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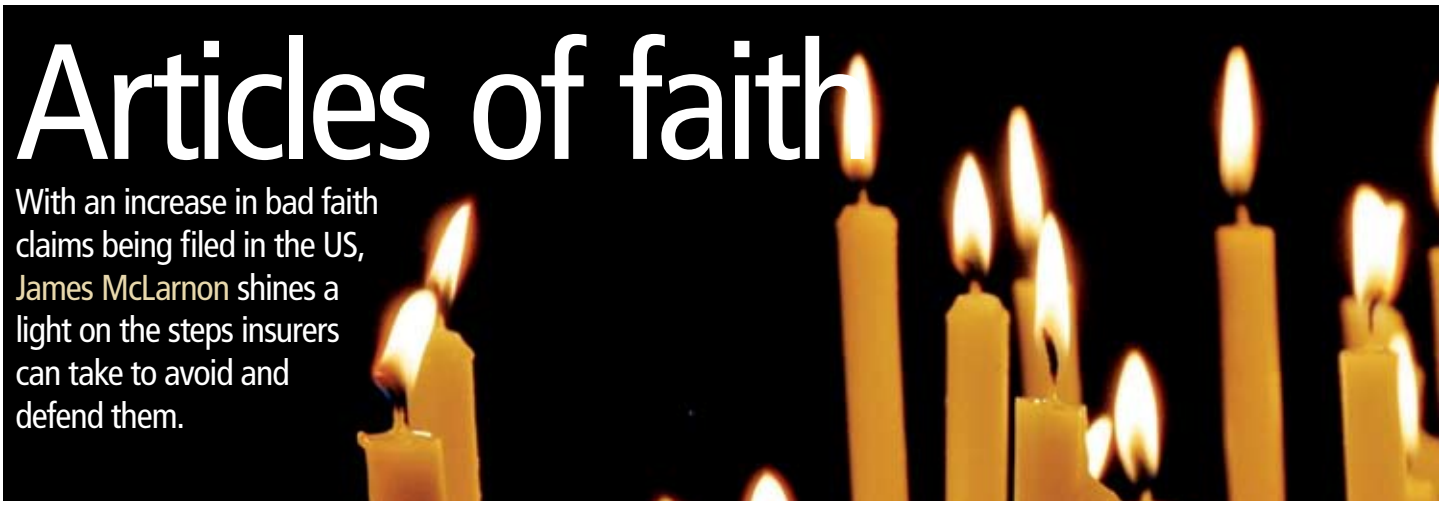
Articles of faith



With an increase in bad faith claims being filed in the US, James McLarnon shines a light on the steps insurers can take to avoid and defend them.

BAD FAITH CLAIMS are being filed at an increasing rate in the US and can lead to significant damage awards. Insurers must not only take steps to avoid these claims but help create a culture where the courts will view such claims with scepticism. The policyholder wants the insurer to pay for what they believe is harmful misconduct, or may use the threat of a bad faith award to seek a favourable claim result. So, insurers need to position themselves to gain favourable outcomes and minimise the damage.

Insurer bad faith claims tend to fall into two broad categories: wrongful denial of policy benefits; and unfair claims handling/settlement practices, with investigation efforts, offers, communications, and timing issues under the spotlight regarding each of these matters.

Focusing specifically on bad faith claims throughout New England" Maine, New Hampshire, Vermont, Massachusetts, Connecticut and Rhode Island" from the perspective of the insurer, what are the different issues faced in each jurisdiction? And, with regards to the first category of claims in the first-party context: what are the standards to which an insurer is held when faced with a claim of bad faith denial of insurance coverage; what are an insurer's and policyholder's obligations in a coverage investigation; how can a policyholder prove that an insurer acted in bad faith; and what are the insurer's best defences to such a claim?

The minefield of potential bad faith claims can be treacherous if those managing risks and handling claims do not understand the geography and topography involved with these claims.

When judges or juries find bad faith, the potential damages against insurers can be staggering, with many jurisdictions allowing for punitive damages and attorneys' fees. Establishing policies and procedures to avoid these 'mines' is the key. However, even the best safeguards are not foolproof, and the current economic climate may encourage claimants to assert marginal bad faith actions. Having a better understanding of the landscape of these claims in New England will help not only to avoid potential calamities, but also to assess and manage potential extra-contractual exposure when handling the claim of insurer misconduct.

