CARLTON FIELDS

Reverse Bad Faith: Does It Exist And Can It Be Useful?

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Last month, in *State Auto Property & Casualty Ins. Co. v. Hargis*, No. 13-5020 (6th Cir. May 6, 2015), the U.S. Court of Appeals for the Sixth Circuit predicted that the Kentucky Supreme Court would not allow insurers to sue policyholders for the tort of "**reverse bad faith**." The court's analysis drew a distinction between the duty of good faith and fair dealing that is implied by law into contracts and the distinct, common law duty that arises from a "special relationship" between the parties. Only the latter duty gives rise to a tort claim. The court also found that no other state has recognized a tort of reverse bad faith. Yet, given recent interpretations of the **contractual** duty, it's arguable that "reverse bad faith" is already here—and what we *should* be asking is whether it can be of any use. **Burning Down the House**

Lori Hargis of Henderson, Kentucky, asked a friend to burn her house down for $10,000 out of the insurance proceeds. When the friend obliged, Ms. Hargis filed a claim under a homeowner's policy with State Auto. The insurer paid out more than $425,000 before filing an action in state court to declare the policy void. The case made some progress—it was removed to federal court, and Ms. Hargis's motion for summary judgment was denied—before circumstances forced Ms. Hargis to plead guilty to the crime (among others) of using fire to commit wire fraud. (Yes, that's a thing. 18 U.S.C. § 844(h).) Her sentence included an order to pay restitution, and the amount of the restitution included the **investigation costs and attorneys' fees** that State Auto had incurred in connection with the claim. Meanwhile, State Auto filed an amended complaint in its declaratory judgment action, seeking to recover whatever losses might not be fully compensated by the order of restitution. The amended complaint added both (i) a statutory claim for a "fraudulent insurance act" and (ii) a claim for what the insurer called "reverse bad faith." In the latter case, State Auto asserted that Ms. Hargis, by committing fraudulent insurance acts, had breached "the duty of good faith which is implied in every contract"—and that State Auto was "**entitled to consequential damages flowing from Hargis' breach**." The district court dismissed the "reverse bad faith" claim, and State Auto appealed. **What, Never?**

In affirming the district court, the Sixth Circuit emphasized two points: (i) that "**[a] common law tort claim for reverse bad faith has not been recognized in any jurisdiction**"; and (ii) that **a tort claim for bad faith differs from a contractual claim for breach of covenant**. That is, while every policyholder—as a party to a contract—owes a contractual duty of good faith and fair dealing, the

court explained that a tort claim for bad faith arises out of a **different duty**.

> The covenant of good faith is an obligation [owed] by both parties, and breach of this covenant can be the basis of **a viable breach of contract claim**. **A *separate tort claim* for bad faith arises from a violation of *a duty to act in good faith that is imposed by the common law, not* by the terms of the contract**. However, **an independent tort claim for breach of that [tort] duty is only permitted where there is a special relationship between the parties** and where distinct elements are present, such as: unequal bargaining power, vulnerability, and trust among the parties; ... and inadequacy of standard contract damages.

See also Kransco v. American Empire Surplus Lines Ins. Co., 2 P.3d 1 (Cal. 2000) ("[T]he scope of the insured's duty of good faith ... and the remedies available to the insurer for a breach ... are fundamentally and conceptually distinct from the insurer's reciprocal duty ... and the remedies available to the insured"). This, the court explained, is why it believes the **common law** duty of good faith is **not** a two-way street. Kentucky's Supreme Court has elaborated this point:

> [A policyholder's] bad faith action is based upon the **fiduciary duty owed by an insurance company** to the insured ... . Furthermore, the **disparate bargaining positions** of an insured and an insurer following a loss are sufficient to justify **treating the insureds as a different class** ... .

