should be aware that although most states have enacted legislation on bad faith insurance practices, the concept of bad faith is defined primarily by court decisions in case law. The law of bad faith is inconsistent among the states and continues to evolve as courts expand the types of behavior that may be addressed through bad faith claims.

Where Does the Insured’s Right Come From?

Modern day bad faith claims started in contract. Early insurance contracts or policies were treated like other contracts. Insureds who were impacted by their insurers’ conduct in claim settlements sued their insurers under a
breach of contract theory or one based upon the fiduciary relationship. The rationale behind the fiduciary relationship, as in the law of agency, is that the insurer was seen as an agent of the insured. As agents, insurers were expected to act according to the fiduciary standards of agents acting on behalf of their principals. While some courts have abandoned the cause of action for breach of fiduciary duty, you should note that some courts continue to refer to fiduciary principles when discussing the relationship between the insurer and the insured in the context of settlement of claims.

As of the mid 1990s, the majority of states recognize a cause of action for breach of the implied duty of good faith and fair dealing. This modern cause of action for insurance bad faith can be traced to the landmark decision, Comunale v. Traders & General Ins. Co., where the California Supreme Court held that “there is an implied covenant of good and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement,” and that the cause of action for bad faith “sounds in both contract and tort.” See, e.g., Comunale v. Traders & General Ins. Co., 50 Cal.2d 654, 658, 662-663 (Cal. 1958).

Nowadays, insurance companies are understood to owe a duty of good faith and fair dealing to their policyholders even if the insurance policy does not specify it. The implied covenant of good faith and fair dealing has been held to govern every duty and obligation of the insurer under the insurance policy. Insurers violate this covenant when they fail to or improperly perform their duties to the insured. This includes the insurer’s duties to defend and indemnify the insured, the insurer’s duties concerning settlement, and other aspects of the insurer–insured relationship. The insured may seek redress against the insurer under the implied duty of good faith and fair dealing when the insurer performs these duties in violation of the covenant.

For more on the implied covenant of good faith and fair dealing, see Implied Covenant of Good Faith and Fair Dealing.

When Is an Insurance Bad Faith Claim Triggered?

The insured must perform all the prerequisites to coverage under the insurance policy before insurers have to perform their duties. In all insurance policies, the insured’s duty in the claim submission process is to comply with the notice requirement. The notice provision is found in the policy and it instructs the insured on how to give notice of any occurrence, accident, loss, or claim to their insurer and what to include in the notice. Providing notice to the insurer triggers the insurer’s duty to determine whether the claim is covered. See Occurrence or Claims-Made Policies.

Providing timely notice preserves the insured’s right to coverage under the policy and allows the insurers to protect their rights by immediately investigating claims and gathering the information necessary to make a determination of coverage. Thereafter, the kinds of insurer duties vary depending upon whether the claim is considered first-party or third-party.

First-Party Insurance

First-party insurance coverage insures against loss or damage sustained by the insured. Allegations of bad faith claims handling and settlement practices can arise in the context of first-party insurance contracts such as those covering homes, automobiles or other personal property, life, health, and workers’ compensation.

First-party insurance bad faith claims often involve the insurer’s improper investigation and valuation of the damage. In first-party policies, the insurer’s duty to investigate is an integral part of the handling of the claim. At the point at which the insurer receives notice of a claim under a first-party policy, the loss already has occurred and it becomes the insurer’s responsibility to determine whether the loss is covered under the policy and, if so, in what amount. For example, if an insurer writes insurance on property such as an automobile and it becomes damaged, the insurer is required to investigate the damage, determine whether the damage is covered under the insurance policy, and pay the proper value of the damaged property. Therefore, a prompt and thorough investigation benefits both insurer and insured. The insurer’s failure to conduct such an investigation constitutes a breach of the implied covenant of good
faith and fair dealing and can be the basis of a finding of bad faith. First-party bad faith claim is also triggered when
the insurer refused to acknowledge the claim at all against the insured.

For more information, see First-Party Property Insurance Policies and New Appleman on Insurance Law Library
Edition § 55.06.

Third-Party Insurance

Third-party insurance coverage insures against liability of a person or entity for loss, damage, or personal injury
caused to a third person. Some examples of third-party policies: workers’ compensation, general liability,
professional liability, employment liability, and directors and officers liability.

You should be aware that there are also policies that contain both first- and third-party coverages such as
homeowner insurance and automobile insurance.

