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Preparing for and Defending Against Bad Faith Claims

By Barbara O’Donnell, Esq.
Zelle McDonough & Cohen LLP

To accurately assess an insurer’s potential bad faith exposure for adverse trial outcomes, settlement conduct, and/or coverage disclaimers, practitioners and claims professionals need to understand (1) the evolving bad faith litigation landscape, (2) varying jurisdictional requirements for viable bad faith claims, (3) recurring scenarios that invite bad faith claims, and (4) effective legal defenses.

The Evolving Bad Faith Litigation Landscape

The arsenal of decisions and statutory remedies policyholders can now draw upon to recover amounts well in excess of stated policy limits by pursuing bad faith claims against insurers can be traced back to a judicial readiness to treat insurance policies as contracts of adhesion that impose onerous terms on parties without adequate bargaining power. Unwilling to limit policyholders to potentially inadequate contractual remedies, courts invoked the implied covenant of good faith and fair dealing inherent in all contracts to award policyholders relief exceeding policy limits when circumstances warranted.

As the Florida Supreme Court explained in Allstate Indemnity Co. v. Ruiz:

[third-party bad faith actions arose in response to the argument that there was a practice in the insurance industry of rejecting without sufficient investigation or consideration claims presented by third parties against an insured, thereby exposing the insured individual to judgments exceeding the coverage limits of the policy while the insurer remained protected by a policy limit. With no actionable remedy, insureds . . . were left personally responsible for the excess judgment amount. This concern gave life to the concept that insurance companies had an obligation of good faith and fair dealing.]

Quoting from prior precedent, the Ruiz court described the emergence of common-law bad faith remedies:

Until this century, actions for breaches of insurance contracts were treated the same as any other breach of contract action and damages were generally limited to those contemplated by the parties at the time they entered into the contract. Eventually, however, . . . insurance companies took on the obligation of defending the insured, which, in turn, made insureds dependent on the acts of the insurers; insurers had the power to settle and foreclose an insured’s exposure or to refuse to settle and leave the insured exposed to liability in excess of policy limits. This placed insurers in a fiduciary relationship with their insureds similar to that which exists between an attorney and client. Consequently, courts began to recognize that insurers “owed a duty to their insureds to refrain from acting solely on the basis of their own interests in settlement.” This duty became known as the “exercise of good faith” or the “avoidance of bad faith.”

To deter insurers from placing their interests ahead of their insureds’, courts scrutinized situations involving excess verdicts to determine if the insurer lost opportunities to settle within limits by making lowball offers, using delay tactics, and/or failing to apprise the insured of material developments.

1 899 So. 2d 1121, 1125 (Fla. 2005) (citation omitted).
3 Ruiz, 899 So. 2d at 1125 (citations omitted).
Concerns over an insurer’s potential ability to misuse its contractual right to control defense and settlement decisions also prompted courts to grant insureds the right to retain independent counsel of their choice when their insurer’s reservation of rights created a potential conflict of interest. In some jurisdictions, courts have expanded upon this safeguard by imposing an affirmative obligation on insurers to notify insureds of their right to retain independent counsel when the reservation of rights creates a potential conflict of interest. In other jurisdictions, including New Jersey, Florida, and Vermont, an insurer must obtain an insured’s consent to its retention of counsel to provide a defense under a reservation of rights.

Similar concerns over the risk that an insured’s interests could be impaired by an insurer’s control over defense and settlement decisions also led some courts to adopt estoppel doctrines that limited the insurers’ ability to assert indemnity coverage defenses when insureds were not fully and timely informed of applicable coverage limitations. Other courts stopped short of adopting estoppel remedies but endorsed burden-shifting consequences that limited insurers’ ability to contest the availability of indemnity coverage if they did not properly carry out their defense obligations.

Courts also invoked the implied covenant of good faith and fair dealing to prevent insurers from placing the interests of one insured or one claimant ahead of another in situations when policy obligations protected multiple insureds or when multiple claimants were vying for potentially insufficient policy proceeds.6

By invoking these theories of liability, insureds could recover a wide array of relief over policy limits including: (1) excess verdicts, (2) payments for noncovered claims and damages, (3) stipulated and consent judgments, (4) independent counsel defense costs, and (5) declaratory judgment costs. While these avenues of extracontractual relief certainly provide insureds with important safeguards, an essential ingredient in fostering the current bad faith landscape—in which some policyholder counsel appear to place greater importance on developing avenues for extracontractual relief than on resolving the underlying claims against their insureds—involves the enactment of unfair claims handling statutes that permit the award of attorney fees, multiple damages, punitive damages, and/or other statutory penalties.

