Bad Faith in North Carolina Insurance Contracts: A Growing Part of Insurance Practice

Constance A. Anastopoulo, Charleston School of Law

Available at: https://works.bepress.com/constance_anastopoulo/2/
Bad Faith in North Carolina Insurance Contracts: A Growing Part of Insurance Practice

By Constance A. Anastopoulo

As insurance contracts and the obligations associated therewith grow more complicated and far-reaching, courts have witnessed an increase in the number of bad faith claims being filed and litigated, both nationally and regionally. It is important to realize that with each decision, the doctrine of bad faith—a judicially created doctrine—is subject to potential change. Since the business of insurance is greatly affected with public interest policies, this escalation in claims raises substantial implications regarding the insurer-insured relationship.

At the heart of most insurance contract disputes are several competing interests. Insureds, who lack equal bargaining power with the insurer, contract only to protect themselves against the specter of accidental or unavoidable loss. To the insured, therefore, a policy of insurance is only as good as the insurer's willingness to pay claims in whatever context the claim arises. Stated another way, the insured's confidence in the insurance contract is only as secure as his or her reasonable belief the policy will ade-
quately provide him or her protection. At the same time, insurance companies have a vested interest in being able to accurately predict their obligations and make appropriate business decisions that will foster economic success, which translates into its ability to pay its obligations for the benefit of its policyholders. This article seeks to provide an overview of bad faith in insurance contracts in general and as it presently exists in North Carolina.

Bad Faith in General

A claim for bad faith typically arises in either the first- or third-party context. See, e.g., Rakes v. Life Ins. Co. of Am., 582 F.3d 886, 893-96 (8th Cir. 2009).

First-party bad faith deals with the insured’s conduct in determining whether to indemnify the insured for loss suffered personally. See generally George J. Kefalas, et al., Bad-Faith Ins. Litigation in the South Carolina Practice Manual, 13-AUG S.C. LAW. 18 (2001). Historically, courts construed a denial of benefits as a breach of contract and limited recovery accordingly. The nature of the insured-insurer contractual relationship, however, led to the emergence of a tort claim, providing additional theories of recovery intended to address the unique characteristics of the insurance contract. California was the first state to recognize an action for bad faith handling of a claim for first-party benefits in Gruenberg v. Aetna Insurance Company, 9 Cal. 3d 566, 108 Cal.Rptr. 480, 510 P.2d 1032 (1973).

Third-party bad faith, on the other hand, concerns the insurer’s conduct in handling the insured’s claim for coverage under a liability insurance policy. In this context, an insured files a claim for defense to a third party’s suit instituted against the insured and indemnification for the costs of any judgment suffered. Stated another way, the insurer owes two duties: (1) to defend a claim even if some or most of the lawsuit is not covered by insurance; and (2) to indemnify—to pay the judgment against the policy holder up to the limit of coverage. As these are contractual obligations, insurers must act with the utmost good faith and fair dealing in determining whether to and ultimately carrying out these duties.

Once the insurer has assumed control of the defense, including the right to accept or reject settlement offers, the implied duty of good faith and fair dealing requires the insurer to put the insured’s interests on equal footing with its own. Thus, there is a duty to settle a reasonably clear claim against the policyholder within the policy limits to avoid exposing the policyholder to the risk of a judgment in excess of the policy limits. See, e.g., Frontier Insulation Constr. v. Merch. Mut. Ins. Co., 91 N.Y.2d 169, 175-78 (1997).

Closely tied to this “duty to settle” is the concept of the excess liability claim. The claim first arose in Crichton v. Security Insurance Company, 66 Cal. 2d 425, 426 P.2d 173 (1967), where a third party offered to settle within the policy limits. Id. at 428, 426 P.2d at 175. After the insurer refused the offer, the insured suffered a judgment at trial substantially exceeding the policy limits. Id. at 428, 426 P.2d at 176. The insurer thereafter paid out only the policy limit, which it considered the extent of its contractual obligation. Id. at 428, 426 P.2d at 176. Consequently, the insured sued the insurer for: (1) loss of property; (2) mental distress; and (3) the amount by which the judgment exceeded the policy limits, all of which were caused by the insurer’s refusal to settle. Id. at 427, 426 P.2d at 175. The court looked to the insurer’s conduct in handling the third-party claim to determine the insurer’s excess liability. Id. Guiding this inquiry was whether a reasonably prudent insurer without policy limits would have accepted the settlement offer. Id. at 430-32, 426 P.2d at 176-78. Although inconclusive, a judgment in excess of the policy limits raises the inference that accepting the offer was reasonable. Id. at 430, 426 P.2d at 176-77. Furthermore, rejection of such an offer renders the insurer liable for the amount of the final judgment whether or not within policy limits. Id.

