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Litigating Bad Faith Insurance Claims: Key Issues and Case Law Update

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A. Brief Overview of Bad Faith Insurance

When an insurance carrier fails to pay a claim that is covered by the insurance policy, the insurer has committed a breach of contract and damages can be awarded for the breach. Unfortunately, the remedies of contract law are generally not adequate for dealing with reckless or systematic spiteful conduct. In an effort to protect the interest of insureds in their dealings with insurance companies, the majority of state courts have fashioned a cause of action out of an amalgam of tort and contract principles that is generally known as the "bad faith cause of action." The cause of action arises in two contexts: (1) that of third-party claims, in which the insured is seeking defense and indemnification from liability to a third party; and (2) that of first-party claims, in which the insured is seeking indemnification from the insurer for a loss suffered by the insured personally.

1. Third-Party Claims

Since control of the defense of the action, including the right to decide to accept or reject a settlement offer, is rightfully assumed by the insurer under the terms of the policy, the issue arises as to what duty is owed by the insurer to give consideration to the interests of the insured in making its decision on settlement. Early case law on this subject was consistent in supporting the insurer's absolute right to make an unfettered decision on settlement.

The South Carolina standard arose from two appeals arising out of the same case and recognized an action arising in tort against an insurer for negligence and bad faith in defense of, and in failing to settle, a suit for the insured's injury. The court adopted the concept of the universal implied duty of good faith and fair dealing implicit in every contract.

The court, in the first *Tyger River* appeal, held that an insurer owes the insured a duty of settling personal injury claims if a settlement is the reasonable thing to do.[1] The Defendant contended that the Plaintiff was not entitled to recover for negligence unaccompanied by fraud or bad faith on the part of the defendant in the negotiations relating to compromise and settlement. The court, in the second appeal, expressly held that an insurer negligently failing to settle the case against the insured by an injured employee is liable to the loss even in the absence of fraud or bad faith.[2] Only a minority of the courts of other states have followed the South Carolina court in expressly reducing the standard from bad faith to negligence.

The remedy most typically applied in the event of an insurer's violation of its duty toward the insured and rejecting settlement within policy limits is that the insurer is held liable for the excess of any resulting judgment for the third party against the insured over the policy limit. Generally added to this amount are the costs of bringing the bad faith cause of action against the insurer. In some cases, courts have allowed for damages for mental suffering, cost to the insured by the insurer's bad faith refusal to settle, and, if the violation is particularly egregious, an award of punitive damages.

The insured's cause of action for bad faith against the insurer is unaffected by the inability of the insured to pay the excess. Frequently in this

[1] *Tyger River Pine Co. v. Maryland Cas. Co.*, 161 S.E. 491 (S.C. 1931).
[2] *Tyger River Pine Co. v. Maryland Cas. Co.*, 170 S.E. 346 (S.C. 1933).

situation, the action is brought against the insurer by the third party plaintiff after assignment of the cause of action by the insured. It is important to note, however, that an injured third party does not have standing to assert a bad faith cause of action directly against an insurer.[3]

2. First-Party Insurance

First-party insurance involves policies covering losses suffered directly by the insured as opposed to losses to third parties for which the insured may be held legally liable. Under the majority view, failure to exercise good faith in deciding whether or not to pay a claim is a breach of the implied duty of good faith and fair dealing, and therefore actionable as a tort. A substantial minority of courts have denied the bad faith cause of action for first-party claims.

In 1983, South Carolina adopted the majority view in *Nichols v. State Farm Mutual Auto Insurance Co.*, 306 S.E.2d 616 (1983). In that case, the court held that if an insured can demonstrate bad faith or unreasonable action by an insurer in processing a claim under their mutually binding insurance contract, he can recover consequential damages in a tort action, and actual damages are not limited by contract. In addition, if he can demonstrate the insurer's actions were willful or in reckless disregard of the insured's rights, he can recover punitive damages.