Particularly in situations involving low-limit automobile or homeowners policies, the potential ability to recover amounts well over the policy limit by pursuing statutory bad faith claims can hold great appeal. As with any other potentially lucrative practice area, inroads made in establishing viable avenues of recovery attract more claims and a greater commitment of resources by the plaintiffs bar.

Compounding matters from the insurer’s vantage point, some statutes also allow claimants to recover statutory penalties and attorney fees from insurers who failed to settle claims involving clear liability and damages. In jurisdictions where claimants as well as policyholders can pursue statutory bad faith claims, an insurer can find itself embroiled in bad faith litigation even if it fully satisfies a judgment entered against its insured or negotiates a full release of claims against the insured.

Adding to the appeal of statutory incentives for pursuing bad faith claims, insurers often present an attractive target for plaintiffs trial counsel. As one firm put it: “A bad faith case is a plaintiff’s attorney’s dream. Every insurance cliché, big business prejudice and ‘underdog’ sentiment, can and should be used. Irrespective of the merits of the defense, insurers are target defendants.”5

As a consequence of these developments, the bad faith landscape in some jurisdictions can appear geared more closely to providing policyholder counsel with a lucrative recovery than safeguarding the appropriate balance of interests between insurer and insured.

As a California judge commented, “It seems to me that attorneys who handle policy claims against insurance companies are no longer interested in collecting on those claims, but spend their wits and energies trying to maneuver the insurers into committing acts which the insureds can later trot out as evidence of bad faith.”6 Echoing this concern, a Florida judge recently observed that “[t]he number of bad faith cases filed in the courts appears to be exponentially increasing, but the increase does not appear to be directly linked to the actions of the insurers.”7

With bad faith claims viewed as the gateway to recovering attorney fees and damages well in excess of policy limits, insurers and policyholders counsel need to be well versed in addressing scenarios in which an insurer’s allegedly flawed investigation, settlement practices, and/or noncompliance with statutory claims handling requirements open the door to extracontractual disputes.

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4 See Contreras v. U.S. Sec. Ins. Co., 927 So. 2d 16 (Fla. Dist. Ct. App. 2006) (finding that an insurer has a duty to protect as many insureds as possible when the plaintiff asserts claims against multiple insureds); Farinas v. Fla. Farm Bureau Gen. Ins. Co., 850 So. 2d 555 (Fla. Dist. Ct. App. 2003) (concluding that an insurer has a duty to settle “as many claims as possible within the policy limits” while minimizing the insured’s exposure to an excess judgment).


6 White v. W. Title Ins. Co., 710 P.2d 309, 328 n.2 (Kaus, J., concurring and dissenting).

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Varying Jurisdictional Requirements for Bad Faith Claims and Remedies

While insurers must certainly exercise care to avoiding forfeiting the right to enforce contract-based coverage limitations, bad faith liability requires more than a mistake or error in judgment. As a California court explained:

“[A]n insurer is not required to pay every claim presented to it. Besides the duty to deal fairly with the insured, the insurer also has a duty to its other policyholders and to the stockholders (if it is such a company) not to dissipate its reserves through the payment of meritless claims. Such a practice inevitably would prejudice the insurance seeking public because of the necessity to increase rates, and would finally drive the insurer out of business.”

Given this tension between the need to safeguard an insured’s interests and the concerns over impossibly substituting the court’s judgment for an insurer’s informed evaluation of claim exposures and settlement valuations, an essential first step in assessing an insurer’s potential bad faith exposure is understanding the required elements of a viable extracontractual claim in the applicable jurisdiction. As the following overview demonstrates, the essential elements of bad faith claims vary considerably between jurisdictions, with some requiring little more than the absence of a reasonable basis for the insurer’s actions and others requiring persuasive evidence of malice, ill will, or dishonesty. A handful of jurisdictions do not recognize a tort-based common-law bad faith remedy and instead restrict policyholders to contractual or statutory remedies.

While bad faith claims start with establishing some form of unreasonable conduct by the insurer, something more than negligence, a mistake, or poor judgment is required to present a meritorious bad faith claim. This holds true whether the bad faith claim rests on the insurer’s alleged breach of the implied covenant of good faith and fair dealing, its fiduciary or quasi-fiduciary obligations owed to its insured, or its violation of unfair insurance practices or claims handling statutes.

In California, the claimant must establish that the insurer engaged in unreasonable conduct that was conscious and deliberate. In Arizona, Colorado, and Iowa, extracontractual liability requires proof that the insurer acted unreasonably and knew or should have known that its conduct was unreasonable. In Indiana, liability will not be imposed without evidence that the insurer acted in a dishonest manner or with ill will motives. In Pennsylvania, the insured must offer “clear and convincing” evidence that the insurer acted in gross or willful disregard of the insured’s interests. In New Jersey, an insurer will not be held liable for a bad faith failure to settle unless its conduct is found to be “actually dishonest, unreasonably optimistic or otherwise in bad faith.” New York courts require evidence that the insurer acted in gross or willful disregard of the insured’s interests. In Connecticut, bad faith requires evidence of “dishonest purpose or moral obliquity . . . it contemplates a state of mind affirmatively operating with furtive design or ill will.”

