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INSURED'S BAD FAITH AS SHIELD OR SWORD: LITIGATION RELIEF FOR INSURERS?

DOUGLAS R. RICHMOND*

I. INTRODUCTION

It is well settled that every contract includes an implied covenant of good faith and fair dealing.¹ Insurance policies, like all other contracts, contain this implied covenant. The implied covenant of good faith and fair dealing is perhaps best expressed as a promise implied in every contract that "neither party will do anything which will injure the right of the other to receive the benefits of the agreement."² In some early insurance cases, courts referred to good faith and fair dealing as a duty of the parties to the contract.³

In 1930, the Wisconsin Supreme Court blended the theories of negligence and bad faith with the theory of breach of the covenant.⁴ In *Hilker v. Western Automobile Insurance Co.*,⁵ the court reasoned:

[T]he good-faith performance of the obligation which the insurance company assumed when it took to itself the complete and exclusive control of all matters that determine the liability of the insured, requires that it be held to that degree of care and diligence which a man of ordinary care and prudence would exercise in the management of his own business were he investigating and adjusting such claims.⁶

In 1967, the California Supreme Court held, in *Crisci v. Security Insurance Co.*,⁷ that an insurer breaches its duty of good faith and fair dealing

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1. Douglas G. Houser et al., *Comparative Bad Faith: The Two-Way Street Opens for Travel*, 23 IDAHO L. REV. 367, 368 (1986-87).

2. *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958).

3. ROBERT H. JERRY, II, UNDERSTANDING INSURANCE LAW 120 (1987); see, e.g., *Brassil v. Maryland Cas. Co.*, 104 N.E. 622, 624 (N.Y. 1914) ("But there is a contractual obligation of universal force which underlies all written agreements. It is the obligation of good faith in carrying out what is written.").

4. See *Hilker v. Western Auto. Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on reh'g*, 204 Wis. 12, 235 N.W. 413 (1931).

5. *Id.*

6. *Hilker*, 204 Wis. at 10, 231 N.W. at 261.

7. 426 P.2d 173 (Cal. 1967).

when it unreasonably refuses to settle a claim within policy limits.⁸ In fact, the court held that the breach amounted to an independent tort.⁹

It is now widely recognized that insurers owe their insureds a duty of good faith and fair dealing under tort law principles.¹⁰ The judicial imposition of a tort duty of good faith and fair dealing is not surprising. In the insurance context, unlike other contractual relationships, the parties to the contract (insurance policy) share a special relationship.¹¹ The special relationship between insurers and their insureds arises out of the parties' perceived unequal bargaining power and the nature of insurance contracts, which potentially allow unscrupulous or predatory insurers to take advantage of their insureds' misfortunes in bargaining for the resolution or settlement of claims.¹² Insurance contracts are more personal than commercial; that is, insureds purchase their policies for security and

8. *Id.* at 177.

9. *Id.* at 178.

10. See *Lissmann v. Hartford Fire Ins. Co.*, 848 F.2d 50, 53 (4th Cir. 1988); *Hamed v. General Accident Ins. Co. of Am.*, 842 F.2d 170, 172 (7th Cir. 1988); *Whyte v. Connecticut Mut. Life Ins. Co.*, 818 F.2d 1005, 1013 (1st Cir. 1987); *Broadhead v. Hartford Cas. Ins. Co.*, 773 F. Supp. 882, 905 (S.D. Miss. 1991), *aff'd*, 979 F.2d 209 (5th Cir. 1992); *Schultz v. Allstate Ins. Co.*, 764 F. Supp. 1404, 1409 (D. Colo. 1991); *Burley v. Homeowners Warranty Corp.*, 773 F. Supp. 844, 859 (S.D. Miss. 1990), *aff'd*, 936 F.2d 569 (5th Cir. 1991); *Jones v. Continental Ins. Co.*, 716 F. Supp. 1456, 1459 (S.D. Fla. 1989), *vacated on other grounds*, 956 F.2d 1052 (11th Cir. 1992); *Red Cedars, Inc. v. Westchester Fire Ins. Co.*, 686 F. Supp. 614, 616 (E.D. Mich. 1988); *Globe Indem. Co. v. Superior Court*, 8 Cal. Rptr. 2d 251, 255 (Ct. App. 1992); *White v. Unigard Mut. Ins. Co.*, 730 P.2d 1014, 1016 (Idaho 1986); *Spencer v. Aetna Life & Cas. Ins. Co.*, 611 P.2d 149, 155 (Kan. 1980); *Lipinski v. Title Ins. Co.*, 655 P.2d 970, 977 (Mont. 1982); *Braesch v. Union Ins. Co.*, 464 N.W.2d 769, 772 (Neb. 1991); *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983); *Bartlett v. John Hancock Mut. Life Ins. Co.*, 538 A.2d 997, 100 (R.I. 1988); *Arnold v. National County Mut. Fire Ins. Co.*, 725 S.W.2d 165, 168 (Tex. 1987); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 858 (Wyo. 1990); see also *Henry A. Hentemann, Uninsured Motorist Coverage Claims and the Bad Faith Issue*, 55 DEF. COUNS. J. 168, 169 n.8 (1988) ("The cause of action for bad faith in third-party claims seems to have received almost unanimous acceptance . . ."). Plaintiffs may even recover for their insurer's alleged bad faith when the event giving rise to a loss is not covered by the policy. See, e.g., *First Tex. Sav. Ass'n v. Reliance Ins. Co.*, 950 F.2d 1171, 1178-79 (5th Cir. 1992) (interpreting Texas unfair insurance practices statute); *Safeco Ins. Co. v. Butler*, 823 P.2d 499 (Wash. 1992).

11. *Viles v. Security Nat'l Ins. Co.*, 788 S.W.2d 566, 567 (Tex. 1990) (citation omitted); *Daniel S. Bopp, Tort and Contract in Bad Faith Cases: Is the Honeymoon Over?*, 59 DEF. COUNS. J. 524, 524 (1992).

12. *Arnold v. National County Mut. Ins. Co.*, 725 S.W.2d 165, 167; see *Holmgren v. State Farm Mut. Auto. Ins. Co.*, 976 F.2d 573 (9th Cir. 1992). The *Holmgren* court observed:

When coverage and liability are established beyond a doubt, . . . a game of the strong against the weak *can* begin. A claim known to be valid and legitimate can be settled for far less than its actual value if the need for funds by the victim is great enough and the insurance company is obstinate enough to use its knowledge of that fact to force acceptance of a lesser sum.

Id. at 578.

peace of mind, rather than entering into such contracts for financial gain. Moreover, insureds often need benefits and coverage when they are in dire or precarious financial straits, thus becoming vulnerable to oppressive tactics by their insurers. By recognizing tort duties, courts were able to overcome the inadequacy of contract remedies to compensate insureds and to deter insurer nonperformance in third-party cases.¹³

While the implied covenant of good faith and fair dealing has always been viewed as mutual, imposing on both insurers and insureds obligations to refrain from injuring the others' rights to receive contract benefits,¹⁴ its application has been decidedly unilateral.¹⁵ Bad faith claims have "been an effective weapon in the hands of insureds and their lawyers for bludgeoning insurers into submission."¹⁶ Only recently have courts started wrestling with the question of insureds' bad faith conduct in claims adjustment¹⁷ and resolution.

This Article examines the argument that insurers defending tort actions for their alleged bad faith should have available to them the traditional tort defense of comparative fault. Comparative fault logically extends to the use of comparative bad faith as an affirmative defense. Additionally, Part IV of the Article discusses the concept of "reverse bad faith." In other words, when may an insurer sue its insured for the insured's alleged bad faith in the adjustment or resolution of a claim?

II. THE INSURED'S BAD FAITH CLAIM FOR RELIEF

Insureds may allege that their insurers acted in bad faith when attempting to resolve third-party and first-party claims. Third-party bad faith claims arise when insurers expose their insureds to monetary liability in excess of policy limits. Insureds bring first-party bad faith claims to recover for personal losses allegedly covered by their disability, health, homeowners, uninsured motorist, or property insurance policies. Courts recognize bad faith causes of action in both contexts.

13. See JERRY, *supra* note 3, at 120; H. Walter Croskey, *Bad Faith in California: Its History, Development and Current Status*, 26 TORT & INS. L.J. 561, 562 (1991).

14. Patrick E. Shipstead & Scott S. Thomas, *Comparative and Reverse Bad Faith: Insured's Breach of Implied Covenant of Good Faith and Fair Dealing as Affirmative Defense or Counterclaim*, 23 TORT & INS. L.J. 215, 216 (1987); see also Silberg v. California Life Ins. Co., 521 P.2d 1103, 1108-09 (Cal. 1974); Kaiser Found. Hosps. v. North Star Reins. Corp., 153 Cal. Rptr. 678, 682 (Ct. App. 1979); Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985).

15. Shipstead & Thomas, *supra* note 14, at 216.

16. *Id.*

17. In the insurance claims context, "adjustment" refers to an insurer's determination of the amount of a loss, the amount of indemnity available to the insured, if any, and if more than one insurance company is involved, the proportion that each insurer must pay.