The court in *Nichols* held that S.C. Code § 38-9-320 applied only to a breach of contract cause of action and was therefore inapplicable to a tort action. Consequently, if the award sounds in tort, an award of attorneys' fees would be improper. However, a bad faith first-party claim sounding in tort can support punitive damages. It is clear that South Carolina has recognized that a

[3] *Kleckley v. Northwestern Nat. Cas. Co.*, 526 S.E.2d 218 (S.C. 2000).

breach of the duty of good faith and fair dealing implicit in every contract of insurance is an action *ex delicto*. A breach of the covenant of good faith and fair dealing implicit in every contract is an action *ex contractu*.

3. Elements Of Bad Faith

The 1996 case of *Cock-N-Bull Steakhouse v. Generali Ins.*, set forth the elements of a cause of action for bad faith refusal to pay first party benefits. The four elements are:

(1) Existence of a contract;
(2) Refusal by insurer to pay benefits due under the contract;
(3) Resulting from the insurer's bad faith or unreasonable action in breach of the implied covenant of good faith and fair dealing; and
(4) Causing damage to the insured.[4]

An insured may recover damages for a bad faith denial of coverage if he or she proves there was no reasonable basis to support the insurer's decision to deny benefits under a mutually binding insurance contract.[5]

Remedies the insured may obtain after the insurer's bad faith refusal to pay first-party benefits include policy proceeds, emotional distress, economic harm, punitive damages and attorney's fees.

4. Elements Of Contractual Bad Faith Claim

[4] *Cock-N-Bull Steakhouse v. Generali Ins. Co.*, 466 S.E.2d 727 (S.C. 1996). *Crossley v. State Farm Mut. Auto Ins. Co.*, 415 S.E.2d 393, 396-97 (S.C. 1992).

[5] *Dowling v. Homebuyer Warranty Corp.*, 400 S.E.2d 143, 144 (1991).

The *Nichols* court determined that a claim arising *ex contractu* was cognizable pursuant to the provisions of S.C. Code § 38-9-320 (1976). This code section has been modified and is now recodified as § 38-59-40, which provides:

> (1) In the event of a claim, loss, or damage which is covered by a policy of insurance or a contract of a nonprofit hospital service plan or a medical service corporation and the refusal of the insurer, plan, or corporation to pay the claim within ninety days after a demand has been made by the holder of the policy or contract and a finding on suit of the contract made by the trial judge that the refusal was without reasonable cause or in bad faith, the insurer, plan, or corporation is liable to pay the holder, in addition to any sum or any amount otherwise recoverable, all reasonable attorneys' fees for the prosecution of the case against the insurer, plan, or corporation. The amount of reasonable attorneys' fees must be determined by the trial judge and the amount added to the judgment. The amount of the attorneys' fees may not exceed one-third of the amount of the judgment.
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> (2) If attorneys' fees are allowed and, on appeal by the defendant, the judgment is affirmed, the Supreme Court or the court of appeals shall allow to the respondent an additional sum as the court adjudges reasonable as attorneys' fees of the respondent on the appeal.
>
> (3) Nothing in this section may be construed to alter or affect the Tyger River Pine Co. v. Maryland Casualty Co., 161 SE 491, 163 SC 229, doctrine.
>
> (4) This section applies to cases filed or removed to federal court and cases appealed in the federal court system.

A refusal to pay without reasonable cause or in bad faith is the statutory standard to sustain a contractual cause of action for bad faith. The court, in its discretion, can award reasonable attorney's fees in an amount up to one-third (1/3) of the amount of the judgment.

B. MCCARRAN-FERGUSON ERISA PRE-EMPTION

(1) McCarran-Ferguson

In the late 18th and early 19th centuries, the insurance industry was relatively unregulated. Most regulation occurred primarily through the restrictions in each corporate charter granted by state legislatures. Insurers found that state regulation was inconsistent and burdensome. Consequently, by the 1860s, insurers were urging Congress to create national standards that would make insurers federal institutions, similar to banks. In the mid 1860s, Paul, a Virginia resident, was appointed by a number of New York insurance companies as their agent. He applied for a Virginia license, but refused to deposit bonds with the State Treasurer as required by Virginia state law. He was not granted a license but he proceeded to sell a policy of insurance to a Virginia resident. He was subsequently convicted for violating the Virginia licensing statute. The Virginia Supreme Court affirmed his conviction and he challenged his conviction in the United States Supreme Court on the grounds that Virginia's stricter requirements for foreign insurers violated the Privileges and Immunities Clause of the United States Constitution. He alleged that the Federal Commerce power allowed regulation of insurers and that this power resided exclusively with the Federal government. In 1869, the U.S. Supreme Court rejected *Paul's* arguments. In so doing, the court held that "issuing a policy of insurance is not a transaction of commerce".[6]

