

Insurance bad-faith mediations

Bad-faith mediations present a challenging set of issues and dynamics that affect how they are best approached and conducted

By Doug deVries

Insurance bad-faith case mediations involve negotiating a unique mix of contract and tort claims. Evaluation and settlement tend to reflect their multi-tiered nature, complexity, and a primary emphasis on addressing underlying contract issues. Preparation by both plaintiffs and defendants before the mediation enhances the prospects for meaningful negotiation and resolution.

Historical background of insurance bad-faith law

An insurance bad-faith tort cause of action seeks to establish that an insurance company, by act or omission, has breached the covenant of good faith and fair dealing implied by law into all insurance policies. (*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654.) While a covenant of good faith and fair dealing is implied in most contracts, it is only in the context of insurance contracts that exposure to extra-contractual tort damages arises from a breach. (*Foley v. Interactive Data Corp.* (1988) 47 Cal.3d 662.) Potential recoveries for insured plaintiffs and corresponding potential exposures for insurer defendants include not only damages for breach of contract, but also attorney fees, emotional distress, and punitive and exemplary tort damages. (*Egan v. Mutual of Omaha Ins. Co.* (1979) 24 Cal.3d 809; *Brandt v. Superior Court* (1985) 37 Cal.3d 813.)

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In California, proof of bad faith requires a showing of more than negligence, but does not require a showing of willful or intentional misconduct. To prove bad faith, the plaintiff must establish that an insurer's breach of its contractual duties and obligations constitutes an unreasonable interference with the insured's rights without proper cause, effectively placing the insurance company's interests above those of its insured. (*Major v. Western Home Ins. Co*. (2009) 169 Cal.App.4th 1197; CACI No.2330.)

Insurance claims handling

The basic standards for fair insurance claims handling are set forth in Insurance Code section 790.03, subdivision (h) and related regulations contained in 10 California Code of Regulations section 2695.1 et seq.; CACI No. 2337.

Essentially, insurance companies are required to promptly, fairly, and reasonably investigate, evaluate, and provide benefits that the insureds are entitled to under the terms of the applicable insurance policy. In this regard, however, while the statute and regulations may be referenced by an expert in opining on reasonable industry standards, violation of them does not create a right of action. (*Moradi-Shalal v. Fireman's Fund Ins. Co*. (1988) 46 Cal.3d 287.) In addition to these standards, reference may be made to general industry standards and an insurance company's internal claims-handling standards.

Two categories of bad-faith cases

Insurance bad-faith actions can be divided into two broad categories:

- First-party cases involving direct actions brought by an insured against their insurer for policy benefits; and
- Third-party cases involving direct-action suits brought against an insurer by judgment creditors of insureds and suits brought by third parties as assignees of an insured, typically in the context of excess judgments.

Insurance bad-faith allegations arise in various insurance contexts, such as automobile, life, disability, health, accidental death and dismemberment, homeowners, commercial, construction, professional errors and omissions, director and officer, employment practices, etc. As a result, the factual contexts underlying bad-faith claims are highly variable, as is the need for developing underlying subject matter expertise as well as non-insurance and insurance expert support.

Insured's burden of proof

Given that bad-faith liability arises from an implied covenant in an insurance policy, contract issues are a primary focus. It is incumbent upon plaintiffs to establish in the first instance that they are entitled to coverage under the applicable insurance policy to which the covenant attaches.

Plaintiffs have the burden of proof to establish that the insurance policy relationship exists, that the policy was in force at relevant times, and that the policy provided coverage for the benefits claimed to have been interfered with or denied. (*Major v. Western Home Ins. Co.*, *supra*.)

Insurer defenses

The covenant of good faith and fair dealing applies to both parties to the insurance contract. However, while insureds can state an affirmative tort claim for bad faith against insurers, there is no counter-claim for insurers for an insured's conduct. Instead, the insured's conduct may be considered when assessing the insurer's conduct. (*Kransco v. American Empire Surplus Lines Ins. Co*. (2000) 23 Cal.4th 393.) In addition, an insured's failure to reasonably cooperate is typically available as a contract defense, and misrepresentation or concealment by the insured may operate as a complete defense. (*Campbell v. Allstate Ins. Co*. (1963) 69 Cal.2d 303; *Cummings v. Fire Insurance Exchange* (1988) 202 Cal.App.3d 1407; CACI No. 2309.)

