

Avoiding Pitfalls in the Expanding Scope of Bad Faith Liability

Practical advice and good faith practices to apply from the beginning of a claim to its resolution.

By Michael A. Hamilton

Insurance bad faith continues to be an area of significant concern for the insurance industry. Over the past several years, many jurisdictions have expanded the scope of an insurer's potential liability for bad faith damages. These developments include the erosion of attorney-client privilege protections, dilution of standards for imposing bad faith liability, increases in institutional bad faith claims, and the broadening of the size and scope of punitive damage awards. Claims professionals must be increasingly vigilant when it comes to handling insurance claims, starting from the acknowledgement of a claim through to the claim's resolution. This article will provide practical advice on avoiding bad faith with good faith practices.

Critical Initial Stages of a Claim

The promotion of good faith at all points in the investigation and claims handling process is paramount. Having a clear philosophical approach starts when the claim is first submitted. At the outset, claims professionals should be familiar with claims handling regulations and any special time requirements for the state laws that apply to the loss. In some jurisdictions, failure to comply with these requirements could be used later as evidence of bad faith conduct. Likewise, it is equally important for all personnel to review the insurance company's internal claims handling guidelines, if any. While the relevance of such claims manuals or protocols has been the subject of many discovery battles in bad faith litigation, it is a good business practice to be familiar with the established internal procedures.

Once a claim is submitted, prompt and frequent communications with the insured are necessary. While this keeps the insured informed about the progress of the investigation and the processing of the claim, it also gives the insurance company the opportunity to demonstrate in writing that it is responding in good faith and a reasonable fashion.

In light of recent court rulings concerning the erosion of the attorney-client privilege, especially as it pertains to bad faith litigation, claims professionals should prepare every internal and external communication with the expectation that someday it may be viewed by a judge or jury. In this age of digital communications, social media, and shorthand, the chances of someone misinterpreting what has been written have increased dramatically. Thus, communications should be clear, unbiased, and detailed.

Reasonable and Timely Evaluation

In many court decisions discussing potential bad faith liability, whether first- or third-party claims are involved, the timeliness of the investigation and communications is often at issue. One of the most frequent complaints concerning the investigation of a claim is what a policyholder perceives to be an unnecessary delay. Insurers are exposed to bad faith not only by the actual delay in evaluating coverage, but the lack of diligence in moving the claim forward in a timely manner. To guard against delays, claims professionals must be proactive. This can come in many forms from file diaries and follow-up phone calls and letters to documenting the efforts made to move the claims process forward.

Insurers must consider all relevant coverage issues and base any coverage determination on the applicable law. In many jurisdictions, a coverage determination is made in good faith when it starts with an analysis of whether the insurer acted reasonably under the circumstances. Accordingly, an insurer should not make a constrained interpretation of policy language in order to avoid a finding of coverage. Likewise, claims for coverage should not be denied without an adequate and documented investigation.

When an insurance claim raises a coverage issue, the claims professional may want to seek the advice of legal counsel. The significance of the insurer's reliance on the advice of independent counsel may depend later on whether the insurer uses it as a defense in bad faith litigation. Insurers must be mindful, however, that reliance on the advice of independent counsel as evidence that it acted in good faith may result in a waiver of the attorney-client privilege.

In the first-party context, use and reliance on experts can provide strong evidence in the defense against an allegation of bad faith. Careful examination of the expert's qualifications, sharing of all relevant information with the expert, and avoiding the appearance of bias by keeping communications objective and nonsuggestive are all practical ways to maximize the effectiveness of the insurer's expert.

In third-party claims, when an insurer faces a settlement demand, the underlying claim must be investigated adequately. Claims professionals should make efforts to document the claims file, recording the steps taken to investigate the claim. A paper trail should be created evidencing that all relevant documentation has been requested and is being considered and evaluated. In addition, the insurer should note every communication with the claimant and make sure it timely responds to any inquiries from the policyholder. With respect to settlement offers, any offer must be reasonable and fair based on the facts at hand and the law. Lowball offers or failure to accept a reasonable offer can be used against an insurer to demonstrate bad faith in some states.

Be Aware of Good Faith Obligations

As the claim moves along, if there comes a point when an undisputed amount is owed, the insurer should pay that amount. This helps minimize potential bad faith exposure down the road.

Even after a claim is resolved in the insurer's favor—for example, where a policyholder unsuccessfully sues for breach of contract—that does not always mean bad faith liability is avoided. While in many instances a party cannot recover for breach of the covenant of good faith and fair dealing if they cannot also recover for breach of the contract, some jurisdictions hold that judicial determinations in the insurer's favor for breach of contract do not preclude bad faith claims. The reasoning employed by some courts is that breach of contract and bad faith claims are separate and distinct causes of action.

In addition, as institutional bad faith claims continue to rise, it is important for carriers to review continually and reassess overall business practices and training. There is nothing wrong with running a successful and profitable insurance company; in fact, there is a corporate obligation to do so. The company's claims operations appropriately contribute to its business goals. Providing excellent service, avoiding underpayment of claims, and thoroughly investigating claims help a company meet these goals.