Farmland Mut. Ins. Co. v. Johnson, 36 S.W.2d 368, 380 (Ky. 2000). In short, the contractual good faith that a policyholder owes to an insurer is not commensurate with the good faith duty that the insurer owes, and it does not rise to the level of a common law duty. **Well, Hardly Ever!**

The analysis in *Hargis* is logical, but the basic issue of an insurer's rights against a fraudulent claimant might still be open to question. For one thing, the Court of Appeals might have slightly overstated the novelty of a "reverse bad faith" claim. The issue has not come up often, and the weight of authority is clearly against such a claim. *E.g.*, *AG Equipment Co. v. AIG Life Ins. Co.*, No. 07-CV-0556 (N.D. Okla. Oct. 10, 2008) ("an insurer may not bring a 'reverse bad faith' action against an insured"); *Royal Indemnity Co. v. Liberty Mut. Fire Ins. Co.*, No. 07-80172 (S.D. Fla. Feb. 28, 2008) (refusing to recognize defense of "comparative bad faith"); *In re Tutu Water Wells Contamination Litigation*, 78 F.Supp.2d 436, 452-53 (D.V.I. 1999) (asserting that no jurisdiction has "extended [the] protection" of the tort of bad faith to insurers); *First Bank of Turley v. Fidelity & Deposit Ins Co. of Md.*, 928 P.2d 298 (Okla. 1996) (no claim for reverse bad faith); Johnson v. Farm Bureau Mut. Ins. Co., 533 N.W.2d 203 (Iowa 1995) (no claim based on insured's bad faith filing of a coverage suit); *Tokles & Son, Inc. v. Midwestern Indem. Co.*, 605 N.E.2d 936 (Ohio 1992) (same). Nevertheless, at least one court appears to have recognized a tort claim for reverse bad faith. In *Fon v. Amica Mut. Ins. Co.*, No. 06-0607 (Mass. Super. Ct. April 30, 2008), an arbitrator ruled that the insured had made "material false statements" in connection with an uninsured motorist claim, and the court found that conclusion "**sufficient to support [the insurer's] ... claim[] of ... bad faith**." The court implied that the

standard is pretty high:

> Bad faith is not simply bad judgment or negligence; it 'imports **a dishonest purpose of some moral obliquity**. It implies conscious doing of wrong. It means a breach of a known duty through some motive of interest or ill will.'

Still, it ruled that making "material false statements" in connection with an insurance claim bears the requisite degree of "moral obliquity." *See also Callahan v. The Norfolk & Dedham Group*, No. NOCV20070365 (Mass. Super. Ct. Aug. 6, 2009) (suggesting that insurer could assert "reverse bad faith" as an affirmative defense). **Who Needs Torts?**

More importantly, the idea that insurers may enforce their insureds' **contractual** duty of good faith appears to be uncontroversial—even where a tort claim has been expressly rejected. So the real issue is **not** whether insurers may assert bad faith claims sounding in tort, but, rather, **whether some of the consequential damages that are available in a tort action might *also* be recovered in a bad faith suit sounding in contract**. After all, consequential damages have been available for **some** contract claims since *Hadley v. Baxendale*, 9 Exch. 341, 156 Eng. Rep. 145 (1854). The answer to this question will necessarily vary from state to state, but it is reasonable to expect contract law to develop in this direction. This is, after all, precisely what has happened to policyholders' claims. In New York, it has long been the rule that "there is no separate cause of action in tort for **an insurer's** bad faith failure to perform its obligations under an insurance contract." *Burkhart, Wexler & Hirschberg, LLP v. Liberty Ins. Underwriters*, 859 N.Y.S.2d 901 (N.Y. Sup. Ct. 2008), *aff'd*, 875 N.Y.S.2d 590 (2d Dep't 2009). But in 2008, New York's highest court ruled (in *Bi-Economy Market, Inc. v. Harleysville Ins. Co. of N.Y.*, 10 N.Y.3d 187 (2008)) that insurers may nevertheless be found liable for consequential damages arising out of breach of the contractual covenant of good faith and fair dealing. Under *Bi-Economy*, the dispositive issue is whether consequential damages were "**reasonably contemplated**" at the time of contracting, in light of

> what liability the [insurer] **fairly may be supposed to have assumed consciously**, or to have warranted the [policyholder] reasonably to suppose that it assumed, when the contract was made.