Lack of coverage for the contractual right or benefit claimed by the insured is asserted as a complete defense, including bad faith. (*Waller v. Truck Exchange, Inc*. (1995) 11 Cal.4th 1.) In turn, this defense may involve issues concerning the appropriate interpretation of the meaning and application of policy terms. Insurance policies are interpreted according to rules applicable to all contracts, but ambiguous terms may be construed to favor coverage. (*Boghos v. Certain Underwriters at Lloyd's of London* (2005) 36 Cal.4th 495.) If a conflict arises over policy terms asserted as a limitation or exclusion of coverage, the burden of proof is on the insurer. (*Aydin Corp. v. First State Ins. Co*. (1998) 18 Cal.4th 1183.)

Reasonableness is the antithesis of bad faith and operates to counter a bad-faith claim. (*Morris v. Paul Revere Life Ins. Co*. (2003) 109 Cal.App.4th 966.) In this regard, insurers assert that mere breach of contract, or mistake or sloppiness in claim handling and determinations do not support a finding of bad-faith liability. (*Tomaselli v. Transamerica Ins. Co*. (1994) 25 Cal.App.4th 1277; *Patrick v. Maryland Casualty Co*. (1990) 217 Cal.App.3d 1566.) The breach-of-contract remedy does not include bad-faith tort damages, and contract damages do not include attorney fees, emotional distress, or punitive and exemplary damages.

Insurers often assert the "genuine dispute doctrine," which essentially holds that an insurer cannot be liable for bad-faith tort damages if, following an otherwise reasonable investigation and evaluation, there remains a legitimate dispute about either the entitlement to benefits or the number of benefits, depending on the type of insurance dispute at issue. (*Wilson v. 21st Century Ins. Co*. (2007) 42 Cal.4th 713; *Chateau Chambray Homeowners Assn. v. Associated Internat. Ins. Co*. (2001) 90 Cal.App.4th 339.)

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Preparation for mediation of a bad-faith claim

Consistent with their experience, insurers tend to take a well-established institutional approach to preparation for mediation. The insurer receives input from retained outside counsel and its claim, legal and financial departments. Assessment of the case, settlement authority, and negotiation strategies and targets are determined.

Given the nature and timing of insurer preparation for bad-faith mediations, plaintiffs' best opportunity to inform and influence an insurer's approach to mediation typically presents itself before rather than during the mediation. This may include conducting thorough discovery to identify and obtain facts, witnesses, and documents, deposing fact witnesses, acquiring the claim file and relevant guidelines, and deposing key claims personnel. If punitive and exemplary damages are a serious objective, the "managing agent" (that person who made the final authorized decision committing the insurer to its claim determination) is identified and deposed. (*Egan v. Mutual of Omaha*, *supra;* Civ. Code, § 3294.)

Plaintiffs can choose to communicate to the insurer their assessment of the insurer's bad-faith risk supported by evidence, affirmative discovery, and analysis well in advance of mediation. If they choose not to do so, the insurer's assessment and preparation for negotiation will be driven solely by its own experiences and self-interest. The more complete the evidence developed by the parties and shared before the mediation, the more likely a negotiation involving the potential for extra-contractual damages may occur.

Evaluation of risk before mediation

It is axiomatic that the value of cases will be affected by the risk of an adverse outcome. Parties, therefore, consider uncertainty of outcome as a material factor in their assessment of settlement value. In bad-faith cases, the risk analysis becomes multi-layered and complex due to the tiered nature of liability. In addition, each layer potentially contains multiple contested issues that can present uncertainty of outcome for both sides. Risk assessment, in turn, requires an acknowledgment that the effect of risk on the outcome is cumulative. In other words, in bad-faith cases, for either party to achieve their intended result, they must encounter numerous obstacles or hurdles, each of which may be highly contested, and which may adversely impact settlement objectives or value.