The requirements for subjecting an insurer to an award of punitive damages are even higher, with most jurisdictions unwilling to award punitive damages or statutory multiple damages in the absence of clear evidence of deliberate and knowing wrongdoing by the insurer or evidence of malice, oppression, or fraud.

Recurring Scenarios That Invite Bad Faith Claims

While bad faith claims are by no means a “slam dunk” given the high burden of proof of an insured faces in many jurisdictions and the insurers’ ability to invoke the defenses discussed below, policyholders, insurers, and their counsel must keep a vigilant eye out for the following scenarios that invite bad faith claims:

- Low policy limit and high exposure claims;
- Lost opportunities to settle within limits;
- Failure to apprise insured of material litigation or settlement developments;
- Flawed investigation unduly focused on developing grounds to deny claim;
- Varying jurisdictional requirements and the insurers’ ability to invoke the defenses of punitive damages are even higher, with most jurisdictions unwilling to award punitive damages or statutory multiple damages in the absence of clear evidence of deliberate and knowing wrongdoing by the insurer or evidence of malice, oppression, or fraud.

18 See Gaylord v. Nationwide Mut. Ins. Co., 776 F. Supp. 2d 1101 (E.D. Cal. 2011) (observing that to obtain punitive damages, the insured must prove fraud, oppression, or malice by ‘clear and convincing evidence’).
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- Competing claims for policy limits;
- Mishandled control of defense, including disregard of conflicting interests and/or insured’s entitlement to independent counsel;
- Failing to timely apprise insured of coverage limitations;
- Overlooked traps in demand letters and/or insufficient attention to efforts to establish bad faith claim in problematic jurisdictions;
- Material violation of statutory claims handling requirements; and/or
- Problematic claims file entries.

As a general rule, successful bad faith lawsuits involve some combination of the foregoing. The following decisions illustrate some of the ways in which “garden variety” claims can result in costly bad faith verdicts when plaintiffs counsel can draw upon one or more of the preceding scenarios.

**Flawed handling of routine claims.** The failure to competently handle routine claims arising out of an automobile collision left an insurer facing a $2,250,000 bad faith judgment under policies with combined limits of $200,000. The dispute in *Taveras v. American Transit Insurance Co.* arose out of a three-way collision between the taxi the plaintiff was riding in, another taxi, and a rental car. American Transit (AT) insured the two taxis. In the underlying action, the court bifurcated the liability and damages phases of trial. In the liability phase, the jury apportioned 70 percent of fault to the taxi the plaintiff was occupying and 30 percent to the other taxi. The rental car owner was required to pay $225,000 under a pretrial high/low settlement agreement.

Prior to the damages phase, AT rejected an offer to settle for the $200,000 combined limit of the policies covering both taxis. After the jury returned a $9 million verdict, which was later reduced to $2.5 million, the owner/operator of the taxi the plaintiff was occupying and 30 percent to the other taxi. The rental car owner was required to pay $225,000 under a pretrial high/low settlement agreement.

- AT violated its own internal protocol by having one claims examiner handle the claims against both of its insureds, despite their conflicting interests.
- AT disregarded its protocols for properly documenting the claims file, which omitted medical records, reports, demands, and periodic claims evaluations.
- AT violated its own protocol of maintaining hard copies of the claims files. At trial, AT only had access to computerized claims notes, which it acknowledged did not include the information needed to properly evaluate the risks to its insureds.
- AT never communicated directly with its insureds because it relied on defense counsel.
- Defense counsel and AT failed to keep the insured apprised of settlement negotiations.
- AT refused to settle the underlying action based on its asserted need for defense counsel’s pretrial reports ignoring its nondelegable duty to evaluate the risk to its insureds.
- Before the liability and damages phases of the trial, the AT personnel with adequate settlement authority never received the file or even knew that the case was going to trial.
- By mishandling the file, AT lost the opportunity to settle the claim at a time following the liability phase of trial.

**Settlement delays and lost opportunities.** In a decision that demonstrates the multiplier effect of bad faith statutory penalties, the Massachusetts Court of Appeals affirmed an award of over $1 million on a policy with limits of $20,000/$40,000 in *Gore v. Arbella Mutual Insurance Co.* Holding that the trial court was entitled to award multiple damages on a $450,000 consent judgment entered against the insured under the Massachusetts claims handling statute,21 the appeals court remanded for the trial court to decide whether to award double or treble damages on the consent judgment. The trial court doubled the consent judgment, based on its conclusion that Arbella’s conduct was willfully reckless but “probably not malicious.”

