THE NEW WAVE OF BAD FAITH DECISIONS AGAINST INSURERS

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The law of bad faith in the performance of insurance contracts is not uniform - in some jurisdictions, a finding of bad faith exposes the insurer to liability in tort; in others, bad faith is defined by statute and statutory damages are available. While the standards and opportunities for recovery vary, the three case studies in this article demonstrate that bad actions by insurers create exposure to a finding of bad faith.

The standard that emerges from these cases is unreasonableness. Ignoring a claim, retaliating against a claimant and blatantly violating express terms of the policy are all unreasonable actions and in these decisions the courts demonstrate a willingness to find bad faith and liability. Most importantly, these cases are a reminder that insurers must pay attention to their claims handling practices or face bad faith liability.

I. *Acacia Research Corp. v. National Union Fire Insurance Co. of Pittsburgh, PA*, Case No. CV 05-501 PSG (C.D.Ca. 2008)

Of the three insurance bad-faith decisions discussed in this Article, none demonstrates the magnitude to which insurers' liability is increased by bad-faith claims handling better than *Acacia*. The defendant's delay in investigating and adjusting the plaintiff's claim in this case resulted in a $31 million judgment on a $10 million policy.

The plaintiffs, Acacia Research Corp. and Combimatrix Corp., purchased a Directors', Officers' and Corporate Liability Insurance ("D&O") policy underwritten by National Union with a $10 million policy limit and a $150,000 self-insured retention. During the National Union policy period, Nanogen Inc., sued Combimatrix and its Vice-President of Research and Development, alleging rights to technology patented by the company.

Combimatrix sent written notice of the lawsuit to National Union seeking defense costs under its D&O policy. About two weeks later, National Union sent a return letter stating it would be in touch shortly with a "preliminary coverage evaluation." Three months later, after the claim file had changed hands several times, National Union sent a letter to Combimatrix requesting additional information. Combimatrix's general counsel provided a detailed response to National's request that same day and continued to provide updates as the litigation progressed. Shortly thereafter, National Union removed the claims handler responsible for the Combimatrix matter and failed to assign a new claims handler to the file for a full 15 months.

By this time, one and a half years into the litigation, with legal bills approaching $2 million, Combimatrix was unable to continue financing the litigation, and decided to settle the suit for nearly $18 million in stock and $2 million cash. After the file was transferred to yet another claims handler, in November 2003, nearly three years after it first received notice of the claim, National Union sent its first coverage opinion to Combimatrix, denying coverage of the claim on the basis of Combimatrix's failure to cooperate and certain policy exclusions.

Acacia and Combimatrix sued National Union seeking reimbursement of litigation and settlement costs for the Nanogen lawsuit under their D&O Policy. The Court found that the plaintiffs submitted a valid claim to National Union and that National Union had duties to communicate with plaintiffs and investigate the claim, even though it had not been advised that the relevant retention had been exhausted. The Court further determined that the settlement was a covered loss and that the plaintiffs did not violate the No-Voluntary Settlement Clause because the settlement occurred after National Union had breached its duties to the plaintiffs.

The Court focused on the insurer's silence and excessive delay in presenting its coverage opinion, concluding that National Union's conduct was inexcusable given the fiduciary duty owed to its insured and such conduct constituted a breach of the covenant of good faith and fair dealing. The Court held that National Union's withholding of benefits under the policy was unreasonable, and therefore met the standard for a claim of bad faith under California law. The Court awarded Plaintiffs the amount of the settlement and defense costs, plus interest. The Court did not award punitive damages, however, finding that there was no evidence of oppression, fraud, or

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malice, and therefore, punitive damages were unwarranted. Nevertheless, the inexcusable delay in investigating and communicating coverage to the insured exposed National Union to liability well in excess of the original $10 million policy limit.

II. *Abercrombie & Fitch v. Federal Insurance Co.*, 2008 U.S. Dist. LEXIS 18597 (S.D. Ohio 2008)

Abercrombie & Fitch ("Abercrombie") procured a D&O policy underwritten by Federal Insurance Co. ("Federal"). During the Federal policy period, Abercrombie was investigated by the SEC and sued by shareholders in several derivative class actions ("Actions"). Abercrombie requested Federal advance defense costs as permitted under the policy and Federal refused. Abercrombie filed a declaratory judgment action against Federal seeking coverage and damages for Federal's alleged bad faith refusal to advance defense costs associated with the Actions and an SEC investigation directed toward the company.

Abercrombie contended in Count VI of its amended complaint that Federal refused to pay any defense costs associated with the Actions and SEC investigation because Abercrombie refused to accept Federal's "interim" funding plan, Abercrombie alleged that denial of any defense funding was retaliatory and constituted bad faith and malicious conduct. Federal moved to dismiss Count VI of the amended complaint, arguing that its refusal to pay defense costs was reasonable. According to Federal, the policy was not a duty to defend policy and did not require Federal to advance defense costs on an ongoing basis absent an agreement between the parties. Rather the policy merely gave Federal the *option* to advance defense costs.