The three basic liability and damages categories in bad-faith cases can be viewed as progressive regarding the difficulty and uncertainty they present at each level. While potentially presenting complex issues, breach of contract involves a relatively lower level of difficulty and a higher level of outcome predictability, both as to liability and amount of damages.

Bad faith is generally more difficult to establish and less predictable regarding liability and amount of damages. Establishing a right to acquire punitive and exemplary damages is exceedingly difficult and unpredictable. For these reasons, mediation of bad-faith cases often focuses primarily on contract liability and damages, secondarily on bad-faith liability and damages, and rarely on punitive and exemplary damages.

Plaintiff risk considerations

Assessment of the advisability of settling the case versus going to trial, referred to as "BATNA analysis" (Best Alternative To A Negotiated Agreement), takes on special significance in bad-faith cases due to their tiered nature. Proceeding to trial on both contract and bad-faith claims can be an expensive proposition involving significant costs associated with extensive discovery and retention of both non-insurance and insurance experts.

If a plaintiff proceeds to trial and loses, they get nothing and are exposed to a defense cost bill. On the other hand, if they win on both contract and bad-faith claims, they stand to obtain a potentially significant verdict. However, if the plaintiff wins the contract claim but loses the bad-faith claim, only contract damages will be recovered. Losing the bad-faith claim at trial carries adverse economic consequences, especially when the contract benefits at issue are modest, as all accrued costs and attorney-fee obligations will operate to reduce the plaintiff's net contract recovery.

Insurer risk considerations

Unlike the plaintiff insured, whose risks are more personal, the insurer's risk assessments are qualitatively different. Evaluating insurer risks with respect to contract benefits is essentially an extension of the insurer's prior claim-handling process. In terms of evaluation, those same benefits had previously been the subject of a process in which the insurer evaluated and established claim reserves at the inception of the insured's claim well before litigation was initiated.

Extra-contractual damages are a different matter. They were not the subject of prior routine evaluation and they are not similarly predictable. If a jury finds an insurer liable for bad faith, there is no formula for determining the amount of an emotional distress award. (CACI No. 2350.) In addition, an award of attorney fees can vary not only in relation to the amount of contract benefits but can also be partially based on the amount of extra-contractual damages other than punitive damages. (*Cassim v. Allstate Ins. Co*. (2002) 100 Cal.App.4th 776.)

The most unpredictable, and potentially concerning, damage exposure the insurer faces is the prospect of punitive damages. Such damage awards represent a condemnation of the insurer and its practices, which can attract unwelcome public and regulatory scrutiny. While punitive damages are not predictable, in general they are now subject to predictable upper limits as a result of the Supreme Court's ruling in *State Farm v. Campbell* (2003) 538 U.S. 408. Essentially, the court held that

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imposition of damages in excess of nine times the compensatory damage award is violative of due process and that any award more than three times compensatory damages may be scrutinized as constitutionally suspect.

Understanding opposing self-interests presented during mediation

Negotiation in insurance bad-faith case mediations, as in other mediations, is driven by the competing self-interests of the participants. The interests of plaintiffs, whether individuals or businesses, are typically singular or personal in their pursuit of a bad-faith remedy.

However, the interest is institutional for insurance companies sued for bad faith. Unlike other tort cases in which the insurer defends its insured's interests against third-party claims, where the insurer defends itself, its policies and practices, employees and agents, reputation, and money are at stake.

The different nature of the participants' interests affects how each prepares for negotiation and assesses their self-interest throughout the negotiation. Both sides typically conduct discovery and otherwise prepare their cases with a view toward success, but that is where the similarity of interest ends.

Defendant insurance companies typically have experience with multiple prior similar cases, whereas the plaintiff is unlikely to have such experience. The insurance bad-faith remedy was first recognized in *Brassil v. Maryland Casualty Co.*, 210 N.Y. 235 (1914), so the insurance industry has many years of experience defending bad-faith cases, assessing them, and negotiating them.