The *Gore* dispute arose out of an accident that occurred when Anthony Caban struck a car driven by Angelina Dattilo. Arbella insured Caban under a policy with liability limits of $20,000 per person and $40,000 per accident. Shortly after the accident, Dattilo’s attorney sent Arbella a letter detailing Caban’s liability and Dattilo’s injuries, enclosing medical records totaling over $25,000, and demanding that Arbella tender the $20,000-per-person policy limits within 30 days. The demand letter offered to fully release Caban and Arbella in exchange for the $20,000 limit.

21 Mass. Gen. L. ch. 93A.
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When Arbella received the demand letter, its investigation had already established that liability and damages were reasonably clear, which triggered its duty to pursue good faith settlement efforts under the claims handling statute. Caban admitted to drinking and smoking marijuana prior to driving and admitted that he was at fault. Arbella’s investigator ruled out any contributory negligence by Dattilo. It was reasonably clear that the damages exceeded the per-person policy limits by at least $100,000.

Despite its recognition of clear liability and damages in excess of the policy limits, Arbella failed to timely respond to, or inform its insured of, the demand letter. Two months later, Arbella informed Caban of his excess exposure but told him that “a formal demand has not been received.”

Five months later, a different adjuster informed Dattilo’s attorney that Arbella was investigating the other passengers’ potential claims to attempt to structure a global settlement. Two months later, Arbella offered Dattilo the $20,000-per-person policy limits in exchange for a release. Dattilo rejected Arbella’s offer, calling it “rather presumptuous under the circumstances.”

The following year, Dattilo and Caban entered into a settlement that included a $450,000 stipulated judgment against Caban with a covenant not to execute and an assignment of Caban’s unfair settlement practices claims. Almost two years later, Dattilo sent Arbella a $1.4 million demand letter. Arbella offered Dattilo $23,966. Dattilo thereafter sued Arbella to recover compensatory and multiple damages. Arbella’s delays violated its obligation “to effectuate a settlement when liability and damages are reasonably clear.”

On appeal, the Massachusetts Appeals Court affirmed Arbella’s liability for unfair settlement practices. First addressing Arbella’s “impermissible delay” in responding to the plaintiff’s settlement demand, the court held that Arbella’s delays violated its obligation “to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear.” The court stated that an insurer has a duty to respond to settlement offers within policy limits by the “deadline prescribed in the offer . . . provided that the time allotted for a response is reasonable.”

Recognizing that what constitutes a reasonable time for a response depends on the circumstances, the court noted that Arbella’s own experts testified that the 30-day response deadline presented in the demand letter was reasonable. Even if the logistics involved in pursuing a global settlement with multiple claimants prevented Arbella from making an offer within 30 days, Arbella needed to promptly respond to the plaintiff’s demand.

Arbella’s delayed response to the demand letter “was compounded by its failure to notify Caban of the settlement offer.” Having waited until after the plaintiff’s deadline for a response had expired and after suit was filed by the plaintiff to inform Caban that he was exposed to liability exceeding the policy limits, Arbella misrepresented that “a formal demand has not been received.” The court concluded that Arbella’s misrepresentation “reinforces the picture of a pattern of bad settlement practice.”

Caban was harmed by Arbella’s failure to inform Caban of the settlement demand and its “dilatory response to Dattilo’s legitimate demand for settlement that predictably led her to spurn Arbella’s late tender and seek an excess judgment.”

Rejecting Arbella’s contention that the plaintiff’s demand letter constituted an attempt to “manufacture a bad faith insurance claim,” the appeals court held that the plaintiff’s alleged tactics, even if established, would not “as a matter of law, relieve Arbella of its duty to respond to a demand when liability was clear and damages exceeded the policy limits.” The court reaffirmed that a “claimant’s conduct is not relevant to the insurer’s duty” to attempt to effectuate a settlement when liability and damages are reasonably clear.

Unreasonable time-limited demands. As Gore illustrates, many bad faith claims involve the insurer’s receipt of time-limited demands. In DeLaune v. Liberty Mutual Insurance Co., an insured with a $10,000 liability policy limit was sued approximately one month after an automobile accident. Eight days after defense counsel retained by the insurer received the file, the plaintiff sent a written offer to settle for policy limits within 10 days. The demand letter enclosed a neurosurgeon’s affidavit asserting that the plaintiff’s injuries “would totally disable him for the rest of his life.” Given the assertion of total disability and the determination that liability was probable, the adjuster recommended informing the insured of a possible excess exposure and “dump[ing] this case as policy limits are only $10,000.” On a Friday, the last day of the 10-day response

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27 Gore, 932 N.E.2d at 842.
28 Id.
29 Id. at 843.
30 Id. at 846.
31 Id. at 846–47.
32 Id. at 847.
33 Id. at 848.
34 Id. at 602.
period, defense counsel told the plaintiff’s counsel that he anticipated obtaining authority to accept the offer by the following Monday. The plaintiff’s counsel declined to grant an extension. On the following Monday, the insurer authorized the policy limit payment and defense counsel attempted to settle the case for $10,000. The plaintiff’s counsel refused the offer.