In general, all New England states will construe policy language and interpret policy provisions by first resolving any ambiguous provision in favour of coverage for the policyholder; and then strictly construing exclusions.

Against that backdrop, if a claim falls clearly within an exclusion, or clearly outside the policy's coverage provisions, an insurer should still have the right to deny it. However, because insurers and policyholders may differ over what is ambiguous, and because provisions are interpreted differently in different jurisdictions (or have not been interpreted at all in some), coverage disputes are inevitable.

Individual state positions

In Massachusetts, if the insurer's position is ultimately held to be correct, courts will not find bad faith. Not surprisingly, it is when the insurer's position is determined to have been erroneous that the denial of coverage is more apt to be challenged as having been issued in bad faith. Massachusetts courts require insurers to rely upon a 'reasonable interpretation' of its obligation under its policy. The courts also use the subjective terms 'good faith denial', based on a 'plausible interpretation'. When acting reasonably and in good faith" even if ultimately determined to be wrong" Massachusetts courts will not find insurers to have separately violated its Consumer Protection Act or its Unfair Claims Handling statute. Also, where there is little to no guidance or precedence from the courts, the insurer is unlikely to be found to have acted in bad faith relative to its coverage position.

Rhode Island courts are more favourable to insurers, and use a 'reasonably debatable' standard set forth in statutory language. The claimant must demonstrate an absence of a reasonable basis in law or fact for denying the claim. Some Rhode Island courts have even added to this that the insured must show that the insurer acted intentionally or recklessly.

Maine courts recognise that "something more than a mere dispute between the insurer and insured as to the meaning of certain policy language" must be shown to support a "knowing misrepresentation" of policy provisions relating to coverage at issue under the Maine Unfair Claims Settlement Practices Act.

Vermont courts apply a 'fairly debatable' standard for insurers to challenge claims. They limit recovery against insurers to instances where the insurer not only errs in denying coverage, but does so unreasonably. If the policyholder's bad faith claim survives the 'fairly debatable' test, the insured then has to prove that the insurer "knew or recklessly disregarded the fact that no reasonable basis existed for denying the claim".

Similar to other New England states, New Hampshire courts apply a 'reasonableness' standard to assess an allegedly unfair denial of payment, but are more favourable to insurers to the extent that bad faith will be found only where the denial of payment is "calculated and not inadvertent". New Hampshire's bad faith law has statutory and common law (in the context of a contractual duty of good faith) aspects.

Connecticut, while implementing a statutory framework to deal with bad faith, has not recognised a private right of action under its Connecticut Unfair Insurance Practices Act. A private action may be allowed under the broader Connecticut Unfair Trade Practices Act, but only where there has been multiple unfair acts indicating a 'general business practice'. Denials of coverage are, therefore, unlikely to prompt statutory claims. The more likely cause of action for an isolated denial of benefits would assert a violation of the covenant of good faith and fair dealing, which is implied in

every contract. To find 'bad faith', Connecticut will require more than simple negligence; the courts will look for a 'dishonest purpose'.

Defence and avoidance

While some of the New England states recognise an 'advice of counsel' defence" and none have disavowed it" the defence requires both the advice and the reliance on the advice to have been reasonable under the circumstances. The advice of counsel will be taken as evidence of good faith, but must be shown to be advice from an independent source and/or buttressed by independent expert opinion. This defence can be dangerous, as it requires waiving the attorney/client privilege relative to communications between the insurer and coverage counsel, as well as opening up the attorney's file, and may even make opinions on other coverage matters discoverable.

States with unfair claims handling practice statutes (Massachusetts, Maine, New Hampshire, Connecticut) generally include provisions of practices for insurers to avoid. Regarding claims investigations, these statutes require the adoption of reasonable standards for the prompt investigation of claims, a reasonable investigation based on all available information, reasonably prompt responses to communications, and the affirmation or denial of coverage within a reasonable time of completion of the proof of loss statement.

For example, in New Hampshire, insurers must advise the insured, in writing, within 10 days of acknowledging receipt of a notice of claim whether the claim has been accepted, rejected, or more time is needed. In Rhode Island, an improper investigation, standing alone, will not support a bad faith action if the insurer had an objectively reasonable basis to deny the claim.