As a result of the holding in *Paul v. Virginia*, the insurance industry enjoyed relative freedom from interference by the Federal government until 1944. In that year, the U.S. Supreme Court handed down the decision of

[6] *Paul v. Virginia*, 75 U.S. 168, 183 (1869).

United States v. South-Eastern Underwriters Ass'n.[7]. In that case, an association of 200 fire insurance companies and 27 individuals were indicted under Section 1 of the Sherman Anti-Trust Act for fixing non-competitive rates and Section 2 for monopolization. The issue was whether the Federal Congress should be deprived of the power to regulate the industry under the Sherman Act, and the court held that insurance transactions were subject to Federal regulation under the Commerce Clause.

Following the *South-Eastern Underwriters* case, the insurance industry found that it would much prefer the state form of regulation under which it had learned to operate successfully, to the unknown Federal legislation that might force significant changes in the industry. As a result, the National Association of Insurance Commissioners (NAIC) proposed legislation to limit the impact of *South-Eastern Underwriters*. The result was the McCarran-Ferguson Act.[8] The salient language of the Act appears in Section 2:

> (a) The business of insurance, and every person engaged therein, shall be subject to the laws of the several States which relate to the regulation or taxation of such business.
>
> (b) No Act of Congress shall be construed to invalidate, impair, or supersede any law enacted by any State for the purpose of regulating the business of insurance, or which imposes a fee or tax upon such business, unless such Act specifically relates to the business of insurance….

The Supreme Court subsequently found that "Congress' purpose was brought broadly to give support to the existing and future state systems for regulating and taxing the business of insurance…[I]ts purpose was evidently to throw the whole weight of its power behind the state's systems."[9] The ultimate

[7] *United States v. South-Eastern Underwriters Ass'n.*, 322 U.S. 533 (1944).
[8] 15 U.S.C. §§ 1011 *et seq.*
[9] *Prudential Ins. Co. v. Benjamin*, 328 U.S. 408, 429-30 (1946).

effect of the McCarran-Ferguson Act was to give supremacy to State regulation of the business of insurance to the extent that State's chose to occupy the regulatory field. In order to avoid Federal intervention and to satisfy the dictates of the McCarran-Ferguson Act, the NAIC, composed of representatives of the industry, drafted model rate regulation and fair trade practices statutes. By 1963, Unfair Trade Practices Statutes were adopted in all of the states. South Carolina has adopted a Claims Practices Act which appears in S.C. Code §§ 38-59-10 *et seq.* Specifically, S.C. Code § 38-59-20 (1976) provides:

> Any of the following acts by an insurer doing accident and health insurance, property insurance, casualty insurance, surety insurance, marine insurance, or title insurance business, if committed without just cause and performed with such frequency as to indicate a general business practice, constitutes improper claim practices:
>
> (1) Knowingly misrepresenting to insureds or third-party claimants pertinent facts or policy provisions relating to coverages at issue or providing deceptive or misleading information with respect to coverages.
>
> (2) Failing to acknowledge with reasonable promptness pertinent communications with respect to claims arising under its policies, including third-party claims arising under liability insurance policies.
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> (3) Failing to adopt and implement reasonable standards for the prompt investigation and settlement of claims, including third-party liability claims, arising under its policies.
>
> (4) Not attempting in good faith to effect prompt, fair, and equitable settlement of claims, including third-party liability claims, submitted to it in which liability has become reasonably clear.
>
> (5) Compelling policyholders or claimants, including third-party claimants under liability policies, to institute suits to recover amounts reasonably due or payable with respect to claims arising under its policies by offering substantially less than the amounts ultimately recovered through suits brought by the claimants or through settlements with their attorneys employed as the result of the inability of the claimants to effect reasonable settlements with the insurers.
>
> (6) Offering to settle claims, including third-party liability claims, for an amount less than the amount