A. *Third-Party Insurance Claims*

Only liability insurance can be considered third-party insurance.¹⁸ Liability insurance is described as third-party insurance because the interests protected by the contract are ultimately those of third parties injured by the insured's conduct.¹⁹ The earliest bad faith cases arose in the third-party insurance context.²⁰ Early third-party bad faith cases usually involved insureds' recovery of extra-contractual damages for their insurers' failure or refusal to defend covered claims, or wrongful refusal to settle claims within policy limits.²¹

The most commonly encountered bad faith scenario—an insurer's failure or refusal to settle a claim within policy limits—is easily understood by way of example: *A*, an insured under an automobile liability insurance policy with a \$100,000 limit, is sued by *B*, who was injured when *A* allegedly ran a red light and their cars collided. *B*'s negligence claim appears sound, and she pleads damages in the amount of \$300,000. *A* tenders defense of the action to her insurer, which hires defense counsel and takes control of the litigation, as is its right and duty under *A*'s policy. After discovery closes but before trial, *B* offers to settle for \$75,000. *A*'s interests and those of her insurer now diverge. From the insurer's perspective, it has nothing to lose by "playing hardball" and rejecting *B*'s settlement offer because, under the terms of its policy, its liability is capped at \$100,000, even if *B* recovers her claimed damages of \$300,000. On the other hand, if the insurer gambles and rejects the settlement offer, the jury might return a defense verdict, thereby saving the insurer \$75,000. From the insured's perspective, however, accepting the settlement offer would spare her potential financial ruin. If the gamble fails and *B* recovers a large judgment, *A* would be liable for any judgment in excess of the \$100,000 policy limits. Simply stated, *A*'s insurer would be gambling exclusively with *A*'s money.²²

18. See JERRY, *supra* note 3, at 43.

19. *Id.*

20. Shipstead & Thomas, *supra* note 14, at 217. Bad faith claims were not entertained by courts until automobile liability insurance was underwritten and automobile liability claims became prevalent. The creation of a cause of action for bad faith was largely created to combat automobile insurers' unscrupulous claims practices. Joan B. Lefkowitz, *New York Third Party Bad Faith: Is It a Plaintiff's Dream or a Defendant's Nightmare?*, 12 PACE L. REV. 543, 544 n.5 (1992).

21. See, e.g., *Crisci v. Security Ins. Co.*, 426 P.2d 173 (Cal. 1967); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958).

22. For a similar example, see John F. Dobbyn, *Is Good Faith in Insurance Contracts a Two-Way Street?*, 62 N.D. L. REV. 355, 357 (1986).

In short, an insurer that assumes its insured's defense against a third-party claim shares a fiduciary relationship with its insured.²³ The insured relinquishes control of her defense and places her potential monetary liability in the insurer's hands. "That kind of relationship carries with it a standard of care that exists independent of the contract and without reference to the specific terms of the contract."²⁴ Thus, it is logical to hold an insurer that subordinates its insured's interests to its own liability for its bad faith conduct.²⁵

In the insurance realm, "bad faith" conduct defies uniform definition.²⁶ In *Brown v. Guarantee Insurance Co.*,²⁷ the California Court of Appeal identified eight factors a court must consider in determining whether an insurer acted properly in refusing to settle an action. The *Brown* factors are:

[(1)] [T]he strength of the injured claimant's case on the issues of liability and damages; [(2)] attempts by the insurer to induce the insured to contribute to a settlement; [(3)] failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; [(4)] the insurer's rejection of advice of its own attorney or agent; [(5)] failure of the insurer to inform the insured of a compromise offer; [(6)] the amount of financial risk to which each party is exposed in the event of a refusal to settle; [(7)] the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and [(8)] any other factors tending to establish or negate bad faith on the part of the insurer.²⁸

The Michigan Supreme Court in *Commercial Union Insurance Co. v. Liberty Mutual Insurance Co.*²⁹ described bad faith conduct as the "arbitrary, reckless, indifferent, or intentional disregard of the interests of

23. *Village of Morrisville Water & Light Dep't v. United States Fidelity & Guar. Co.*, 775 F. Supp. 718, 734 (D. Vt. 1991); *Jones v. Continental Ins. Co.*, 716 F. Supp. 1456, 1459 n.5 (S.D. Fla. 1989) ("In third-party insurance actions the insurer assumes complete control over the insured's defense and, at the same time, acquires a fiduciary duty to act in the insured's best interests."), *vacated on other grounds*, 956 F.2d 1052 (11th Cir. 1992); *Motorists Mut. Ins. Co. v. Said*, 590 N.E.2d 1228, 1235 (Ohio 1992) (declaring an insurer's duty "analogous to that of a fiduciary"); *JERRY*, *supra* note 3, at 120. *But see* Todd Brown & J. Clark Kelso, *Commercial Torts: 1992 Developments*, 28 TORT & INS. L.J. 178, 179 (1993) (stating that generally there is "no fiduciary relationship between the insurer and the insured").

24. *Georgetown Realty, Inc. v. Home Ins. Co.*, 831 P.2d 7, 14 (Or. 1992).

25. *See* *JERRY*, *supra* note 3, at 120.

26. *See id.* at 116.

27. 319 P.2d 69 (Cal. Ct. App. 1958).

28. *Id.* at 75.

29. 393 N.W.2d 161 (Mich. 1986).

[the insured].³⁰ Similar to *Brown*, the *Commercial Union* court identified a number of factors to be used in determining the existence of bad faith: failure to keep the insured informed of relevant litigation developments; failure to inform the insured of all settlement demands outside policy limits; failure to solicit a settlement offer or to initiate settlement negotiations when circumstances warrant; failure to accept a reasonable compromise offer of settlement when the facts demonstrate obvious liability and serious injury; rejecting a reasonable settlement offer within policy limits; attempting to coerce or obtain an involuntary contribution from the insured in order to settle within policy limits; failure to properly investigate a claim before rejecting a settlement offer; disregarding the advice of an adjuster or attorney; serious and recurrent negligence by the insurer; undue delay in accepting a settlement offer within policy limits when the potential verdict is high; refusing to settle a case within policy limits after an excessive verdict when the chances of reversal on appeal are slight; and failing to appeal following a verdict in excess of policy limits when there exist reasonable grounds for such an appeal.³¹

Many courts require more than a showing of mere negligence to support a bad faith claim.³² Rather, as a general rule, the insurer must have engaged in some degree of intentional wrongdoing.³³ Several states have tried to find a middle ground, allowing bad faith recovery based on negligence, but requiring intent if punitive damages are also sought.³⁴ The Ohio Supreme Court in *Centennial Insurance Co. v. Liberty Mutual Insurance Co.*³⁵ made clear that "bad faith, although not susceptible of concrete definition, embraces more than bad judgment or negligence. It imports a dishonest purpose, moral obliquity, conscious wrongdoing, breach of a known duty through some ulterior motive or ill will partak-

30. *Id.* at 164.

31. *Id.* at 165-66 (footnotes omitted); *see also* JERRY, *supra* note 3, at 116-17 (listing factors a trial court may consider in determining "whether liability for bad faith conduct should exist in a third-party setting").

32. *See, e.g.,* Pavia v. State Farm Mut. Auto. Ins. Co., 589 N.Y.S.2d 510, 515 (Sup. Ct. App. Div. 1993); Ganaway v. Shelter Mut. Ins. Co., 795 S.W.2d 554, 556 (Mo. Ct. App. 1990); Insurance Co. of N. Am. v. Citizensbank of Thomasville, 491 So. 2d 880, 882 (Ala. 1986); Dolan v. Aid Ins. Co., 431 N.W.2d 790, 794 (Iowa 1988).

33. *See* Braesch v. Union Ins. Co., 464 N.W.2d 769, 777 (Neb. 1991).

34. These states include California, Indiana, South Carolina, and Wyoming. *See* Mock v. Michigan Millers Mut. Ins. Co., 5 Cal. Rptr. 2d 594, 607 (Ct. App. 1992); Indiana Ins. Co. v. Plummer Power Mower & Tool Rental, Inc., 590 N.E.2d 1085, 1093 (Ind. Ct. App. 1992); Nichols v. State Farm Mut. Auto. Ins. Co., 306 S.E.2d 616, 619 (S.C. 1983); McCullough v. Golden Rule Ins. Co., 789 P.2d 855, 860-61 (Wyo. 1990).

35. 404 N.E.2d 759 (Ohio 1980).

ing of the nature of fraud."³⁶ A variety of other specific acts or conduct may constitute bad faith on an insurer's part. Examples include unduly or unreasonably restrictive interpretation of policy language, deceptive practices to avoid paying claims,³⁷ deliberate misinterpretation of records or policy language to defeat coverage,³⁸ unreasonable litigation conduct,³⁹ and the like.