Hand-in-hand with the insurer's investigation obligations, policyholders are required to cooperate with the investigation of the claim. The insured's obligations typically derive from the policy language itself. For example, a commercial property insurance policy, under its 'duties in the event of loss', requires the policyholder to provide notice, produce a signed proof of loss and inventory upon request, and submit to an examination under oath if requested. Failure to comply with these obligations may, depending on the circumstances and the jurisdiction, be deemed grounds for denying coverage.

Many states will require a 'substantial and material' breach of a policy condition, and prejudice to the insurer, in order to deny coverage for a failure to cooperate. For example, failure to submit to a properly noticed 'examination under oath' has been held to be a material breach of the insurance contract and to negate coverage. However, if the insurer notices the examination for a burdensome time or place so that the policyholder will not appear, such an act or practice could expose the insurer to a claim for bad faith.

Also significant is not only what each jurisdiction looks for as proof of prejudice, but which party will be deemed to have the burden of proof. In Massachusetts this difficult burden falls on the insurer. Unless material evidence is no longer available" which often creates a classic Catch-22, how can the insurer prove that it was unable to acquire evidence if, because of the policyholder's lack of cooperation, the insurer is unable to prove the material evidence ever existed?" Massachusetts courts are extremely reluctant to find prejudice. Conversely, in Rhode Island and Connecticut, the courts place the burden of proving a lack of prejudice to the insurer on the policyholder.

Tactical advantage

When coverage has been denied, the policyholder may challenge that coverage position by filing a declaratory judgment action with the court. In addition to seeking the cost of bringing the 'dec' action, the policyholder is likely to add claims for breach of contract and bad faith. The policyholder is likely to combine a claim for bad faith investigation with bad faith denial. This allows the policyholder's attorney the tactical advantage of conducting costly and intrusive discovery of the claims file, the insurer's internal policies, procedures and guidelines, communications with coverage counsel (if advice of counsel is asserted as a defence), and other similar files to try and establish a company-wide bad faith practice. Unwelcome depositions of claims handlers and their supervisors are also commonplace.

Policyholders will also seek punitive damages and attorneys' fees to leverage a favourable result to the coverage dispute.

Most jurisdictions put the burden on the policyholder to prove that the insurer had no reasonably legitimate basis for its position, but will not penalise the policyholder for a breach of the implied duty of good faith and fair dealing that runs to all parties of a contract and forms at least the conceptual basis for insurance bad faith claims. In some states, insurers have attempted to assert 'reverse bad faith' claims against policyholders for filing frivolous claims. However, no New England state's appellate level court has recognised such a cause of action, possibly because sanctions for frivolous actions are otherwise available through each state's Rules of Civil Procedure" although a trial judge in Massachusetts recently found reverse bad faith based on a policyholder's misrepresentations during an investigation and awarded investigation and litigation costs.

Whether or not a judge or jury serves as fact finder is also jurisdiction-specific. In Rhode Island, by statute, bad faith insurance claims are decided by juries. Whereas, in Massachusetts, there is no right to a jury trial and the judge often retains the bad faith claim to decide themselves.

The best defence to bad faith claims comes months or years before litigation when the claim is received and handled. Insurers should avoid these claims by establishing clear procedures with simple ways to document compliance. Once necessary information is gathered, if a complex coverage question or 'grey area' is involved, retain coverage counsel to obtain a well-reasoned and objective opinion. Do not suggest how any issue should be analysed or resolved. Do not ignore the advice and opinions received.

Positive steps to take

Take advantage of the investigative tools available. Communicate with the policyholder in a timely and professional manner. Convey requests for information and decisions regarding coverage using clear language, without legalese. Invite further information and discourse when denying coverage. Treat every communication regarding a claim as a potential piece of evidence that will be blown up and exhibited during a trial.

If bad faith litigation follows, keep communications professional. Conduct reasonable discovery and do not unreasonably object to discovery. Do not hide investigation or claims handling 'mistakes'. Get the court involved if discovery is overreaching. Depose the policyholder's attorney if appropriate and if the testimony is potentially relevant. File counterclaims for breach of contract, deceit, and 'reverse bad faith' where appropriate. But remember, bad faith litigation tactics can legitimise the marginal claim or make a potentially difficult claim exponentially worse.

Insurers are not on equal footing with policyholders in most New England states. Nevertheless, careful and reasonable coverage denials, coupled with improved communications and claims handling, as well as appropriately aggressive defence of bad faith claims, should improve the perception of insurers, result in more reasonable bad faith verdicts and discourage the marginal or less legitimate claims.

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