At trial, the plaintiff recovered a $360,000 verdict. In the ensuing bad faith lawsuit against the insurer, the appellate court concluded that the evidence did not rise to the level of bad faith. The court determined that issuing a 10-day time-limited demand only eight days after defense counsel was assigned and less than a month after the accident was unreasonable. The court suggested that this demand was a “set up” because the plaintiff’s counsel rejected the policy limits offer when it was received on the Monday following the expiration of the arbitrary 10-day time period.

Best practices. Even when insurers have well-founded defenses to bad faith claims, they know from experience that bad faith lawsuits frequently prove costly and disruptive. In addition to discovery disputes over the production of the insurer’s claims file, reserves, treatment of similar claims against other insureds, and the like, bad faith lawsuits also require claims representatives to spend hours preparing for depositions. Consequently, even when the factual support for a bad faith claim is thin, the presence of one or more of the red flags discussed above can materially increase the price tag an insurer may be prepared to pay to resolve a dispute.

Knowing how disruptive and costly it can be to defend against a bad faith lawsuit, prudent insurers strive to adhere to a range of best practices to lessen their exposure to, and strengthen their defenses against, bad faith claims. While these best practices vary from company to company, they generally include the following:

• Ongoing training to help claim examiners spot and respond to “red flags” that evidence efforts to establish bad faith claims;
• Creating specialized teams to handle potential bad faith claims;
• Carefully supervising to ensure that claims are handled in a timely and professional manner;
• Splitting files between defense and coverage matters and between multiple insureds or claimants in appropriate circumstances; and
• Closely monitoring claims in “problem” jurisdictions.

Defenses against Bad Faith Claims

Even with careful adherence to best practices, a percentage of disputes will result in extracontractual litigation. When required to defend against potentially high-exposure bad faith claims, insurers can draw upon the following defenses to avoid or lessen their exposure.

Genuine dispute or fairly debatable defense. With extracontractual liability dependent on the insured’s ability to establish that the insurer’s actions involved more than a mistake or error in judgment, whether framed as reckless disregard of the insured’s interests, willful self-interest, or improper motive, insurers can avoid or limit bad faith liability in many jurisdictions by establishing the existence of a genuine dispute over the insured’s entitlement to recovery. As the California Supreme Court explained in Wilson v. 21st Century Insurance Co., the “genuine dispute” defense represents a “close corollary” to the principle that “an insurer’s denial of or delay in paying benefits gives rise to tort damages only if the insured shows the denial or delay was unreasonable.”

A variant of the genuine dispute doctrine is the “fairly debatable” doctrine, which holds that a coverage denial will not give rise to extracontractual liability if the insurer’s position was based on a fairly debatable interpretation and/or application of the relevant policy language.

In the context of third-party liability claims, the genuine dispute or fairly debatable defense is only available when the insurer’s coverage position is based on a reasonable interpretation of policy language or applicable law. The defense does not allow a liability insurer to invoke a genuine issue of fact to avoid its duty to defend because any questions regarding the availability of a defense obligation must be resolved in the insured’s favor.

The decisions upholding these defenses include the following recurring scenarios:

• Whether policy covers claims: When an insurer’s denial of additional insured coverage rested on a “fairly debatable,” albeit mistaken, interpretation of the applicable policy provision and underlying contract, the insurer was entitled to summary judgment on the bad faith claim, 35

35 171 P.3d 1082, 1088 (Cal. 2007).

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even though the additional insured established its right to coverage.37

- **Entitlement to coverage:** In a dispute over an insured’s entitlement to underinsured motorist (UIM) coverage for a knee injury allegedly sustained in an auto accident where emergency room records did not document any bruises, swelling, contusions, or abrasions; the insured first complained of knee pain after participating in yoga after the accident; and the insured delayed seeking medical treatment, it was “not unreasonable” for the insurer to question whether the insured’s activities, rather than the auto accident, caused the knee injury.38

- **Claim value:** Disagreement over what repairs were covered under a homeowners policy that required the insureds to repair or replace their damaged property within 180 days as a prerequisite to obtaining replacement cost established a genuine dispute shielding the insurer from bad faith liability.39

- **Claims handling:** Disagreement between the injured worker’s and the insurer’s respective physicians over the need for further medical treatment and the insured’s asserted entitlement to change doctors sufficed.40

The California decision of **Gaylord v. Nationwide Mutual Insurance Co.**41 provides useful guidance regarding the availability of the genuine dispute defense. In **Gaylord**, policyholders sought first- and third-party coverage under a Nationwide farm owner’s policy issued when contaminated feed caused the death of their own cattle and generated lawsuits by the owners of cattle left in their care. The plaintiffs’ first-party claim was time-barred under the policy’s governing one-year limitation period and coverage limitations, but they established a potential entitlement to coverage under their policy’s third-party liability provisions.