B. First-Party Insurance

Although early bad faith claims involved third-party actions, courts soon realized that if a breach of the implied covenant of good faith and fair dealing in third-party insurance cases constituted a tort, the same should hold true in a first-party setting.⁴⁰ The 1970 decision by the California Court of Appeal in *Fletcher v. Western National Life Insurance Co.*⁴¹ signaled the dawn of first-party insurance bad faith litigation. In *Fletcher*, an insurer was held liable in tort for damages caused by its refusal to indemnify its insured under a disability policy.⁴² Comparing third-party principles with the situation before it, the *Fletcher* court stated:

We think that, similarly, the implied-in-law duty of good faith and fair dealing imposes upon a disability insurer a duty not to threaten to withhold or actually withhold payments, maliciously and without probable cause, for the purpose of injuring its insured by depriving him of the benefits of the policy. We think that . . . the violation of that duty sounds in tort notwithstanding that it also constitutes a breach of contract.⁴³

The suggestion in *Fletcher* was affirmed and energized by the California Supreme Court in *Gruenberg v. Aetna Insurance Co.*,⁴⁴ now widely acknowledged as the landmark case of first-party bad faith litigation.⁴⁵ The insurers in *Gruenberg* denied liability for the plaintiff's fire loss.⁴⁶

36. *Id.* at 762 (quoting *Slater v. Motorists Mut. Ins. Co.*, 187 N.E.2d 45 (Ohio 1962)).

37. *See Bankers Life & Cas. Co. v. Crenshaw*, 483 So. 2d 254, 270-73 (Miss. 1985), *aff'd*, 480 U.S. 915 (1987); *Timmons v. Royal Globe Ins. Co.*, 653 P.2d 907, 910-11 (Okla. 1982).

38. *See Hall v. Svea Mut. Ins. Co.*, 493 N.E.2d 1102, 1104-05 (Ill. App. Ct. 1986).

39. *See White v. Western Title Ins. Co.*, 710 P.2d 309, 316-17 (Cal. 1985), *abrogated by statute as stated in Focus Inv. Assocs., Inc. v. American Title Ins. Co.*, 797 F. Supp. 109, 113 n.1 (D.R.I. 1992).

40. Bopp, *supra* note 11, at 526.

41. 89 Cal. Rptr. 78 (Ct. App. 1970).

42. *Id.* at 93.

43. *Id.*

44. 510 P.2d 1032 (Cal. 1973).

45. Bopp, *supra* note 11, at 526.

46. *Gruenberg*, 510 P.2d at 1035.

Essentially, Aetna and two other insurers believed that the plaintiff committed arson in connection with a fire at his cocktail lounge and restaurant.⁴⁷ Explaining its endorsement of a bad faith cause of action in the first-party context, the court stated:

[I]n *Comunale* and *Crisci* we made it clear that “[l]iability is imposed [on the insurer] not for a bad faith breach of contract but for failure to meet the duty to accept reasonable settlements, a duty included within the implied covenant of good faith and fair dealing.” In those two cases, we considered the duty of the insurer to act in good faith and fairly in handling the claims of third persons against the insured, described as a “duty to accept reasonable settlements”; in the case before us we consider the duty of an insurer to act in good faith and fairly in handling the claim of an insured, namely a duty not to withhold unreasonably payments due under a policy. These are merely two different aspects of the same duty. That responsibility is not the requirement mandated by the terms of the policy itself—to defend, settle, or pay. It is the obligation, deemed to be imposed by the law, under which the insurer must act fairly and in good faith in discharging its contractual responsibilities. Where in so doing, it fails to deal *fairly and in good faith* with its insured by refusing, without proper cause, to compensate its insured for a loss covered by the policy, such conduct may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing.⁴⁸

Some states have only recently recognized the first-party bad faith tort cause of action.⁴⁹ Wyoming first recognized the tort of first-party insurance bad faith in 1990 in *McCullough v. Golden Rule Insurance Co.*⁵⁰ The Wyoming Supreme Court reasoned that such recognition would provide insurers with “additional impetus for good faith.”⁵¹ At worst, the availability of an action in tort would add nothing to insurers’ liability.⁵² Nebraska finally joined the majority of states in 1991 in *Braesch v. Union Insurance Co.*⁵³ The *Braesch* court identified three factors justifying the application of tort principles to the admittedly contrac-

47. *See id.* at 1034-35.

48. *Id.* at 1037 (citation omitted).

49. Several states consider first-party bad faith claims contractual but allow a broader range of damages (including punitives), while other states characterize such claims as purely contractual and confine recovery to strictly benefit of the bargain (contract) damages. *See* *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 857 (Wyo. 1990).

50. *Id.*

51. *Id.* at 859.

52. *Id.* (quoting *White v. Unigard Mut. Ins. Co.*, 730 P.2d 1014, 1018 (Idaho 1986)).

53. 464 N.W.2d 769 (Neb. 1991).

tual nature of first-party insurance. First, the insurance industry is "affected with a public interest," as "plainly evidenced by the high degree of regulation of the insurance industry."⁵⁴ The public character of risk and loss distribution requires that all those issuing or receiving benefits act in good faith.⁵⁵ Second, the "noncommercial aspect of insurance distinguishes it from other types of contracts for which a breach does not sound in tort."⁵⁶ People buy insurance to protect themselves from calamity and to assure themselves of security and peace of mind. When insurers fail to provide the very item that was the insured's implicit objective in purchasing the policy, contract damages are inadequate.⁵⁷ Third, the inequity in the bargaining power between insurers and their insureds differentiates insurance contracts from "run-of-the-mill contract[s]."⁵⁸

Not all courts have welcomed the extension of the tort of bad faith from the third-party to the first-party setting. Thus, courts frequently attempt to distinguish the two.⁵⁹ In the context of a third-party claim, the insurer and insured share a fiduciary relationship arising out of the insurer's exclusive right to contest, litigate, or negotiate the claim.⁶⁰ No such fiduciary relationship exists in a first-party setting. Rather, the first-party relationship is predominantly adversarial.⁶¹ The insurer and insured necessarily become legal adversaries and clearly are not principal and agent dealing in trust.⁶² Absent a fiduciary duty, insureds do not need a tort weapon to combat insurers who might otherwise subordinate their insureds' interests. An aggrieved insured need only sue its insurer on the policy to obtain relief.⁶³

Despite the fundamental differences between third-party and first-party claims, a number of courts have followed California's lead in *Fletcher* and *Gruenberg*. In fact, an overwhelming majority of jurisdic-

54. *Id.* at 774.

55. *Id.*

56. *Id.* at 775.

57. Bopp, *supra* note 11, at 527.

58. Braesch v. Union Ins. Co., 464 N.W.2d 769, 775 (Neb. 1991).

59. JERRY, *supra* note 3, at 123; *see, e.g.*, Beck v. Farmers Ins. Exch., 701 P.2d 795, 798-800 (Utah 1985).

60. *See* JERRY, *supra* note 3, at 123.

61. *Id.*

62. "Generally, insurer and insured are in an adversary relationship whenever there is any claim by an insured for loss under any insurance policy." Missouri *ex rel.* Safeco Nat'l Ins. Co. of Am. v. Rauch, 849 S.W.2d 632, 634 (Mo. Ct. App. 1993) (citing Shafer v. Automobile Club Inter-Ins. Exch., 778 S.W.2d 395, 398 (Mo. Ct. App. 1989)).

63. JERRY, *supra* note 3, at 123-24.

tions that have addressed the issue now recognize the tort of bad faith in first-party cases.⁶⁴

III. COMPARATIVE FAULT AND COMPARATIVE BAD FAITH

The implied duty of good faith and fair dealing is mutual; the duty is owed by insurers and insureds alike.⁶⁵ Accordingly, both parties should be held to certain standards of conduct during the resolution of third-party and first-party claims.⁶⁶ Reason would seem to dictate that states recognizing the doctrine of comparative fault should allow an insurer defending a bad faith action to raise the affirmative defense of negligence or bad faith conduct by its insured. In the bad faith context, comparative fault refers to the comparison of an insured's negligence and an insurer's alleged willful misconduct. Comparative bad faith is just what the name implies: a comparison of an insured's willful misconduct against that of the insurer. In practice, however, courts often fail to distinguish between the two terms and commonly use them interchangeably.

A. Comparative Fault

Comparative fault principles seemingly result in an incongruity when applied in bad faith cases. Specifically, in comparative fault situations, an insured's negligence is being compared with an insurer's bad faith. In other words, mere negligence is being compared with willful misconduct.

64. *Braesch v. Union Ins. Co.*, 464 N.W.2d 769, 774 (Neb. 1991). *Rawlings v. Apodaca*, 726 P.2d 565, 579 (Ariz. 1986), concisely summarizes the views of courts recognizing the tort of bad faith in third-party and first-party cases. Workers' compensation insurers are subject to bad faith liability in many states. See *Boylan v. American Motorists Ins. Co.*, 489 N.W.2d 742 (Iowa 1992).

65. *Rawlings*, 726 P.2d at 569-70; *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038, 1041 (Cal. 1980); *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198, 200 (Cal. 1958); *California Cas. Gen. Ins. Co. v. Superior Court*, 218 Cal. Rptr. 817, 822 (Ct. App. 1985); *Modisette v. Foundation Reserve Ins. Co.*, 427 P.2d 21, 25 (N.M. 1967); *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 801 (Utah 1985).