Bad Faith in North Carolina

As North Carolina courts carved out the state’s own bad faith jurisprudence over the years, they wrestled with the bad faith tort-contract distinction as well as the type of recoverable damages in this peculiar cause of action. At the heart of this struggle, however, is a recognition that “[a]n insurance company is expected to deal fairly and in good faith with its policyholders.” Robinson v. NC Farm Bureau Ins. Co., 86 N.C. App. 44, 50, 356 S.E.2d 392, 395 (1987), disc. review denied, 321 N.C. 592, 364 S.E.2d 140 (1988). It is also axiomatic that damages for breach of contract should seek to place the injured party, as much as possible, in the position he or she would have occupied had the contract been performed. See generally Burrell v. Sparkles Reconstr. Co., 189 N.C. App. 104, 657 S.E.2d 712 (N.C. App. 2008). Logically therefore, a breach of contract claim should only yield the plaintiff damages in the amount of coverage called for by the policy. Nationwide Mut. Ins. Co. v. Mabe, 115 N.C. App. 193, 198, 444 S.E.2d 664, 667 (1994). Nevertheless, due to the ever-increasing number of claims for bad faith, the distinction between breach of contract and bad faith tort actions led courts to promulgate rules permitting recovery in tort, including punitive damages.

In 1976, the North Carolina Supreme Court in Newcom v. Insurance Company reviewed the judicial history of attempts to obtain punitive damages in breach of contract cases and affirmed the trial court’s dismissal of the punitive damages claim, reasoning:

The breach of contract represented by defendant’s failure to pay is not alleged to be accompanied by either fraudulent misrepresentation or any other recognizable tortious behavior. [T]he allegations in the complaint of oppressive behavior by defendant in breaching the contract are insufficient to plead any recognizable tort. They are, moreover, unaccompanied by any allegation of intentional wrongdoing other than the breach itself even were a tort alleged. Punitive damages could not therefore be allowed even if the allegations here considered were proved.

291 N.C. 105, 114, 229 S.E.2d 297, 302 (1976). In other words, the plaintiff must show something more than a mere refusal to pay in order to recover punitive damages—the plaintiff must show: (1) a refusal to pay after recognition of a valid claim; (2) bad faith; and (3) aggravating or outrageous conduct. Michael v. Metro Life Ins. Co., 631 F. Supp. 451, 455 (W.D.N.C. 1986). Generally, an insurer acts in bad faith when its refusal was “not based on honest disagreement or innocent mistake.” Daily v. Integon Gen. Ins. Corp., 75 N.C. App. 387, 396, 331 S.E.2d 148, 155 (1985), disc. rev. denied, 314 N.C. 664, 336 S.E.2d 399 (1985). “Aggravation” has been defined to include fraud, malice, such a degree of negligence as indicates a reckless indifference to plaintiff’s rights, oppression, insult, rude-

In addition to the potential avenues of recovery that rest primarily upon common law, the North Carolina General Statutes provide a mechanism by which wronged insureds can recover for the bad faith committed by their insurers. Working together, the Unfair Claim Settlement Practices Act, codified at N.C.G.S. § 58-63-15(11) (formerly codified at N.C.G.S. § 58-54.4(11)), and the Unfair Trade or Deceptive Practices Act [the UTPA] codified at N.C.G.S. § 75-1, et seq., create a private right of action that allows a plaintiff to reference the behaviors outlawed by the Unfair Claim Settlement Practices Act in her claim brought pursuant to the UTPA. To understand how these statutes work together, it is helpful to address each statute separately.


- (f) Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear;
- (h) Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled;
- (m) Failing to promptly settle claims where liability has become reasonably clear;
- (n) Failing to promptly provide a reasonable explanation of the basis in the policy in relation to the facts or law for denial of the claim or for the offer of compromise settlement. Id.

However, the Unfair Claim Settlement Practices Act, N.C. Gen. Stat. § 58-63-15 (2009), does not provide for a private right of action; in fact, it specifically provides that "no violation of this subsection shall itself create any cause of action in favor of any person other than the commissioner." Id.

An aggrieved insured, however, is not without recourse because conduct that violates the Unfair Claim Settlement Practices Act also violates the UTPA. See Gray v. NC Ins. Underwriting Ass'n, 352 N.C. 61, 71, 529 S.E.2d 676, 683 (2000) (holding "conduct that violates subsection (f) of N.C.G.S. § 58-63-15(11) constitutes a violation of N.C.G.S. § 75-1-1, as a matter of law."); see also United States Virginia Bank v. Air-Lift Assocs., 79 N.C. App. 315, 319020, 339 S.E.2d 90, 93 (1986) ("The purpose of G.S. 75-1.1 is to provide a civil means to maintain ethical standards of dealings between persons engaged in business and the consuming public within [North Carolina] ...."). Therefore, a plaintiff harmed by an insured engaging in actions outlawed by the Unfair Claim Settlement Practices statute may pursue her claim by filing a private right of action alleging violations of the UTPA; however, the allegations must be plead properly. A notable benefit to bringing a bad faith claim under Chapter 75 is

CONTINUED ON PAGE 30
Sit-Ins (cont.)

to the needs and perspectives of minorities in the country.