The relevant policy language regarding defense costs stated:

> If the Insureds and the Company agree on the allocation of Defense Costs, the Company shall advance on a current basis Defense Costs allocated to the covered loss. If the Insureds and the Company cannot agree on an allocation:
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> (i) no presumption as to allocation shall exist in any arbitration, suit or other proceeding;
>
> (ii) the Company shall advance on a current basis Defense Costs which the Company believes to be covered under this coverage section until a different allocation is negotiated, arbitrated or judicially determined …

The court found that although Abercrombie overreached in Count VI, the policy terms were unambiguous and required Federal to advance defense costs for the portion of the claim it believed to be covered until an appropriate allocation was agreed upon or determined through a dispute resolution process. Federal could not, therefore, refuse to pay any defense costs if at least some of the claims against Abercrombie in the Action and the SEC Investigation were covered. Therefore, in light of the clear policy language, the Court could not conclude that there was no set of facts upon which Abercrombie could base its claim for bad faith where under Ohio law, a bad-faith claim exists where the insurer's refusal to pay a claim is without reasonable justification.[2]

III. *Bi-Economy Market, Inc. v. Harleysville Ins. Co.,* 10 N.Y.3d 187, 886 N.E. 2d 127, 856 N.Y.S. 2d 505 (2008)

In *Bi-Economy*, the New York Court of Appeals, in a 5-2 decision, reversed a grant of summary judgment in favor of the insurer and held that the insured could assert a claim for extra-contractual consequential damages where the insurer failed to timely investigate and pay the insured's first-party claim. The dissent criticized the majority decision, which appears to have overturned well-established New York precedent barring the granting of punitive damages in insurance cases except in the most egregious circumstances.

Bi-Economy, a Rochester meat market, procured a comprehensive business policy underwritten by Harleysville Insurance Company ("Harleysville"). In the event of a loss, the policy provided for replacement costs of its building and contents as well as lost business income for up to one year from the date of the loss. Specifically, the

[2] The court also addressed Abercrombie's second basis for a claim of bad faith - i.e., that Federal's refusal to pay defense costs was in retaliation for Abercrombie's rejection of Federal's settlement proposal. According to Federal, to the extent these allegations rely upon Federal's offer of compromise, they were inadmissible under Federal Rule 408. The court stated that it could not make a determination on the admissibility of the relevant communications at the pleadings stage but denied Federal's motion on this basis as well.

policy stated that Harleysville would "pay for the actual loss of Business Income… sustain[ed] due to the necessary suspension of [Bi-Economy's] 'operations' during the 'period of restoration.'"

In October 2002, Bi-Economy suffered a devastating fire, and its building and inventory were completely lost. Bi-Economy submitted a claim to Harleysville for the loss. Harleysville disputed the insured's claim for actual damages and advanced only the sum of $163,161.92. More than one year later, Bi-Economy was awarded an additional sum of $244,019.88 through alternative dispute resolution. During this time, Harleysville offered to pay only seven months of the insured's business income loss despite the policy providing for a full twelve months. Bi-Economy never resumed business operations.

Bi-Economy sued Harleysville, asserting claims for bad faith claims handling, tortuous interference with business relations and breach of contract, and seeking consequential damages for the complete demise of its business. Harleysville moved for, and was granted, partial summary judgment dismissing Bi-Economy's breach of contract claim and moved to amend its answer to raise the defense that the policy excluded consequential damages. The trial court granted the motion for summary judgment and the Appellate Division affirmed, citing language in the contract barring coverage for "consequential losses."

The Court of Appeals reversed, explaining that the implicit covenant of good faith and fair dealing in insurance contracts is intended to give the insured peace of mind, and that business interruption insurance in particular is designed to ensure that a policyholder can keep their business afloat in the event of a disaster. The court stated that Harleysville knew that failure to perform promptly could cause the insured's demise, undercutting the very purpose of the agreement and causing the precise damage to the insured which the policy was purchased to avoid. According to the Court, such consequential damages were contemplated by the parties to the contract and were reasonably foreseeable by the insurer. The Court held that when the insurer's "excessive delay or improper denial" results in additional damages, such as the permanent closure of the business, liability should fall on the insurer, not as a punitive measure, but merely to give the insured the benefit it bargained for.

As for the contract's bar against recovery for "consequential loss," the court noted "consequential loss" and "consequential damages" are not the same. Consequential losses stem from delay of third parties or from loss of business arrangements or opportunities outside the control of the insurer. Consequential damages are in addition to the damages caused by a calamitous event and are caused by the insurer's own injurious conduct.

The dissent argued that under well established New York law punitive damages are not available for breach of an insurance contract unless the plaintiff shows both egregious conduct directed at the insured and a pattern of similar conduct directed at the public generally, and that the majority's attempt to cloak punitive damages as consequential damages was both unwarranted and set a dangerous precedent. The policy contains limits and the insurer's exposure, absent egregious conduct, should be capped at the policy's limit of liability.

IV. Conclusion

In all three cases, there was an explicit breach of the policy by the insurer - and in two of these cases, it resulted in lost opportunities for the insured. In *Acacia*, there was a total failure by National Union to honor the policy in any way whatever for nearly two years, forcing the insured to enter into an unfavorable settlement. In *Bi-Economy*, Harleysville only offered to pay seven months loss of income on a policy that called for 12 months, and the business was unable to rebuild. In *Abercrombie*, Federal's failure to advance *any* defense costs appeared a clear violation of the express terms of the contract, thus warranting Abercrombie's bad faith claims to proceed. These cases may be the start of a new wave of bad faith liability for insurers, as courts show little tolerance to unreasonable claims handling practices that adversely affect insureds.