Third-party insurance bad faith claim often involves the insurer’s improper refusal to either defend its insured
against a lawsuit or pay a judgment or settlement of a covered lawsuit.

Duty to Defend

When the policy obligates the insurer to provide a defense, an insurer must defend an insured against any claim
raising a potential liability for a covered loss. The duty to defend is ascertained by comparing the allegations in the
underlying complaint with the language of the policy imposing the duty to defend. If the facts of a complaint show
that at least one claim is potentially covered by the policy, then the duty to defend is triggered and the insurer must
undertake the defense of the insured for all the claims in the complaint. Some insurance policies broadly state that
the insurer shall have both the right and the duty to defend and appoint an attorney to defend any claim against an
insured alleging a wrongful act even if such a claim is groundless, false, or fraudulent.

The insurer’s defense of the insured includes appointing counsel and covering all defense fees and costs, as well
as those of experts. An insurer may be held to have acted in bad faith when it unreasonably refuses to pay defense
costs incurred by the insured. You should note that a mere denial of benefits under the policy does not demonstrate
bad faith; the insurer’s refusal must be unreasonable for the insured to prevail on a bad faith claim.

Duty of Indemnification

You should be aware that an insurer’s duty to defend may be triggered even if the insurer ultimately has no
obligation to indemnify the insured against a loss.

The insurer’s duty of indemnification is separate from the duty to defend. This duty requires the insurer to reimburse
the insured or pay a judgment entered against the insured in the underlying lawsuit, up to the policy limit of
coverage. The duty to indemnify often can be determined only after liability against the insured has been
established, either by judgment or settlement of a claim. This is usually at the conclusion of the underlying litigation
against the insured. The duty to indemnify exists only when the final judgment is for a covered act or omission of
the insured.

Duty to Settle

The insurer’s improper refusal to settle a covered lawsuit within its policy limit is also grounds for an insurance bad
faith claim. Courts have also recognized that the insurer’s duty to protect the insured’s right may require settlement
of claims even though the express terms of the policy do not impose such a duty. See, e.g., Comunale, 50 Cal.2d at
659. Bad faith may be inferred when an insurer has rejected a settlement offer prior to conducting an appropriate
investigation of the underlying case. Insurers also have a duty to notify the insured of settlement offers and to follow
reasonable advice by their attorneys to settle claims.

For more on duties, see Insurance Policy Interpretation: Defining the Insured and Insured/Insurer Duties and New
How Does One Benefit from Bringing an Insurance Bad Faith Claim?

**Bad Faith Actions by Insured**

In most jurisdictions, the insured cannot bring a bad faith claim if the policy does not cover the loss. A minority of courts allow for a bad faith claim even in the absence of coverage where the manner in which the claim is handled—as opposed to the fact that the claim is denied—may be subject to the insurer bad faith claim.

When an insurer violates the covenant of good faith and fair dealing, the insured may be forced to litigate in order to obtain coverage afforded by the policy. The insured as plaintiff in a bad faith litigation solely finances the coverage litigation against the insurer. The insured may sue the insurance company on a tort claim in addition to a standard breach of contract claim. The contract-tort distinction is significant because certain damages and penalties may not be available to the insured.

**Contract Claim**

In jurisdictions holding that an insurer’s breach of the implied covenant of good faith and fair dealing sounds in contract, a successful insured can recover those damages normally available for breach of contract. The insured’s recovery includes the insurance proceeds under the policy. As a matter of public policy, punitive damages or exemplary damages are not available for contract claims. In addition, consequential damages for breach of contract are traditionally subject to certain constraints not applicable to tort actions. However, the statute of limitations for contract claims tends to be longer than those of tort claims.

**Tort Claim**

In jurisdictions holding that a bad faith claim sounds in tort, a successful insured may be able to obtain the following judgments against the insurer:

- **Excess judgments.** Numerous courts have held that an insurer’s bad faith conduct may give rise to a claim for damages beyond the policy limits. When the insured recovers damages beyond the policy limit, it is known as excess judgments. This issue has arisen in the context of an insurer’s bad faith refusal to settle within the policy limits. Courts have also allowed the insured to recover excess judgments where the insurer wrongfully breached its duty to defend the underlying action.

- **Punitive damages.** In addition to excess judgments, the insured may be entitled to punitive damages in a bad faith action. Punitive damage awards are available to punish an insurer’s bad faith actions, which incentivize insurers to act in good faith towards their insured. Some courts also recognize the availability of exemplary damages to punish bad faith conduct.