> otherwise reasonably due or payable based upon the possibility or probability that the policyholder or claimant would be required to incur attorneys' fees to recover the amount reasonably due or payable.
>
> (7) Invoking or threatening to invoke policy defenses or to rescind the policy as of its inception, not in good faith and with a reasonable expectation of prevailing with respect to the policy defense or attempted rescission, but for the primary purpose of discouraging or reducing a claim, including a third-party liability claim.
> (8) Any other practice which constitutes an unreasonable delay in paying or an unreasonable failure to pay or settle in full claims, including third-party liability claims, arising under coverages provided by its policies.

This provision does not create a private cause of action. However, it can be used to establish a standard of care which can be used in support of a bad faith claim.

(2) ERISA Pre-emption

In 1987, the U.S. Supreme Court handed down its decision in *Pilot Life Ins. Co. v. Dedeaux*[10]. In that case, the court held that Section 514 of the Employee Retirement Income Security Act of 1974 (ERISA)[11] pre-empts certain common law tort and contract claims when an insured employee benefit plan is involved. This makes ERISA an exclusive remedial scheme. The effect of this decision is that carriers which provide such plans may not be sued for bad faith performance of their obligations under the policies. ERISA provides no remedy equivalent to the state law of bad faith.

In *Duncan v. Provident Mut. Life Ins. Co. of Philadelphia*[12] Justice Finney stated:

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10 *Pilot Life Ins. Co. v. Dedeaux,* 481 U.S. 41 (1987).
11 29 U.S.C. § 1144.
12 *Duncan v. Provident Mut. Life Ins. Co. of Philadelphia,*.427 S.E.2d 657 (S.C. 1993).

> In a case involving the Mississippi common law of bad faith, *Pilot Life Ins. Co. v. Dedeaux,* 481 U.S. 41, 107 S.Ct. 1549, 95 L.Ed.2d 39 (1987), the United States Supreme Court gave the following summary of the terms "relates to," "saving clause," and "deemer clause," as related to their effect on the provisions of ERISA.
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>> If a state law "relate[s] to ... employee benefit plan[s]" it is preempted. § 514(a). The saving clause excepts from the pre-emption clause laws that regulat[e] insurance." § 514(b)(2)(A). The deemer clause makes clear that a state law that "purport[s] to regulate insurance" cannot deem an employee benefit plan to be an insurance company. § 514(b)(2)(B). Id. at 45, 107 S.Ct. at 1552.
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> The *Pilot Life* Court, citing Metropolitan Life Ins. Co. v. Massachusetts, 471 U.S. 724, 105 S.Ct. 2380, 85 L.Ed.2d 728 (1985) concluded that, in a common sense meaning, in order for a law to regulate insurance the law "must not just have an impact on the insurance industry, but must be specifically directed toward that industry." Id., 481 U.S. at 50, 107 S.Ct. at 1554. Therefore, if a state law does not regulate insurance, it is not saved by the preemption clause.

In jurisdictions where the tort of bad faith is available, allegations of a bad faith breach are routinely added as a count to most ERISA claims. The reasoning is that the bad faith allegation adds leverage to the claim. In addition, the possibility exist that *Pilot Life* will be overruled or limited, as it affects state common law remedies.