66. Some standards certainly exist. For example, insureds owe their insurers a duty of cooperation. Particularly, in third-party insurance claims, the insured's duty to cooperate "is essentially the flipside of the insurer's duty to defend." *JERRY, supra* note 3, at 555. In any given case an insured commits to: attending depositions, hearings and trials; providing evidence, or assisting in its discovery and collection; cooperating in or supporting settlement negotiations; and enforcing the insurer's subrogation rights. *Id.* In first-party insurance claims, the insured often must cooperate with the insurer in its investigation to make available or open property for inspection, give recorded statements, submit to examination under oath, submit to physical examinations by chosen physicians, and produce documents or records. *Id.* at 555-56.

Several courts have rejected this comparison,⁶⁷ while others have expressed bewilderment.⁶⁸ However, the comparison has developed in California. This is not surprising, since for many years California courts have led the country in fashioning insurance remedies and have recognized comparative fault in negligence versus willful misconduct in personal injury cases for more than a decade.⁶⁹

In 1990, a California appellate court explicitly recognized comparative fault as an affirmative defense to an insurer's claimed bad faith in *Patrick v. Maryland Casualty Company*.⁷⁰ The plaintiff in *Patrick* purchased homeowner's insurance from Maryland Casualty Company.⁷¹ In December 1982, a series of windstorms blew shingles from a portion of the plaintiff's roof.⁷² The plaintiff temporarily repaired the affected portion of the roof to prevent further damage and submitted a claim.⁷³ Thereafter, the parties' versions of events differed.⁷⁴ Maryland Casualty stated that the plaintiff was in no hurry to resolve the claim, communicated no sense of urgency regarding payment, and mailed in the claim rather than hand-delivering it or calling.⁷⁵ Maryland Casualty asserted that it, on the other hand, acted reasonably and with due diligence regarding the claim.⁷⁶

The plaintiff alleged that he told the adjuster with whom he dealt that water was pouring through holes in the roof and that he needed money to make the necessary repairs.⁷⁷ The situation progressively worsened. According to the plaintiff:

[Maryland Casualty] . . . forced him to get needless documentation and estimates which caused seemingly endless delays; then told him the check was in the mail; then told him the check must have been lost; and then delayed further in issuing another one.

67. See, e.g., *Washington v. Group Hospitalization, Inc.* 585 F. Supp. 517, 521 n.6 (D.D.C. 1984); *Stumpf v. Continental Cas. Co.*, 794 P.2d 1228, 1233 (Or. Ct. App. 1990) ("[I]t would be nonsensical to hold that an insured who has bargained away control of his own case nevertheless may be liable for conducting it negligently.").

68. See, e.g., *Continental Cas. Co. v. United States Fidelity & Guar. Co.*, 516 F. Supp. 384, 393 (N.D. Cal. 1981) ("The applicability of the principle of contributory/comparative negligence to an action for breach of the duty to settle is uncertain.").

69. See *Sorensen v. Allred*, 169 Cal. Rptr. 441, 443-46 (Ct. App. 1980).

70. 267 Cal. Rptr. 24 (Ct. App. 1990).

71. *Id.* at 26.

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. *Id.*

As a result of this delay, three months later in early March of 1983 after further water damage to his house, [plaintiff] called [Maryland Casualty] again to complain that he still needed the money, and that water damage to his house was continuing. . . . [Plaintiff], who was a carpenter . . . then got up on the roof again to do the necessary repairs himself. He claimed that [Maryland Casualty's] employee had told him to do this work himself, although he also later admitted that doing the work himself might have been his own idea after all.

In any event, once he got up on the roof again, [plaintiff] decided . . . he would need to replace the entire roof. . . . He went out to buy the necessary supplies, then later returned. While he was walking backward on the roof . . . he lost his balance and had to jump eight feet down onto the sidewalk. Both of his heels were severely injured. . . . He presented evidence showing that as a result he has been disabled from his job as a carpenter ever since.⁷⁸

In addressing Maryland Casualty's alleged breach of the implied covenant of good faith and fair dealing,⁷⁹ the trial court refused the insurer's request that the jury be instructed to assess the fault of the parties by comparing the insurer's bad faith with the plaintiff's negligence.⁸⁰ The jury returned a verdict in favor of the plaintiff and awarded both compensatory and punitive damages.⁸¹ Maryland Casualty appealed, and the First District Court of Appeal reversed.⁸²

The *Patrick* court clearly stated its rationale. First, it noted that although an appellate court had not previously considered comparative fault, the absence of precedent was "no good reason to reject it."⁸³ Indeed, most defenses now recognized in tort cases were once novel.⁸⁴ Second, the court saw no reason to reject the defense when it was already recognized in products liability actions in which a plaintiff's negligence would be measured against a manufacturer's strict liability.⁸⁵ "While the duty of good faith and fair dealing arises out of a contractual relationship between the parties, breach of the duty and ensuing dam-

78. *Id.*

79. *See id.*

80. *Id.* at 27.

81. *Id.*

82. *Id.* at 26.

83. *Id.* at 28.

84. *Id.*

85. *Id.*

ages are governed by tort principles."⁸⁶ Third, California courts already allowed the comparison of fault attributable to negligence and willful misconduct in personal injury actions.⁸⁷ Thus, as previously noted in the products liability context, such a comparison appeared legally sound. Finally, the court reasoned that comparative fault should not "be avoided by plaintiff's unilateral manipulation of the mere denomination of his claim where the defendant contends that, if there was any liability at all, it arose as a result of negligence; and where that theory is supported by the evidence."⁸⁸ *Patrick* thus concluded that "comparative negligence may be available as an affirmative defense in an action for [an insurer's] bad faith."⁸⁹

In *National Chiropractic Mutual Insurance Co. v. Cannon*,⁹⁰ the court held that the insured's negligence outweighed the insurer's, thus negating proximate cause and the insurer's liability for breach of its duty of good faith and fair dealing.⁹¹ In *Cannon*, chiropractor Donald Cannon was sued in a California state court for malpractice. Cannon tendered his defense to National Chiropractic Mutual Insurance Co. (NCMIC).⁹² Ultimately, the plaintiffs prevailed.⁹³ However, Cannon's conduct in the malpractice action was a major contributing factor in the plaintiffs' success.⁹⁴ Cannon refused to consent to settlement, fired NCMIC's chosen defense counsel shortly before trial, failed to obtain substitute counsel, attempted to remove the case to federal court, and failed to appear at trial.⁹⁵

NCMIC filed an interpleader action in federal court seeking a declaratory judgment absolving it of liability above its malpractice insurance policy limits with Cannon.⁹⁶ Cannon counterclaimed against NCMIC for the breach of its duty of good faith and fair dealing.⁹⁷ The district court held that NCMIC breached its duty of good faith owed Cannon attend-

86. *Id.* (quoting California Cas. Gen. Ins. Co. v. Superior Court, 218 Cal. Rptr. 817, 821 (Ct. App. 1985)).

87. *Id.* The application of comparative fault principles to negligent conduct on one hand and willful misconduct on the other was announced in *Sorenson v. Allred*, 169 Cal. Rptr. 441 (Ct. App. 1980).

88. *Patrick*, 267 Cal. Rptr. at 29.

89. *Id.* at 30.

90. Nos. 89-15903, 89-16013, 1991 U.S. App. WL 39887 (9th Cir. Mar. 20, 1991).

91. *Id.* at *2.

92. *Id.* at *1.

93. *Id.*

94. *Id.*

95. *Id.* at *2.

96. *Id.* at *1.

97. *Id.*

ant to the underlying malpractice action by failing to advise him of a conflict of interest and his right to engage independent counsel of his own choice.⁹⁸ The court found, however, that Cannon's bizarre conduct amounted to a breach of his duty to cooperate with NCMIC in his defense.⁹⁹ In fact, the court ultimately held that Cannon's conduct was unreasonable as a matter of law and constituted the proximate cause of the malpractice award.¹⁰⁰ The court entered summary judgment in NCMIC's favor, and the Ninth Circuit Court of Appeals affirmed.¹⁰¹

Cannon is an unusual case because of the insured's grossly negligent conduct. At the same time, it demonstrates that insurers' need to compare their insureds' fault with their own, and the fairness of allowing such comparisons.

A slightly different comparative fault situation was litigated in *California State Automobile Ass'n Inter-Insurance Bureau v. Bales*.¹⁰² The defendant was an attorney hired in 1983 by an elderly plaintiff, Dorothy Cooper, to prosecute her personal injury claim against an insured of California State Automobile Association Inter-Insurance Bureau (CSAA).¹⁰³ Attorney Bales failed to energetically pursue the claim, refused to negotiate a settlement with CSAA, and failed to seek an early trial date to which Cooper was entitled.¹⁰⁴ The action was finally settled in May 1987.¹⁰⁵ In December 1987, Cooper was represented by new counsel and sued CSAA for bad faith, alleging that it failed to settle her personal injury action promptly despite clear liability of its insured.¹⁰⁶ CSAA pleaded as an affirmative defense Bales's negligence in handling Cooper's original claim.¹⁰⁷ CSAA also cross-claimed against Bales for implied equitable indemnity, alleging that Bales was largely responsible for the delays that led to Cooper's claimed damages.¹⁰⁸ Therefore, CSAA argued, Bales should pay his comparative share of those damages.¹⁰⁹

98. *Id.* at *2.