- **Consequential damages.** An insured may also recover consequential damages resulting from the insurer’s bad faith handling of claims. The insurer’s misconduct usually involves delay in processing claims and a refusal to finish processing them unless the insured accedes to the insurer’s interpretation of a policy provision.

- **Non-economic damages.** Many courts also allow for recovery of damages for mental suffering or emotional distress. Some courts impose a strict standard of proof to support an award to the insured for emotional distress suffered as a result of bad faith conduct by the insurer. Some courts do not require the insurer’s conduct to be outrageous or that the mental distress suffered by the insured to be severe to recover for mental suffering or emotional distress.

- **Attorney’s fees.** A minority of states have held that attorney’s fees may be recovered in an action against an insurer for bad faith. If an insured can demonstrate that attorney’s fees were incurred as damages caused by an insurer’s bad faith conduct, those fees may be recoverable.

You should also note that many states have enacted statutes that permit victims of bad faith insurance practices to recover attorney’s fees, penalties, and other damages, including punitive damages. For more on damages, see
Bad Faith Claims


**Bad Faith Actions by Third Parties**

Insurers may find themselves sued by the plaintiff who originally sued the insured. Some jurisdictions allow the third-party to bring a direct action against the insurance company. The majority rule is that the insureds (first-party) must first assign their rights under the insurance policy to the third-party. After the assignment, the third-party may be able to bring an action for bad faith denial of a claim against the insurer.

**Direct Action**

Not all states allow a bad faith action to be filed by a third-party who is a victim of an alleged wrongful denial of the insured’s claim. The third-party who is plaintiff in the underlying action may proceed directly against the insurance company under a state statute authorizing a direct action.

**Assignment**

Courts generally have allowed insureds to assign their right to pursue policy proceeds once a loss has occurred because an assignment of this right does not affect the risk assumed by the insurer. Once the loss for which coverage is sought has occurred and the basis for the insurer’s potential liability is fixed, the right to the insurance proceeds is assignable. You should be aware that an assignment of the insureds’ breach of contract and tort claims against the insurer is not an assignment of the insurance policy itself, but an assignment of the insureds’ cause of action against the insurer.

The insureds are sometimes confronted with an insurer that either refuses to authorize the acceptance of a reasonable settlement offer or refuses to fund the settlement of the underlying litigation. The insureds, abandoned in bad faith by their liability insurer, can settle the underlying case by assigning their bad faith claims against the insurer to the plaintiff.

A distinction is often drawn as to whether an assignment of an interest in an insurance policy occurred before or after a loss. An assignment after a loss does not alter the risks assumed by the insurer and consequently should not require the insurer’s consent.

Sometimes the insureds may find it desirable to settle before trial if the potential exposure is large or when faced with an uncooperative insurer. In these situations, the insureds settle the underlying case with the plaintiff by assigning their bad faith claims against the insurer to the plaintiff before trial. The parties agree to put on an uncontested show trial where liability and damages will be set (i.e., final verdict and judgment against the insureds). The settlement is made in anticipation of potential liability to the insureds. The assignment serves to eliminate the insureds’ own exposure to liability.

Assignments can also occur after trial when judgment is obtained against the insureds. In this situation, the insureds attempt to defend themselves by paying for counsel out-of-pocket and lose the case.

Whether the assignment occurs before or after trial, the insureds make a special settlement agreement with the plaintiff where the plaintiff agrees not to enforce the final judgment against the insureds. In exchange for not executing on the final judgment, the plaintiff gets an assignment of the assignable components of the insureds’ causes of actions against the insurer. Furthermore, the plaintiff agrees to rely solely on the assigned claims for recovery even if the plaintiff is unsuccessful in pursuing the claims against the insurer.

You should be aware that the insurer can challenge the enforceability of an assignment. The insurer may assert that the settlement involving the assignment results from collusion between the insureds and the plaintiff in the underlying action. Where the assignment occurs before trial, the insurer may raise the argument that the insureds breached their duty of cooperation or failed to adequately defend the claim after the assignment.

For more on insurance bad faith litigation, see New Appleman Insurance Bad Faith Litigation §§ 1.01, et seq.
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State Law Surveys
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Annotated Forms
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• Notice of Circumstance (Claims-Made Policy)
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