C. **RECENT COURT DECISIONS**

On April 7, 2003, the United States Supreme Court decided *State Farm Mut. Automobile Ins. Co. v. Campbell* on a Writ of Certiorari to the Supreme Court of

Utah. Curtis Campbell caused an accident in which one person was killed and another permanently disabled. His insurer, State Farm, contested liability and declined to settle the ensuing claims for the $50,000.00 policy limit. In so doing, it ignored its own investigator's advice and took the case to trial. The carrier assured Campbell and his wife that they had no liability for the accident. State Farm also stated that they would represent their interest and that they did not need independent counsel. A Utah jury returned a judgment for over three times the policy limit and State Farm refused to appeal. The Utah Supreme Court denied Campbell's own appeal and State Farm paid the entire judgment. The Campbells then sued State Farm for bad faith, fraud, and intentional infliction of emotional distress. The trial court's initial ruling granting State Farm's summary judgment was reversed on appeal. On remand, the court denied State Farm's Motion to Exclude Evidence of dissimilar out of state conduct. In the first phase of a bifurcated trial, the jury found that State Farm's decision not to settle was unreasonable. In the second phase, which address the issue of compensatory damages, evidence was introduced that pertained to State Farm's business practices in numerous states but bore no relation to the type of claims underlying the Campbell's complaint. The jury awarded the Campbells $2.6 million dollars in compensatory damages and $145 million in punitive damages, which the trial court subsequently reduced to $1 million dollars and $25 million dollars respectively.

Between the first and second phase of the trial, the United States Supreme Court refused to sustain a $2 million dollar punitive damages award which accompanied a $4,000.00 compensatory damages award in the case of *BMW of North America, Inc. v. Gore*.[13] Applying the factors set forth in *Gore*, the Utah Supreme Court reinstated the $145 million dollar punitive damages award.

The United States Supreme Court reversed and remanded the case, holding that a punitive damages award of $145 million dollars, where full compensatory

[13] *BMW of North America, Inc. v. Gore,* 517 U.S. 559.

damages are $1 million dollars, is excessive and violates the due process clause of the Fourteenth Amendment. The Supreme Court has instructed court's reviewing punitive damages to consider (1) the degree of reprehensibility of the defendant's misconduct, (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award, and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases.[14] In applying the *Gore* factors, the majority found that the award was excessive, and cited the Cooper Industries case for the proposition that the due process clause of the Fourteenth Amendment prohibits the imposition of grossly excessive or arbitrary punishments on a tortfeasor.[15]

In 2006, the South Carolina Supreme Court faced a similar issue regarding punitive damages in a bad faith claim in the case of *James v. Horace Mann Ins. Co.*[16], the Plaintiffs maintained a homeowners insurance policy with Defendant insurance company which provided coverage for liability arising out of animal bites, with $25,000.00 in limits per occurrence. In August 2002, James Geiger was bitten by Plaintiff's dog and was hospitalized due to injuries sustained from the bite. Plaintiffs submitted Geiger's claim to the insurance company to handle. The adjuster assigned to handle the claim immediately tendered certain med pay coverage, but refused to tender any of the $25,000.00 in liability benefits to Geiger absent proof of liability despite the fact that S.C. Code § 47-3-110 imposes strict liability upon dog owners for damages arising from dog bites, except in limited circumstances. Geiger brought suit against Plaintiffs and the case proceeded to trial with the jury awarding Geiger $50,500 in damages. The insurance company paid its policy limits and Plaintiffs paid the remaining $25,500.

Thereafter, Plaintiffs filed this suit against the Defendant insurer seeking a declaratory judgment and damages for insurer's breach of contract, negligence, and bad

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[14] *Id.* at 575.
[15] *Cooper Industries, Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001).
[16] *James v. Horace Mann Ins. Co.,* 638 S.E.2d 667 (S.C. 2006).

faith. At trial, Geiger testified that the adjuster told him that he must prove negligence to recover any amounts in excess of the med pay coverage. Importantly, Geiger also testified he would have accepted a settlement offer prior to hiring an attorney and he would not have hired an attorney if the adjuster had told him the correct law and agreed to cover his medical bills and lost wages. The action was submitted to the jury which awarded Plaintiffs $146,600 in actual damages and $1 million in punitive damages. The insurer moved for new trial nisi remittur and asked the trial court to reduce the punitive damage award. The trial court denied the motion.