99. *Id.*

100. *Id.*

101. *Id.*

102. 270 Cal. Rptr. 421 (Ct. App. 1990).

103. *Id.* at 422.

104. *Id.*

105. *Id.*

106. *Id.* at 422-23.

107. *Id.* at 424.

108. *Id.* at 423.

109. *Id.*

The trial court dismissed CSAA's cross-claim, and the First District Court of Appeal affirmed.¹¹⁰ The appellate court reasoned that, in such circumstances, allowing insurers to pursue implied equitable indemnity claims would create conflicts of interests for plaintiffs' personal injury counsel:

Where the attorney represents either a first or third party claimant on an insurance policy, the interest of the client is necessarily adverse to that of the insurer, even though there may not be any underlying action against the insurer. In such situations, there is a possibility that conduct of the insurer may subject it to liability for bad faith. That possibility in turn creates a potential conflict between the attorney's duty to pursue the client's claim vigorously, and the understandable desire to avoid conduct which might later be the basis for the attorney's personal liability in indemnity to the insurer. An attorney who believed that the insurer had engaged or was about to engage in bad faith claims practices might well choose to avoid such liability by acting to shield the insurer, even though his or her client would be ill-served by such action.¹¹¹

The appellate court did, however, recognize the validity of CSAA's affirmative defense.¹¹² *Bales* thus expanded the comparative fault doctrine to allow a comparison of plaintiffs' or insureds' counsel's conduct with the insurer's conduct.

To date, no other courts have followed California's lead.¹¹³ For example, the United States District Court for the Southern District of Iowa in *Kelly v. State Farm Mutual Automobile Insurance Co.*¹¹⁴ recently concluded that contributory fault is not available as an affirmative defense to bad faith claims.¹¹⁵

The application of comparative fault as an affirmative defense to bad faith claims is both logical and reasonable. *Patrick* illustrated that the comparison of an insured's negligent conduct with an insurer's alleged willful misconduct does not amount to a comparison of "apples and oranges." Insurers are no different from other corporate defendants and, as any other litigant, they ought to be allowed to plead and prove traditional affirmative defenses to tort claims.

110. *Id.*

111. *Id.* at 423-24 (footnote omitted).

112. *See id.* at 424.

113. Bopp, *supra* note 11, at 537.

114. 764 F. Supp. 1337 (S.D. Iowa 1991).

115. *Id.* at 1340-41.

B. Comparative Bad Faith

Comparative bad faith rests on the fundamental principle that allowing recovery for an insurer's willful misconduct is illogical or unfair if the insured did not comply with its contractual obligations or procured the policy through fraud or the like.¹¹⁶ Generally, insurers cannot raise the defense of comparative bad faith when insureds merely breach their contracts.¹¹⁷

The concept of comparative bad faith first appeared in 1984 in *Fleming v. Safeco Insurance Co. of America, Inc.*¹¹⁸ The plaintiff in *Fleming* was severely injured when the car in which she was a passenger was struck by a stolen vehicle.¹¹⁹ At the time of the accident she maintained uninsured motorist coverage from Safeco with policy limits of \$15,000.¹²⁰ Safeco offered \$10,000 in settlement of her claim, which the plaintiff rejected.¹²¹ The matter was ultimately resolved by a \$15,000 arbitration award more than one year after the accident.¹²² After payment of the arbitration award, the plaintiff sued Safeco for compensatory and punitive damages on the ground that Safeco had been guilty of bad faith, as well as malicious and oppressive conduct in handling her claim.¹²³ A jury returned a verdict in the plaintiff's favor, awarding her gross compensatory damages totalling \$14,300.¹²⁴ The jury determined that twenty-six percent of plaintiff's compensatory damages were attributable

116. See *Leidesdorf v. Fireman's Fund Ins. Co.*, 470 F. Supp. 82, 85 (S.D.N.Y. 1979) (allowing recovery for insurer's willful misconduct when an insured has not shown compliance with all obligations under the policy would work an unconscionable result.); *Petersen v. Mutual Life Ins. Co. of N.Y.*, 803 P.2d 406, 409 n.2 (Alaska 1990) (reasoning that the insured "cannot now complain about [the insurer's] alleged bad faith in handling the claim where it arose under a policy procured by activity which itself amounts to bad faith"); *Cherry v. Anthony, Gibbs, Sage*, 501 So. 2d 416, 420 (Miss. 1987) ("It is difficult to see how the insurance adjuster can be faulted for bad faith when it is clear that the [insureds] did not cooperate with him in his investigation."); *Mutual of Enumclaw Ins. Co. v. Cox*, 757 P.2d 499, 504 (Wash. 1988) (explaining that a bad faith claim under a state consumer protection statute would not be served by awarding damages, attorneys' fees, and costs to an insured who attempted to defraud an insurer).

117. George H. Mitchell & Christopher Robbins, *Comparative Bad Faith—“Reverse Bad Faith:” When Should You Make a Claim Against Your Own Insured?*, Insurance Claims Supervision Seminar (Defense Research Inst., Chicago, Ill.), Oct. 29-30, 1992, at E-18 (citing *Othman v. Globe Indem. Co.*, 759 F.2d 1458, 1464 (9th Cir. 1985), *overruled*, 832 F.2d 1080 (9th Cir. 1987)).

118. 206 Cal. Rptr. 313 (Ct. App. 1984).

119. *Id.* at 314-15.

120. *Id.* at 315.

121. *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

to her bad faith conduct and seventy-four percent to Safeco's bad faith conduct.¹²⁵ The jury also awarded the plaintiff \$116,500 in punitive damages.¹²⁶

The court observed that the comparison of the parties' bad faith was unprecedented, but since neither party objected to the special verdict form, and since neither party chose to address the issue on appeal, its propriety was not discussed.¹²⁷ Safeco did contend on appeal that the punitive damages award should be reduced by its insured's bad faith, as were the compensatory damages.¹²⁸ The *Fleming* court rejected the argument, noting that "bad faith on the one hand, and malice, oppression or fraud on the other hand are not equivalents, and any attempt to compare them would amount to a comparison of apples and oranges."¹²⁹

An Arizona court reached a different conclusion in another Safeco case, *Borland v. Safeco Insurance Co. of America*.¹³⁰ In deciding whether to allow an award of punitive damages against the defendant insurer, *Borland* "also [thought] it proper to consider the insured's conduct."¹³¹ The *Borland* plaintiff had almost immediately consulted with a knowledgeable insurance attorney upon delay in the payment of her claim.¹³²

Despite his understanding of insurance law, the attorney did not properly investigate the claim and generally failed to act with diligence.¹³³ In fact, the plaintiff's attorney, although well versed in insurance matters, "stood by and permitted the [insurer] to fumble its way into difficulty without seriously trying to straighten things out."¹³⁴ As a result, the court struck the plaintiff's punitive damage award.¹³⁵

To date, only one court has expressly addressed the concept of weighing an insured's comparative bad faith against an insurer's bad faith.¹³⁶

125. *Id.*

126. *Id.*

127. *Id.* at 321.

128. *Id.*

129. *Id.*

130. 709 P.2d 552 (Ariz. Ct. App. 1985).

131. *Id.* at 558.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.* at 559.

136. Mitchell & Robbins, *supra* note 117, at E-10.

In *California Casualty General Insurance Co. v. Superior Court*,¹³⁷ a California appellate court recognized and adopted the defense.¹³⁸

The insured plaintiff in *California Casualty* allegedly suffered a loss compensable under the uninsured motorist coverage provided by the defendant insurer's automobile liability insurance policy.¹³⁹ When the insurer declined to pay the plaintiff's claim, the plaintiff pursued the matter through arbitration and received a favorable award. The plaintiff then sued California Casualty for its alleged breach of the duty of good faith and fair dealing, fraud, intentional infliction of emotional distress, and certain statutory violations.¹⁴⁰ The insurer sought leave to amend its answer to include an affirmative defense of comparative bad faith by the plaintiff and her former attorney in the handling and management of her claim.¹⁴¹ The trial court denied the insurer's motion, and the issue reached the Court of Appeal by writ of mandamus.¹⁴²

The plaintiff contended that no authority recognized comparative bad faith as an affirmative defense to an action for an insurer's bad faith.¹⁴³ Thus, the comparative bad faith defense was not legally cognizable or, at the very most, constituted a "disfavored defense."¹⁴⁴ The court easily rejected the plaintiff's argument:

Plaintiff's assertion that the defense of "comparative bad faith" would constitute a "disfavored" defense is not persuasive and, indeed, is a bit puzzling. If, as plaintiff seems to suggest, the fact that "comparative bad faith" has not been heretofore recognized in a published appellate opinion as a partial or complete defense to a bad faith action renders it a "disfavored" defense, we reject that suggestion. Presumably, most defenses now recognized in tort cases were at one time novel and not expressly recognized in published judicial decisions. "Disfavored" defenses are such because of public policy considerations, not because they are novel.¹⁴⁵

California Casualty was persuaded that, in an appropriate case, an insured's breach of the implied duty of good faith and fair dealing that contributed to the insurer's untimely resolution of the subject claim

137. 218 Cal. Rptr. 817 (Ct. App. 1985).