Having established a potential entitlement to liability coverage based on an ambiguity in the policy and their reasonable expectation of coverage, the policyholders argued that Nationwide could not invoke a genuine dispute defense to defeat their bad faith claim. In support of this argument, the policyholders relied on a prior decision by the Eastern District of California, **Harbison v. American Motorists Insurance Co.**,42 that questioned whether the doctrine can ever apply when a duty to defend is at issue. In rejecting the plaintiffs’ argument, the **Gaylord** court explained that it would not follow **Harbison** because the Ninth Circuit and California district courts “have applied the genuine dispute rule in cases involving the duty to defend.”43 Given these prior decisions, the **Gaylord** court concluded that an insurer that denies liability coverage based on a legal dispute over the interpretation or application of policy language can invoke the genuine dispute doctrine as a defense to a bad faith claim.

Addressing the contours of this defense, the **Gaylord** court recognized “[w]here there is a ‘genuine issue’ or ‘genuine dispute’ as to the insurer’s liability under the policy for the claim asserted by the insured, there can be no bad faith liability imposed on the insurer for advancing its side of that dispute.”44 A genuine dispute “exists only where the insurer’s position is maintained in good faith and on reasonable grounds.”45 In granting Nationwide summary judgment on the plaintiffs’ bad faith claim, the court explained that Nationwide diligently attempted to investigate the potential availability of coverage, it conveyed its willingness to reassess its denial if warranted by additional information, and it referred the matter to outside coverage counsel for review.

In liability coverage disputes, the genuine dispute doctrine will not shield an insurer from bad faith liability when its coverage position rests on a factual, instead of a legal, dispute. As the court explained in **Century Surety Co. v. Polisso**,46 when the complaint allegations and extrinsic facts known to the insurer establish a potentially covered claim, a liability insurer cannot establish a “genuine” or “legitimate dispute” regarding its duty to defend. Consequently, the insurer acted improperly in **Polisso** when it denied defense coverage based on disputed factual questions concerning the application of the policy’s faulty work and completed operations provisions. Unable to rely on the genuine dispute doctrine, the insurer was bound by the jury’s $2 million punitive damages award.

In many jurisdictions, the genuine dispute or fairly debatable defense can fully defeat bad faith liability. In others, the existence of a genuine or fairly debatable dispute is a factor weighed in the insurer’s defense, but not an absolute bar to liability. In a handful of jurisdictions, the defense triggers burden-shifting consequences concerning the “reasonableness” determination underlying the evaluation of an insurer’s extracartular liability.

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37 Kmart, 2013 WL 6670746, at *3.
41 776 F. Supp. 2d 1101 (E.D. Cal. 2011).
44 Gaylord, 776 F. Supp. 2d at 1124 (quoting McCoy v. Progressive W. Ins. Co., 90 Cal. Rptr. 3d 74, 80 (Ct. App. 2009)).
45 Id. (quoting Wilson v. 21st Century Ins. Co., 68 Cal. Rptr. 3d 746, 754 (Ct. App. 2007)).
46 43 Cal. Rptr. 3d 468 (Ct. App. 2006).
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Advice of counsel defense. Reliance on the advice of its counsel or other retained experts can establish that an insurer carefully and reasonably evaluated the insured’s entitlement to coverage. However, it will not, in and of itself, shield an insurer from bad faith liability if the insurer’s own conduct does not survive scrutiny. 47

While an advice of counsel defense does not, standing alone, shield an insurer from extracontractual liability, an insurer’s readiness to consult with counsel or experts to arrive at a well-founded coverage determination can significantly buttress the insurer’s defenses when its reliance on its counsel or experts was reasonable. Accordingly, the insurer needs to be certain that the advice provided by its counsel is correct and that its experts cannot be challenged as biased or lacking the requisite degree of experience and knowledge.