More recently, a number of New York trial courts have permitted claims that are hard to distinguish from the first-party bad faith suits common in other jurisdictions. *See, e.g., Mutual Association of Administrators v. National Union Fire Ins. Co. of Pittsburgh, PA*, 2012 WL 4752439 (N.Y. Sup. Ct. Sept. 17, 2012); *Schlachter, Stumbar, Parks & Salk, LLP v. OneBeacon Ins. Co.*, 2011 WL 6756971 (N.D.N.Y. 2011); *Savino v. The Hartford*, 886 N.Y.S.2d 69 (N.Y. Sup. Ct. 2009); *Rodriguez v. Allstate Ins. Co.*, 931 N.Y.S.2d 462 (Sup. Ct. 2011); *Grinshpun v. Travelers Cas. Co. of Conn.*, 23 Misc.3d 1111(A) (N.Y. Sup. Ct. 2009). **Reverse to the Future?**

The logic of *Bi-Economy* could easily be applied to reverse bad faith, and that is pretty close to what happened in *Utica Mut. Ins. Co. v. Century Indemnity Co.*, No. 6:13-CV-995 (N.D.N.Y. May 11, 2015). In that case, an insurer issued both primary and umbrella policies to a pump manufacturer that allegedly used asbestos in its packing and gaskets, and it purchased reinsurance for certain of the

umbrella policies. The policyholder sued for coverage, and the insurer settled the case in 2007. According to the reinsurer, the settlement "terminated [the insurer's] obligations under its primary policies … and shifted the financial obligations and burdens to the [reinsured] umbrella policies." It charged that the insurer, during negotiations with the policyholder, had expressly communicated about "introduc[ing] terms and findings into the settlement for the sole purpose of maximizing its reinsurance." The insurer sued the reinsurer, seeking additional reimbursement for payments under the umbrella policy. In March 2015, the reinsurer moved for leave to amend its answer and, specifically, to add counterclaims, including a claim for **breach of the duty of good faith and fair dealing**. In that claim, the reinsurer sought both a declaration that the insurer had forfeited its right to coverage and **consequential damages**—including the fees and costs associated with the insurer's lawsuit. Last month, the district court affirmed a Magistrate Judge's decision to grant the reinsurer's motion. The court observed that, under New York law, "a reinsured owes its reinsurer a duty of utmost good faith." Consequently, the court rejected the argument that the proposed amendment would be futile:

> This claim—whether labeled as one for 'reverse bad faith' or something else—is at least a plausible one under current New York precedent.

One Step Beyond

Utica Mutual did not discuss the duty of an insured, as opposed to a *reinsured*, but other courts have indicated, under similar circumstances, that **both a primary insurer *and its insured* owe the same duty of good faith to an excess carrier**. *A.W. Chesterton Co. v. Northbrook Excess & Surplus Ins. Co.*, No. 96-4871 (Mass. Super. Ct. Sept. 29, 1999); *Kaiser Foundation Hospitals v. North Star Reins. Corp.*, 153 Cal.Rptr. 678, 682 (Cal. Ct. App. 1979). More basically, there is nothing in that opinion—or even in the Sixth Circuit's analysis in *Hargis*—that would preclude an insurer from arguing that the costs of investigating and litigating a fraudulent claim were "reasonably contemplated," within the meaning of *Bi-Economy*, at the time the insured purchased the policy. After all, the insurer is *required* to investigate claims. Thus, there still appears to be plenty of space for litigation over "reverse bad faith." *See, e.g.*, *Endurance American Specialty Ins. Co. v. Lance-Kashian & Co.*, No. CV F 10-1284 (E.D. Cal. Sept. 13, 2010) (recognizing breach of covenant claim against insured that had allegedly obstructed liability insurer's ability to reduce the fees charged by insured's defense counsel). **Who Needs "Reverse Bad Faith"?**

A thornier question is whether reverse bad faith has any practical utility. In a first-party context, it would not appear to satisfy any pressing need. In *Hargis*, the insurer *already* had recourse under a Kentucky statute that awards "all reasonable investigation and litigation expenses"—albeit only in cases where "there has been a criminal adjudication of guilt." Ky. Stat. § 304.47-020(3). *See also Harleysville Mut. Ins. Co. v. Gray*, No. 1:11cv234 (W.D.N.C. March 19, 2012) (rejecting claim for reverse bad faith, where statutory claim required a criminal conviction). Even if Ms. Hargis had not entered a guilty plea, the insurer might still have been able to pursue those costs through a common law claim for fraud or misrepresentation. In *Fon*, for example, the court upheld a claim for "deceit" at the same time it appeared to create one for "bad faith." On the other hand, third-party cases present insureds

with numerous opportunities to collude with plaintiffs, or with co-defendants, or with defense counsel. Some of those acts of collusion might prejudice the rights of an insurer, even without violating any express policy term. When that happens, reverse bad faith looks like a plausible remedy. *Republished with permission by Law360 (subscription required). Originally published by PropertyCasualtyFocus.*

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