138. *Id.* at 821.

139. *Id.* at 818.

140. *Id.* at 818.

141. *Id.* at 818-19.

142. *Id.* at 818.

143. *Id.* at 820.

144. *Id.*

145. *Id.* at 821 (footnotes omitted).

might constitute at least a partial affirmative defense to the insurer's alleged breach.¹⁴⁶ In so holding, the court noted that the duty of good faith and fair dealing is a "two-way street."¹⁴⁷ Moreover, "[t]he specific content of each party's duty is 'dependent upon the nature of the bargain struck between the insurer and the insured and the legitimate expectations of the parties which arise from the contract.'"¹⁴⁸ There could be little question, the court observed, that an insurer providing uninsured motorist coverage has a reasonable expectation that the insured suffering a loss will promptly and accurately furnish all known evidence and information pertinent to the claim.¹⁴⁹ If an insured's failure to do so delays or impedes the insurer's investigation or payment of the claim, the court reasoned, there exists no sound reason that the doctrine of comparative fault should not be applied to bad faith cases.¹⁵⁰

Accordingly, the appellate court permitted the insurer to amend its answer and allege the affirmative defense of the insured's comparative bad faith.¹⁵¹ Therefore, under the principles of comparative bad faith as enunciated in *California Casualty*, the trier of fact must weigh any bad faith by the insured against the alleged bad faith of the insurer and reduce any damage award in direct proportion to the insured's assessed fault.¹⁵²

However, *California Casualty* has drawn scholarly criticism. Some commentators question whether the application of comparative bad faith principles afford insurers a "double defense."¹⁵³ Those critics contend that the application of comparative bad faith allows an insurer to use identical evidence to demonstrate the reasonableness of its conduct and, at the same time, compel a reduction in the insured's claimed damages.¹⁵⁴ Allowing a reduction in an insured's damages because of her bad faith, even though the trier of fact concluded that the insurer acted in bad faith notwithstanding the insured's conduct, seems to provide an insurer with two means of using the same evidence in its favor.¹⁵⁵

146. *Id.* at 822.

147. *Id.*

148. *Id.* (quoting *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980)).

149. *Id.* at 822-23.

150. *Id.* at 823.

151. *Id.*

152. Mitchell & Robbins, *supra* note 117, at E-12.

153. WILLIAM M. SHERNOFF ET AL., INSURANCE BAD FAITH LITIGATION § 2.03[3][b], at 2-22 (1993).

154. *See id.*

155. *Id.*

Courts in states other than California have refused to instruct juries on comparative bad faith without expressly rejecting the doctrine. In the Georgia case of *Alexander Underwriters General Agency, Inc. v. Lovett*,¹⁵⁶ the trial court refused to instruct the jury on the insured's alleged bad faith.¹⁵⁷ While affirming the trial court, the Georgia Court of Appeals grounded its decision only on the lack of evidence in the record to support the instruction.¹⁵⁸ *Lovett*, therefore, neither rejected nor endorsed the doctrine. Similarly, in *Jessen v. National Excess Insurance Co.*,¹⁵⁹ a New Mexico trial court refused to instruct the jury on comparative bad faith. The New Mexico Supreme Court affirmed, stating that it was "not decid[ing] whether such an instruction necessarily would be inappropriate in another case."¹⁶⁰

If courts prove willing to adopt the comparative bad faith defense, an interesting and perhaps troubling situation arises in those states employing modified comparative fault. For example, some states bar recovery to a plaintiff who is fifty percent at fault or greater. In those states, an insured who hinders or delays investigation or payment of a claim might recover nothing, no matter how egregious the insurer's misconduct. Should an insurer's willful misconduct go completely unpunished? Most courts would probably answer in the negative, given the quasi-public nature of the insurance business. In modified comparative fault states, then, bad faith actions forseebly might be excepted from the affirmative defense.

C. *Why Should Comparative Fault and Comparative Bad Faith Be Recognized as Affirmative Defenses to Bad Faith Claims?*

Several compelling reasons exist urging courts to recognize insureds' comparative fault and comparative bad faith as affirmative defenses. First, the application of comparative fault and comparative bad faith will take nothing away from plaintiffs with "clean hands" and valid claims,¹⁶¹ nor will their application offer predatory or unscrupulous insurers appreciable refuge. Absent supporting evidence, comparative fault or comparative bad faith jury instructions simply will not be given. Allowing an insurer to plead and prove its insured's comparative fault or bad faith

156. 357 S.E.2d 258 (Ga. Ct. App. 1987).

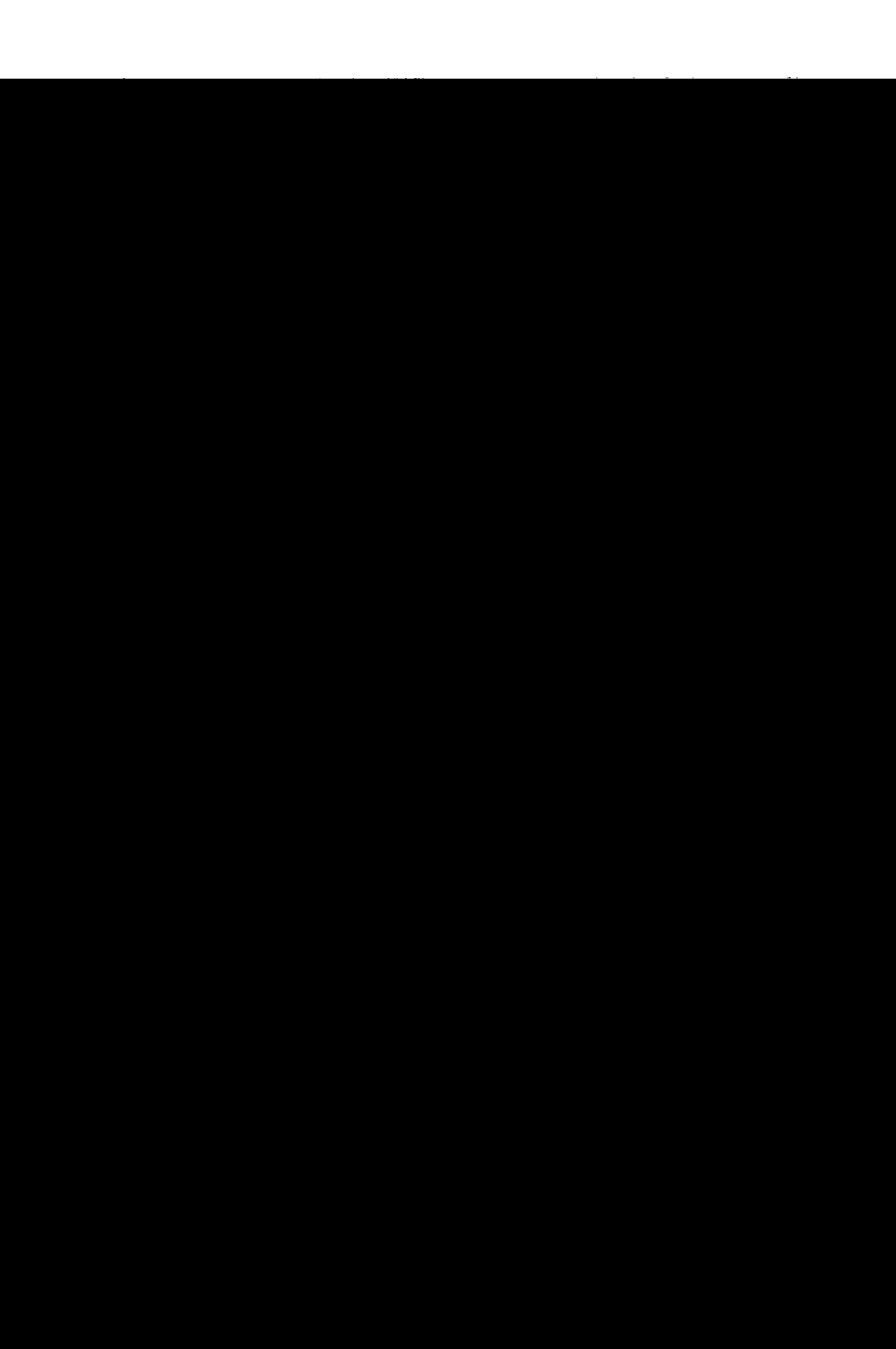
157. *Id.* at 265.

158. Indeed, the record demonstrated that the insured "did all he could" to carry out his related obligations. *Id.* at 265.

159. 776 P.2d 1244 (N.M. 1989).

160. *Id.* at 1249.