In the Gaylord decision discussed above, 48 the insurer was able to point to its retention of outside coverage counsel to buttress its assertion of a genuine dispute defense. The insurer was able to rely on its counsel’s conclusion that several policy exclusions defeated coverage because the expert’s report creates a legitimate factual question regarding the validity of an insured’s claim for benefits, making the insured’s claim at least fairly debatable. 51

In Worth Bargain Outlet, Inc. v. AMCO Insurance Co., 52 the insurer offered supporting expert reports to defeat a bad faith claim that challenged its claim payment as unreasonably low. While allowing the breach of contract claim to proceed, the court granted the insurer summary judgment on the bad faith and punitive damages claims because of the genuine dispute over the insured’s claimed entitlement to additional lost business income payments.

The insured argued that the insurer “dishonestly selected its experts’ and those ‘experts were unreasonable’ in their investigation of Plaintiff’s claims.” In rejecting this argument, the court noted that the “only argument Plaintiff puts forth to suggest a biased investigation is the fact that [one of the experts] was hired 20 times by Defendant before Plaintiff’s claim, and 30 to 40 times since.” The court held that it “would be an unreasonable inference to conclude that [the consultant] was a biased expert simply because it had worked for the Defendant” on many occasions. 53

As the Worth decision illustrates, while reliance on the advice of counsel or other experts usually enhances the insurer’s ability to defeat a bad faith claim, the insurer needs to ensure that its selection of experts or reliance on the advice of counsel will withstand scrutiny. As the Gaylord court cautioned, “[r]eliance on an expert opinion will not defeat a bad faith claim where the insurer dishonestly selected the expert, the expert was unreasonable, or where the insurer does not conduct a thorough investigation.” 54

An insurer’s reliance on an advice of counsel or expert defense will also backfire if the insurer “acted unreasonably by shopping for an expert” to support its position. 55 An insured may be able to establish that the insurer improperly engaged in expert shopping if the insurer contacted a number of experts and retained the expert who offered to support a claim denial. A claimant may also argue that expert shopping can be inferred from an insurer’s repeated use of the same expert or its use of an expert who only works for insurance companies.

An insurer must also be able to establish that its reliance on the advice of counsel or other experts was reasonable. As the Fifth Circuit held in Szumigala v. Nationwide Mutual Insurance Co.:

[If] it is simply not enough for the carrier to say it relied on advice of counsel, however unfounded, and then expect that valid claims for coverage can be denied with impunity pursuant to such advice. The advice

47 See Hamilton Mut. Ins. Co. v. Buttery, 220 S.W.3d 287, 294 (Ky. Ct. App. 2007) (recognizing that an insurer’s reliance on advice of counsel does not provide an absolute defense to a bad faith claim; an insurer cannot “delegate its duty of good faith and fair dealing to anyone else—even its counsel”).
48 776 F. Supp. 2d 1101.
49 Id. at 1126.
50 56 P.3d 524 (Utah 2002).
51 Id. at 535.
53 Id. at *11.
54 776 F. Supp. 2d at 1126 n.17.
55 See Provident Life & Accident Ins. Co. v. Brenner, 41 F. App’x 54, 57 (9th Cir. 2002).
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of counsel is but one factor to be considered in deciding whether the carrier’s reason for denying a claim was arguably reasonable. We believe that where, through verbal sleight of hand, the advising attorney concocts an imagined loophole in a policy whose plain language extends coverage, such advice is heeded at the carrier’s risk.56

In Barnes v. Oklahoma Farm Bureau Mutual Insurance Co., an Oklahoma court cited favorably to the Fifth Circuit’s decision in rejecting an insurer’s reliance on an advice of counsel defense where the evidence established that counsel’s advice was “wholly unfounded; “contrary to the unmistakable meaning of the relevant provision(s) of [the UIM statute],” “at odds with existing case law recognizing the legislative intent behind underinsurance coverage,” “inconsistent with a provision of the insurance policy issued to [the plaintiff],” and “nothing other than verbal sleight of hand.”57

In weighing the risks associated with asserting an advice of counsel defense, the insurer and its counsel need to carefully evaluate the waiver of privilege consequences that follow from the express or implied assertion of an advice of counsel defense in the applicable jurisdiction. In some jurisdictions, the privilege will not be deemed waived unless the insurer expressly invokes an advice of counsel defense.58 In other jurisdictions, an insurer does not need to expressly assert advice of counsel as a defense to waive its attorney-client privilege on the view that in bad faith litigation, “advice of counsel is inextricably interwoven into the fabric of the facts that occurred.”59 For example, in Jones v. Nationwide Insurance Co., a Pennsylvania court held that an insurer placed its reliance on the advice of counsel at issue by asserting as an affirmative defense its contention that it “acted reasonably and in accordance with the insurance contract and the applicable laws of the Commonwealth of Pennsylvania when issuing the policy of insurance, and when handling, investigating and evaluating plaintiff’s claim.”60

Consequently, to avoid the inadvertent waiver of privileged communications, an insurer and its counsel need to know, before answering the plaintiff’s bad faith complaint, whether the insurer must expressly invoke an advice of counsel defense to bring about a waiver or whether merely asserting that it did not act in bad faith, or that it acted in accordance with governing law, is enough to waive the privilege. Depending on the law in the applicable jurisdiction, an insurer that wants to avoid the disclosure of its attorney-client communications may need to unequivocally state at an early stage of proceedings that it does not intend to assert an advice of counsel defense.