Dynamics of mediation negotiations

Mutual exchange of mediation briefs between parties has become uncommon in bad-faith mediations. Either the plaintiff shares its brief and the insurer does not, or neither party shares their brief.

Two primary factors contributed to insurance carrier reluctance to serve a mediation brief over the last 30 years. First, insurers became concerned that sensitive information about their claim handling was being widely disseminated among the plaintiffs' bar despite expected confidentiality. Second, insurers became reluctant to preview the case-specific legal authorities and analysis they would later use to support potential dispositive motions if settlement was not achieved at the mediation.

Difficult starts to negotiation in bad-faith mediations are the norm. Plaintiffs tend to open with high demands that incorporate all elements of potentially available damages for both contract and bad-faith claims. Depending on the case, this can include punitive damages. However, it is more common in bad-faith mediations for punitive damages to be referenced only generally as a potential exposure but not included in the numerical demand. Defendant insurers tend to open with low offers focusing on contract damages and communicating a rejection of liability in general and extra-contractual tort liability in particular.

As a result, significant disagreements are expected at the outset of the negotiation. Working through them with the mediator's assistance usually involves an intensive exchange and discussion of specific party positions. The focus is on the significant liability and damages issues that can impact case valuation, including the attendant risks.

The mediator reviews the submitted briefs in detail and endeavors to present to each party an accurate and effective presentation of the opposing party's legal and factual assertions along with monetary demands and offers that are being exchanged. In the process, the mediator guides the parties to move away from a focus on positional disputes to the positive aspects of money negotiation and ultimate resolution.

Insurer liability

Insurance bad-faith liability involves the plaintiff attempting to establish three different remedial tiers – contract, tort, and punitive and exemplary damages. If the plaintiff meets its burden of proof by a preponderance of evidence and prevails on a breach-of-contract claim, the recovery can include contract benefits, including pre-judgment interest, but not tort damages. If the plaintiff meets its burden of proof by a preponderance of evidence on bad faith, the plaintiff can also recover, in addition to contract benefits, *Brandt* costs and attorney fees, and emotional-distress damages. (*Brandt v. Superior Court*, *supra*.) To recover punitive damages, however, the plaintiff must prove, in addition to bad faith, that the insurer acted with intent, malice, oppression, or fraud by clear and convincing evidence, as required by Civil Code section 3294.

Unique mediation settlement agreement terms for bad-faith cases

When an insurance bad-faith case settles, in addition to dismissal of the entire action with prejudice and other standard release provisions, insurers invariably insist on including a confidentiality provision and occasionally a non-disparagement clause in the release or settlement agreement.

In addition, the matter of "surrender" can arise. For instance, in the case of life insurance and disability insurance, settlement often includes the surrender of an individual policy or all rights under group policies. On the other hand, in cases involving other types of insurance claims, the policies are not necessarily surrendered but remain in effect. In these cases, "carve out" provisions may be included to provide for the release of certain claims or coverage but otherwise maintain coverage in force.

Finally, there is the matter of the potential taxability of insurance

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bad-faith settlements, a complex subject that cannot be fully covered in this article. As a general observation, tort recovery on an insurance bad-faith claim does not constitute recovery for physical injury, so obtaining tax advice may be advisable. Neither counsel nor insurers generally include taxability in the settlement negotiations. Still, the manner and timing of settlement funding may be discussed with tax considerations in mind. Releases and settlement agreements invariably include broad disclaimers regarding the issue of taxation.

As in other mediations, the essential terms of agreed bad-faith settlements can be memorialized by use of term sheets signed by the parties at the conclusion of the mediation. In state-based cases, an executed written term sheet will be subject to enforcement pursuant to Code Civil Procedure section 664.6. In federal court, the state code section does not apply but the court has inherent power to enforce agreements. (See *Facebook, Inc. v. Pacific Northwest Software, Inc*. (9th Cir. 2011) 640 F.3d 1034.)

Conclusion

Insurance bad-faith mediations present challenging dynamics. The participants' different interests and approaches affect how they are prepared for and conducted. Negotiation can be difficult given the multi-tiered nature of the remedies. Effective preparation for the mediation is essential to a successful resolution.


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