161. Bopp, *supra* note 11, at 539.



insurer's subrogation rights when the equipment was damaged.¹⁷⁰ *Altphilisch* drew no distinction between an insurer's assertion of comparative bad faith as an affirmative defense to contractual liability and its employment of the same theory as an action or counterclaim, believing each to be equally valid.¹⁷¹

The need for insurers to have available their own bad faith cause of action is apparent in both third-party and first-party cases. This is especially true in the third-party setting, where commercial insureds are becoming "self-insurers" up to levels far greater than previously considered, with insurance companies covering only excess potential liability.¹⁷² Consider the following hypothetical:¹⁷³ The Mayhem Corporation manufactures construction and farm equipment. Mayhem's commercial general liability insurance policy, which covers its potential products liability exposure, has an upper limit of \$4,000,000. In order to keep the related premiums at an acceptable level, however, Mayhem maintains a self-insured retention (SIR)¹⁷⁴ of \$500,000. A young worker is paralyzed when a Mayhem forklift overturns. The injured worker sues Mayhem, alleging that the machine was defectively designed. The plaintiff seeks \$3,000,000 in compensatory damages. Mayhem tenders the matter to its insurer, which assumes the defense. After investigating, the insurer enters into settlement negotiations with the plaintiff and offers to settle the case for \$800,000.

Assume that all of the facts and circumstances indicate that the offer should be accepted, and it appears that the plaintiff will accept. Notice, however, that the shoe is now on the other foot. From Mayhem's perspective, the plaintiff's acceptance of the insurer's \$800,000 settlement offer will cost it no less than a jury verdict in the full amount of \$3,000,000, because in either event its liability will be limited to the first \$500,000. This appears to make a gamble on a jury verdict worthwhile, since there is at least a possibility of a defense verdict or relatively modest (less than \$500,000) verdict. From the insurer's perspective, however, acceptance of the offer will limit its loss to \$300,000, while a large verdict could cost it anywhere from \$1,000,000 to \$2,500,000.

170. *Id.* at 92.

171. *See id.* at 94.

172. Dobbyn, *supra* note 22, at 368.

173. For similar examples, see *id.* at 368; Mitchell & Robbins, *supra* note 117, at E-26 to E-27.

174. An SIR is best thought of as a deductible, which is a concept familiar to anyone who has purchased automobile collision or liability insurance.

The plaintiff accepts the offer, but Mayhem, either seized by self-righteousness¹⁷⁵ or in an act of bad faith, refuses to contribute its SIR toward the settlement. Mayhem's insurer now faces at least two unpleasant options: The insurer can either contribute the amount of the SIR itself, or it can take the case to trial with the attendant risks. With a \$500,000 retention, the insurer can hardly absorb the SIR as a cost of doing business or as an accommodation to its good client, Mayhem. Indeed, Mayhem has substantial leverage by which it might force its insurer to waive most or all of the SIR, or to allow the action to go to trial. Notice, however, that Mayhem's means of bringing that leverage to bear is exactly the type of conduct that courts condemn as bad faith when practiced by insurers.¹⁷⁶ Assuming that a reasonable defendant would settle the case for \$800,000 and Mayhem's refusal to contribute its SIR furthers its interests to the detriment of its insurer's interests, Mayhem is guilty of classic third-party bad faith.¹⁷⁷

An insured might also conduct its affairs in bad faith in a first-party setting. For example, an insured might deliberately interfere with or impair its insurer's subrogation rights, or willfully conceal or misrepresent material facts regarding a loss. An insured might also sue its carrier for bad faith in an attempt to coerce the carrier into paying a disputed or fraudulent claim. A commercial insured faced with a catastrophic loss might also effectively expand its coverage by baiting its insurer into denying coverage or refusing to defend related litigation.

Consider, for example, this hypothetical: ABC corporation operates a massive warehouse complex in which numerous companies store hundreds of millions of dollars worth of dry goods and foodstuffs. ABC maintains a policy of comprehensive general liability (CGL) insurance with Floyd's of London with an upper limit of \$1,000,000. ABC also has a warehouse legal liability policy (covering bailed goods, among other risks) with an upper limit of \$10,000,000. A fire sweeps the complex, destroying or contaminating tons of food product. The insurers of the companies storing goods in the warehouse complex pay losses exceeding \$50,000,000 and make demand on ABC, threatening subrogation actions if ABC or its insurers do not make good their losses. Floyd's and the warehouse legal liability insurer immediately hire defense counsel who,

175. It is not uncommon for a manufacturer to believe that its "quality" product had no causal role in an accident and that by settling, its insurer is wrongly admitting or implying that the insured's product is "defective."

176. Dobbyn, *supra* note 22, at 369.

177. *Id.*

in turn, hire forensic engineers and fire investigators to determine the fire's cause and origin.

ABC has a serious problem: Faced with over \$50,000,000 in potential liability, it has but \$11,000,000 in available insurance. Obviously, the potential \$39,000,000 uninsured loss would bankrupt the corporation. But what if ABC's insurers declined to defend pending or threatened litigation, or declined to pay potentially covered claims? ABC's corporate counsel thus concocts a plan whereby its insurers' experts' access to the complex is limited, interfering with their cause and origin investigation and driving up costs; defense counsel are prevented from interviewing ABC employee witnesses, or must do so under unreasonable conditions; and documents or records are concealed or access to them delayed. ABC then provides plausible explanations for these actions, although the insurers are suspicious of ABC's motives. Ultimately, Floyd's and the frustrated warehouse legal liability insurer inform ABC that it has breached its duty to cooperate, deny ABC coverage, and withdraw their defense.

Subsequently, the insurers of many of ABC's customers file subrogation actions. ABC's counsel consents or stipulates to judgments in the full amount of the combined claims, agreeing with the subrogated insurers that they will attempt to collect their judgments only from ABC's insurance. ABC then assigns its causes of action to the subrogated insurers, who sue Floyd's and its warehouse legal liability insurer for their alleged bad faith in denying coverage and refusing to defend the subrogation actions.

Have ABC's insurers acted in bad faith, or did ABC breach its duty to cooperate and thus relieve them of liability? That question must ultimately be answered by a jury. Regardless of the outcome, ABC's in-house counsel has orchestrated quite a coup: Its counsel has preserved the corporation's assets while effectively increasing ABC's insurance coverage by a factor of five if its assignees prevail in a bad faith action. Everything ABC did to favorably position itself was, of course, done in bad faith.

How will courts respond to such exercises of bad faith by insureds? How *should* courts respond? When insurers are guilty of bad faith in third-party and first-party actions, they are liable for judgments above their policy limits, compensatory damages and, in many jurisdictions, punitive damages. Assuming the duty of good faith and fair dealing is reciprocal, should not the available remedies be reciprocal? In other words, should insureds who act in bad faith be liable for judgments in excess of policy limits or SIRs and be subject to punitive damage

awards? Insurers pursuing tort actions against their insureds for bad faith might be said to be pursuing "reverse bad faith" claims.

A. Judicial Response

Faced with limited precedent, it is difficult to predict how courts will respond to reverse bad faith claims.¹⁷⁸ Generally, there is little in the history of the judicial treatment of disputes between insureds and insurers to suggest that insurers can expect widespread equal treatment.¹⁷⁹

*First Lehigh Bank v. North River Insurance Co.*¹⁸⁰ is one of the few reported decisions in which an insurer alleged reverse bad faith by its insured where the court ultimately rejected the cause of action.¹⁸¹ In *First Lehigh*, the plaintiff bank sued the North River Insurance Co. ("North River") to recover under a banker's blanket bond for a loss attributable to fraud committed by a bank employee.¹⁸² North River counterclaimed under three theories, one being the bank's alleged breach of its duty of good faith and fair dealing.¹⁸³

The bank filed a claim with North River alleging it suffered a loss of approximately \$400,000 due to the dishonest acts of an employee.¹⁸⁴ Specifically, the bank claimed that the employee concealed and entered into unauthorized loan transactions.¹⁸⁵ North River began its routine claims investigation and requested copies of minutes from directors' meetings, loan reports, and FDIC examination reports.¹⁸⁶ The bank informed North River that the information sought was confidential and that it would have to enter into a related confidentiality agreement.¹⁸⁷ The parties attempted to negotiate an agreement, but before they could agree on its terms, the bank sued North River to collect on its claim.¹⁸⁸ After a consent protective order was entered, discovery began.¹⁸⁹ The bank provided North River with records that made no reference to the

178. In the two earliest reported decisions in which insurers essentially alleged "reverse bad faith," the actions sounded in contract rather than in tort. See *Safeco Ins. Co. of Am. v. Tholen*, 173 Cal. Rptr. 23 (Ct. App. 1981); *Liberty Mut. Ins. Co. v. Altfillisch Const. Co.*, 139 Cal. Rptr. 91 (Ct. App. 1977).

179. *Dobbyn*, *supra* note 22, at 377.

180. No. CIV.A.88-7746, 1989 WL 146654 (E.D. Pa. Dec. 4, 1989).

181. *Id.* at *5.

182. *Id.* at *1.