**Does reverse or comparative bad faith shield an insurer from liability?** Insurers have not fared well in attempting to defeat or limit extracontractual liability by offering evidence of an insured’s own bad faith or failure to cooperate as an affirmative defense or cross-claim. While some commentators express support for these defenses as a way to counter the seeming proliferation of ill-founded bad faith claims, most courts decline to recognize either defense based in part on the view that the imposition of tort or extracontractual liability on insurers is justified by “special factors inapplicable to the insured.”61 Consequently, most courts restrict insurers to their contract-based remedies for an insured’s breach of its duty to cooperate.

In keeping with this approach, in Kransco v. American Empire Surplus Lines Insurance Co., the California Supreme Court declined to follow an earlier California Court of Appeals decision that “for the first time held that in a bad faith action the insurer could interpose as a defense the tort concept of comparative fault, in an entirely new form known as comparative bad faith.”62 Attempting to avoid bad faith liability for failing to settle the underlying action prior to the entry of an excess verdict and a $10 million punitive damages award against its insured, the insurer in Kransco argued that the “insured’s comparative bad faith and comparative negligence as a litigant in the underlying third party action was a contributing legal cause of the verdict and should reduce its liability for tort damages in the bad faith action.”63 The evidence of the insured’s alleged bad faith included its submission of false interrogatory answers denying awareness of prior similar accidents involving its product (a backyard water slide that contained warnings against adult use—the 35-year-old plaintiff was rendered quadriplegic after he “jackknifed” onto the slide). The trial court initially accepted this argument and allowed the jury to answer special questions that assigned the insured 90 percent in comparative fault. Concluding that it had erred in instructing the jury on comparative bad faith, the trial court granted the plaintiff’s motion for a JNOV and awarded him the full amount of his damages.

Affirming this outcome, the California Supreme Court concluded that “allowing an insurer to assert a defense of comparative bad faith . . . misleadingly equates an insured’s contractual breach of the reciprocal covenant of good faith and fair dealing with an insurer’s tortious

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56 853 F.2d 274, 282 (5th Cir. 1988).
57 11 P.3d 162, 174 (Okla. 2000).
60 Id.; see also Tackett v. State Farm Fire & Cas. Ins. Co., 653 A.2d 254, 259 (Del. 1995) (holding that the insurer waived the attorney-client privilege by making “factual assertions in defense of a claim which incorporate, expressly or implicitly, the advice and judgment of counsel”).
62 Id. at 10 (citing Cal. Cas. Gen. Ins. Co. v. Superior Court, 218 Cal. Rptr. 817, 822 (Ct. App. 1985)).
63 Id. at 4.
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breach of the covenant."64 The court also noted that courts in several other jurisdictions, including Oklahoma, Montana, Iowa, Texas, Oregon, Florida, and Hawaii, have rejected the defenses of comparative or reverse bad faith.65 The Kransco court cautioned that its rejection of the comparative or reverse bad faith defenses does not prevent an insurer from offering “[e]vidence of an insured’s misconduct […] factually disprove the insurer’s liability for bad faith by showing the insurer acted reasonably under the circumstances.”66

While efforts to invoke reverse or comparative bad faith as a stand-alone defense or cause of action have met with little success following Kransco, a few courts have signaled some support for the availability of a reverse or comparative bad faith defense.67 Even when reverse bad faith does not support a stand-alone defense, the evidence can still allow an insurer to establish that it acted reasonably under all of the relevant circumstances.

64 Id. at 12.
65 Id. at 12 n.11.
66 Id. at 13.

Conclusion

While most insurance disputes are resolved without the assertion of bad faith, mishandled claims can readily subject insurers to liability well in excess of stated policy limits when skillful counsel can invoke statutory penalties and/or offer evidence of insurer misconduct. To lessen their exposure to and/or successfully defend against costly bad faith claims, insurers need to be able to demonstrate that they responded to the insured’s claim in a forthright, reasonable, and diligent manner and that any mistakes that were made did not rise to the level of malice or willful misconduct. With the lines of battle clearly drawn, policyholder’s and insurer’s counsel need to both remain closely attuned to the scenarios that invite bad faith claims and the factual and legal defenses that insurers can draw upon to avoid extracontractual liability.

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