Defendant insurance company appealed, arguing the trial court erred in not reducing the punitive damages award and that the award of punitive damages violated due process. The Court noted that previously in *Gamble v. Stevenson*[17] South Carolina developed an eight factor post-verdict review that trial courts are required to conduct to determine if a punitive damages award comports with due process. The United States Supreme Court in *BMW of North America v. Gore*[18] has also set forth three guideposts that trial courts must apply to an award of punitive damages to determine whether the award violates due process. The Gamble factors are: 1) defendant's degree of culpability; (2) duration of the conduct; (3) defendant's awareness or concealment; (4) the existence of similar past conduct; (5) likelihood the award will deter the defendant or others from like conduct; (6) whether the award is reasonably related to the harm likely to result from such conduct; (7) defendant's ability to pay; and (8) other factors deemed appropriate.[19] The trial court concluded that the insurer's degree of culpability was significant because of the adjuster's false statement regarding the applicable law, and the insurer attempted to conceal this conduct. The court determined the ratio of actual to punitive damages of 6.82 times was reasonable, and the insurer stipulated it had the financial resources to satisfy the judgment. In applying the *Gamble* factors, the court concluded that the trial court conducted a proper post-verdict review and that the punitive damage award

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[17] *Gamble v. Stevenson*, 406 S.E.2d 350 (S.C. 1991)
[18] *BMW of North America v. Gore*, 517 U.S. 559 (1996).
[19] *Gamble v. Stevenson*, 406 S.E.2d 350, 354 (S.C. 1991).

comports with due process. The court noted “Although we find the punitive damages award was reasonable under the *Gamble* factors, we must also review the trial court's ruling on punitive damages under *Gore*.” [20]

The Court further examined the award in light of the *Gore* guideposts which are: 1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual and potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases. In evaluating the first guidepost the Court concluded that the insurers conduct was “extremely reprehensible.” As to the second, the Court noted that a single digit multiplier was more likely to comport with due process and concluded that even though a substantial portion of the actual damages award was nonpecuniary it was not duplicative of the punitive award. Thirdly, in comparing the punitive award to comparable civil penalties (i.e. S.C. Code § 38-2-10 which allow Department of Insurance to impose administrative penalties of $15,000 or $30,000 if the conduct was willful) the Court found “the statutory penalties are set at such a low level, there is little basis for comparing it with any meaningful punitive damage award.”[21]

Ultimately the Court upheld the punitive damage award and found the award was reasonable, and not the result of passion, caprice, or prejudice, and not in violation of due process.

In sum, the recent decisions regarding bad faith claims deal primarily with the imposition of punitive damages. The holding in *State Farm Mut. Automobile Ins. Co. v. Campbell* has been highly criticized by other courts. Justices Scalia, Thomas and Ginsburg filed dissenting opinions. Justices Scalia and Thomas are of the opinion that the Due Process Clause provides no substantive protections against “excessive” or

[20] *James v. Horace Mann Ins. Co.,* 638 S.E.2d 667, 671 (S.C. 2006).
[21] *Id.* at 672.

"unreasonable" awards of punitive damages. Justice Ginsburg focused on the conduct of State Farm and believed that the judgment of the Utah Supreme Court should have remained undisturbed. Since that opinion was handed down, Chief Justice Rhenquist and Justice O'Conner have been replaced by Chief Justice Roberts and Justice Alito. As a result, it is highly likely that the impact of the *State Farm* case will be short lived.

D. New Legislative Initiatives

There is no current pending legislation in South Carolina that would affect bad faith claims. Legislation is currently pending to repeal or modify portions of the McCarran-Ferguson Act for the purposes of bringing the insurance industry under more pervasive federal regulation. The primary goal of those advocating change appears to be subjecting the insurance industry to the anti-trust constraints of the Sherman, Clayton, and Federal Trade Commission Acts. On February 15, 2007, the U.S. Senate introduced a proposed amendment to the McCarran-Ferguson Act entitled The Insurance Industry Competition Act of 2007, S.618. On that same date a proposed bill with the same name was introduced in the House as H.R. 1081. Both proposals seek to provide for Federal regulation of unfair methods of competition as between insurers by placing them under the auspices of the Federal Trade Commission Act and the Department of Justice. To date, both bills remain in committee. These proposals would not affect the state common law regarding bad faith claims but do signal an incursion by the Federal government into areas of regulation previously controlled by the states.