"By 2050, we will no longer be a majority white nation," Chaife said. "Our own state has seen a 600% increase in the Latino population in the last ten years, and we are facing a cultural test of where our values are. Do we actually believe in the common good and what is the common good? Our country was founded, the white part of the country, by the Puritans who talked about a model of Christian charity, about caring for each other, about loving each other, about bearing each other's pain. We haven't been there for a while, we haven't really understood the importance of hearing the other side."

Asked about current social movements, including the gay rights movement, Chaife concluded saying there was a need to "recognize the indivisibility of human rights."

Elon Law student Tiffany Atkins said the forum sent the right message to law students. "They each gave a different perspective on the importance of the sit-ins and how the law played a part in a movement that shaped our country," Atkins said. "I thought it was great that they challenged us to be empowered to really make change."

Elon Law student Amanda Tauber said the forum was important in helping law students consider their roles as attorneys.

"It was a great change to all of us to be active," Tauber said. "We can't sit on our hands and wait for change to happen. As lawyers, we will have the influence, the intelligence, and the creativity to really make an active change in our communities and in the world."

Elon Law presented the forum in partnership with the law school's Black Law Students Association and Phi Alpha Delta chapter, and with support from the Law School Admission Counsel as part of DiscoverLaw.org. The Admissions Office at Elon Law sponsored the forum, inviting college and high school students from minority communities currently underrepresented in the legal profession to attend, providing an opportunity to consider what careers in the law can achieve.

Philip Craft is the director of communications for Elon University School of Law.

Bad Faith (cont.)

that a successful plaintiff may seek both treble damages and attorney's fees. See generally N.C.G.S. Chapter 75-16, et. seq.; see also Marshall v. Miller, 302 N.C. 539, 548, 276 S.E.2d 397, 403 (1981).

To succeed in a claim for unfair or deceptive trade practices under the UTPA, a plaintiff generally must show: (1) defendants committed an unfair or deceptive act or practice; (2) in or affecting commerce; and (3) that plaintiff was injured thereby. First Atl. Mgmt. Corp. v. Daniel Reaey Co., 131 N.C. App. 242, 252, 507 S.E.2d 56, 63 (1998). See also N.C. Gen. Stat. § 75-1.1 (2005). "A practice is unfair when it offends established public policy as well as when the practice is immoral, unethical, oppressive, unscrupulous, or substantially injurious to consumers." Marshall v. Miller, 302 N.C. 539, 548, 276 S.E.2d 397, 403 (1981). Interpreting the Unfair Claim Settlement Practices statute, North Carolina courts have held that "[n]ot attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonable clear, is "inherently unfair, unscrupulous, and injurious to consumers." Country Club of Johnston City, Inc. v. US Fidelity & Guar. Co., 150 N.C. App. 231, 247, 563 S.E.2d 269, 280 (2002) (quoting N.C. Gen. Stat. § 58-63-15(11)(f) (2005)). Therefore, a plaintiff alleging bad faith should allege the insurer's actions violate the Unfair Claim Settlement Practices Act and therefore constitute an unfair trade practice, which the UTPA creates a private right of action to pursue.


However, damages may be recovered either for the breach of contract claim, or for the violation of §75-1.1, but not for both. United Laboratories, Inc. v. Kaykendall, 437 S.E.2d 374, 379, 335 N.C. 183 (N.C. 1993). See also, Vasquez v. Allstate Ins. Co., 529 S.E.2d 480, 137 N.C.App.741 (N.C.App. 2000).

Conclusion

Bad faith litigation continues to grow and expand and courts are faced with the question of defining what constitutes an insurer's obligation to act in good faith, or to not act in bad faith. While all courts have agreed that an insurer owes some duty in this respect, courts wrestle with what constitutes that duty, or a breach thereof. State legislatures have circumscribed those duties to some extent but questions remain. As the concept evolves, it is important to understand ways in which bad faith will be characterized and delineated. It is also important for practitioners on both sides to recognize the potential areas that create the greatest risk of a bad faith claim, and what steps can be taken to address those areas before the claim arises. Exploring these matters in detail will hopefully provide practitioners tools to assist them as they navigate this evolving area of law.

A graduate of the University of North Carolina School of Law, Constance Anastaplo is an assistant professor of law at the Charleston School of Law. In addition to teaching Insurance and Torts, Professor Anastaplo enjoys her role as a consultant in litigation involving novel and complex issues related to the obligation of insurers.