183. *Id.*

184. *Id.*

185. *Id.*

186. *Id.*

187. *Id.*

188. *Id.*

189. *Id.*

pertinent or relevant unauthorized loans but, instead, referred to letter of credit transactions.¹⁹⁰ North River later discovered that the records were altered before their production.¹⁹¹ North River alleged that the bank had deleted all references to loans claimed to be unauthorized or concealed, that the bank prepared a fraudulent letter of credit which was reflected in the loan reports, and that the bank altered the board of directors' meeting minutes to reflect the dishonest employee's termination.¹⁹²

North River's counterclaim for the bank's alleged breach of its duty of good faith and fair dealing posed a novel issue for the court in *First Lehigh*.¹⁹³ The court recognized that "the utmost fair dealing should characterize the transactions between an insurance company and the insured."¹⁹⁴ Nonetheless, the court dismissed North River's counterclaim.¹⁹⁵ The court concluded: "Breach by the [bank] of its duty of good faith and fair dealing may permit the insurer to avoid liability under the policy. However, it will not support a separate action for money damages by [North River] against the [bank]."¹⁹⁶ The *First Lehigh* court offered no reasoning to support its conclusion. It noted, however, that dismissal of the counterclaim did not leave the insurer without recourse.¹⁹⁷ North River remained free to sue the bank for malicious use of process should it prevail in the pending suit.¹⁹⁸

The position enunciated by *First Lehigh* at the very least evidences little concern for judicial resources and litigants' financial resources. Rather than resolve all issues in one suit, *First Lehigh* suggests a judicial preference for at least two potential actions, further burdening courts and increasing parties' litigation costs. Moreover, it deprives insurers of what would appear to be a compulsory counterclaim for no apparent reason other than the nature of the defendant's business.

The Ohio Court of Appeals rejected the reverse bad faith doctrine in *Tokles & Son, Inc. v. Midwestern Indemnity Co.*¹⁹⁹ In *Midwestern Indemnity*, the plaintiff sued its insurer for breach of contract and bad faith

190. *Id.*

191. *Id.*

192. *Id.*

193. *Id.* at *2.

194. *Id.* at *4 (quoting *Dercoli v. Pennsylvania Nat'l Mut. Ins. Co.*, 554 A.2d 906, 909 (Pa. 1989) (citation omitted)).

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. No. L-89-395, 1991 WL 355145 (Ohio Ct. App. Sept. 13, 1991).

when it denied the plaintiff's claim for the theft of a truck.²⁰⁰ The insurer counter-claimed for the insured's alleged bad faith.²⁰¹ Although Ohio law allows insurers to be held liable for bad faith, the appellate court refused to hold insureds similarly liable because of the parties' economic and financial disparities.²⁰² Reasoning that there is no duty imposed upon an insurer to act in good faith when there is no disparity of financial resources, the court of appeals affirmed the trial court's dismissal of the insurer's counterclaim.²⁰³

Midwestern Indemnity is an intellectually and logically vacant decision. Why should a party's mere identity bar its attempted recovery when defrauded? There is no philosophical or theoretical basis on which courts can easily reject the concept of reverse bad faith. If courts are reluctant to recognize this cause of action because insureds are economic underdogs lacking insurers' business acumen and leverage, they are mistaken.²⁰⁴ Insureds sufficiently sophisticated to use their SIRs as a means of leveraging litigation costs, or to bait their insurers into a bad faith defense in order to expand coverage for catastrophic losses, hardly need judicial shelter. Such insureds are usually corporations with financial and legal resources, which enable them to face their insurers on a level playing field. The argument that the duty should not be applied reciprocally because insurance policies are "adhesion contracts" must also fail²⁰⁵ since "[t]he duty of good faith and fair dealing is based upon a covenant implied by the courts, and not from a clause drafted by the insurers."²⁰⁶

B. How Should the Courts Respond?

Fundamental fairness and equity require that courts recognize a reverse bad faith cause of action for insurers. Moreover, the recognition of a cause of action for an insured's bad faith requires nothing more than a limited amount of judicial consistency.²⁰⁷

200. *Id.* at *2.

201. *Id.*

202. *Id.* at *12.

203. *Id.* at *13.

204. Dobbyn, *supra* note 22, at 372.

205. *See id.*

206. *Id.*

207. *Id.* at 371.

1. Third-Party Cases or Claims

In the third-party situation described previously, an insured refusing to contribute its SIR toward settlement or, similarly, an insured refusing to settle a claim falling completely within its SIR, would do so with the knowledge that by irresponsibly disregarding its insurer's interests it exposed its insurer to ultimate liability for the full amount of any subsequent judgment.²⁰⁸ Yet, "[o]n the other hand if the insured gave his consent to the settlement, he would also be binding himself to the obligation to pay the [claim] up to the amount of the deductible."²⁰⁹ This is exactly the obligation for which it bargained in order to reduce its premiums.

An actionable duty of good faith and fair dealing would leave insureds at liberty to exercise their own business judgment, free from risk, so long as they simply refrained from exercising that judgment in bad faith.²¹⁰ Additionally, "there would be little danger that courts or juries would [search] to find bad faith on the part of insureds."²¹¹ This has arguably held true when insurers' conduct is at issue.²¹² Courts' and juries' perception of insured Davids versus insurer Goliaths will probably not fade any time soon. Moreover, insurers—always sensitive to litigation costs—are unlikely to pursue borderline or unwinnable bad faith claims. Essentially, rejecting reverse bad faith claims in the third-party context, while simultaneously imposing tort liability on insurers for similar conduct, is tantamount to judicially licensing bad faith conduct by insureds.

2. First-Party Cases or Claims

The vitality of first-party reverse bad faith claims depends largely on the particular facts from which they arise. Where an insured merely aggravates or prolongs claim adjustment, an insurer seeking affirmative relief will surely be confronted with the argument that it has not been damaged.²¹³ Indeed, insurers may often find it difficult to prove damages sufficient to justify litigation costs and expenses.

208. *Id.*

209. *Id.*

210. *Id.*

211. *Id.*

212. *Id.*

213. Shipstead & Thomas, *supra* note 14, at 226. This argument simply ignores economic realities. When an insurer must devote its capital or human resources to claims activities that are prolonged or frustrated by an insured's bad faith, that insurer clearly suffers an economic loss. For example, in a commercial claims context, indemnitory exposures, adjustment costs,

A strong argument for a first-party action can be made when an insured commits fraud in the presentation of a claim. In such a case, the equities shift noticeably to the insurer's favor.²¹⁴ The insurer is then forced to marshal its resources to investigate and adjust a claim made by the insured solely to exploit the insured's rights under the policy.²¹⁵ Such facts certainly justify the insurer's recovery of compensatory—and perhaps punitive—damages from the insured.²¹⁶ A bad faith cause of action for insurers is mandated when an insured, in addition to presenting a fraudulent or groundless claim, sues the insurer for bad faith after the claim is denied.²¹⁷ Under these circumstances, the insurer is burdened with the defense of and potential exposure in the frivolous bad faith action, having already incurred the expense of investigating the claim.²¹⁸ Here, the insured's malicious use of the bad faith lever should be sufficient to form the basis of a punitive damage award.²¹⁹

In summary, an insurer should be able to assert a first-party bad faith claim against an insured if: (1) the insured knowingly withholds relevant evidence from the insurer, fabricates or falsifies evidence, or engages in other fraudulent conduct; or (2) the insured sues the insurer for bad faith without probable cause, to gain an unfair economic advantage, or for the purpose of coercing the carrier to pay a disputed claim.²²⁰

V. CONCLUSION

The doctrines of comparative fault and comparative bad faith enunciated by California courts in *Patrick v. Maryland Casualty Co.*²²¹ and *California Casualty General Insurance Co. v. Superior Court*²²² clearly are in evolutionary stages. It remains to be seen whether these two doctrines will be widely accepted by courts, let alone how they might be modified or refined.²²³ Reverse bad faith has yet to be expressly recognized. Nev-

and legal expenses stemming from illegitimate claims can be substantial. *Id.*; see also Mitchell & Robbins, *supra* note 117, at E-25.

214. Shipstead & Thomas, *supra* note 14, at 226.

215. *Id.*

216. *Id.*

217. *Id.*

218. *Id.*

219. *Id.*

220. See Mitchell & Robbins, *supra* note 117, at E-24.

221. 267 Cal. Rptr. 24 (Ct. App. 1990).

222. 218 Cal. Rptr. 817 (Ct. App. 1985).

223. Few commentators or scholars are optimistic that courts will apply the duty of good faith and fair dealing to insureds and insurers alike.

Regardless of where the equities may lie on this issue, the future course of the law seems fairly predictable. Until the courts are willing to liberate their thinking from the

ertheless, logic and legal consistency dictate that all three doctrines be accepted and applied. The duty of good faith and fair dealing, with accompanying tort remedies for its breach, must be a two-way street open to insureds and insurers alike.

restrictive notions of fictitious expectations which they have divined and projected into the minds of passive insureds, and until those same courts are willing to recognize that commercial and industrial insureds do not fit within the stereotype of "sailors, idiots, and infants," there is scarcely a chance that the law will deal even-handedly with the two parties to insurance contracts.

Dobbyn, *supra* note 22, at 379.