AMERICAN COLLEGE of COVERAGE COUNSEL

Novel Issues and Emerging Trends in Bad Faith Litigation

American College of Coverage Counsel
2022 Annual Meeting

Intercontinental Chicago
May 11-13, 2022

Angela R. Elbert
Neal Gerber & Eisenberg LLP
Chicago, IL
aelbert@nge.com

R. Hugh Lumpkin
Reed Smith, LLP
Miami, FL
hlumpkin@reedsmith.com

Rick Hammond
Insurance Claims and Litigation Consultants, LLC
Lisle, IL
rickhammond@insurancelawconsultants.com

Bryan Weiss
Selman Breitman LLP
San Francisco, CA
bweiss@selmanlaw.com

Bad Faith in the Absence of Coverage - Recent Trends and Developments
***Coventry v. American States* and its Progeny**

Rick Hammond, J.D., CLU
Insurance Claims and Litigation Consultants, LLC

Background

One of the leading cases regarding the issue of bad faith in the absence of coverage and, therefore, the starting-off point for this article is *Coventry Associates v. American States Insurance Company*, 136 Wash. 2d 269, 961 P.2d 933 (1998). In *Coventry*, American States essentially conceded that it had acted in bad faith while investigating Coventry's claim, but contended that its bad faith conduct was not actionable as a matter of law because it had been established that there was no coverage for the insured's loss. In essence, American States argued that because its denial of the claim ultimately proved to be correct, Coventry was not harmed as a result of its bad faith claims investigation. However, Coventry argued that an insured suffers harm from a bad faith claims investigation regardless of whether the denial of coverage eventually turns out to be appropriate.

Both the trial court and the Washington State Court of Appeals agreed with American States and determined that Coventry was unable to establish harm, even though the denial of their claim may have been procedurally deficient. According to the Court of Appeals, "mere procedural errors in handling a specific claim do not support an action for bad faith because the errors do not harm the insured." However, the Washington Supreme Court disagreed and reversed both lower courts and held that an insured may maintain an action against its insurer for a bad faith investigation of its claim and for violating the Claims Practices Act ("CPA"), regardless, of whether the insurer was ultimately correct in determining that coverage did not exist, i.e., an insurer's duty of good faith is separate from its duty to indemnify if coverage exists. Although the court determined that a proper cause of action for bad faith existed, it also held that the insured has a burden to prove damages:

> While we hold the cause of action is available to first-party insureds, we decline to hold in the first-party context a rebuttable presumption of harm exists once an insurer acts in bad faith. This is not to say that a first-party insured suffers no harm when its insurer conducts a bad faith investigation of the claim. When an insurer fails to adequately investigate an insured's claim, the insured must either perform its own investigation to determine if coverage should have been provided or take no action at all. In either situation, the insured does not receive the full benefit due under its insurance contract.

The policyholder in *Coventry* also sought to impose coverage by estoppel, i.e., a remedy that may be extended to an insured where coverage was wrongfully or rightfully denied by the insurer, based on the insurer's bad faith claims handling conduct. The court explained that while coverage by estoppel may be appropriate in certain third-party bad faith actions, it is not the appropriate remedy in most first-party bad faith actions. Thus, in the third-party context, an insurer's failure to honor the contractual obligation to protect the threatened interests of the insured "contributes" to the harm suffered by the insured. Whereas, in the first-party bad faith context, the loss occurs before the insurer is even aware that a claim exists and, therefore, the insurer does not contribute to the loss.

After considering the parties' arguments, the court held that Coventry was not entitled to coverage by estoppel or a return of a portion of its premium, but that its damages are limited to the amounts it incurred as a result of the bad faith investigation, as well as general tort damages:

> The record before us establishes that Coventry was required to go through some financial expense as a result of the bad faith investigation conducted by American States. These expenses include the cost of hiring their own experts and investigators to determine if American States should have covered the claim. To that extent, Coventry is entitled to make a claim for those amounts and damages normally associated with bad faith and CPA violations. Coventry must, like every other plaintiff, establish those damages at trial.
>
> American States violated its duty of good faith and fair dealing in investigating Coventry's claim. Although coverage was eventually shown to be excluded under the policy, American States still breached its contract with Coventry by acting in bad faith and, thus, harming Coventry. As such, Coventry is entitled to bring actions for bad faith and violation of the CPA. Coventry is not entitled, however, to coverage by estoppel or return of a portion of the premium paid. Rather, Coventry's damages should be limited to its expenses as a result of American States' bad faith acts and ensuing tort and CPA damages.

In the aftermath of *Coventry*, a small but, what seems to be, a growing number of states have established a cause of action for bad faith in the absence of coverage. Under that backdrop, the following is an overview of several recent and noteworthy multi-jurisdictional decisions that pick up where *Coventry* left off.

* * * * * *

Bad Faith in the Absence of COVID-19 Business Interruption Coverage

Albuquerque Ambulatory Eye Surgery Center v. Transportation Insurance Company, 1:21-cv-00280-KWR-JFR, US District Court for the District of New Mexico (October 12, 2021)

On March 11, 2020, the first confirmed case of COVID-19 was reported in New Mexico. That same day, New Mexico Governor, Michelle Lujan Grisham issued an executive order in response to the state's increasing infection rates and declared a public health emergency. In the following months, New Mexico's Department of Health Secretary, Kathyleen Kunkel, issued additional public health orders, including orders limiting the size of gatherings to no more than 100 people, advising citizens to stay home, and warning citizens to undertake only outings "absolutely necessary for their health, safety, or welfare." Additionally, on March 16, 2020, the American Academy of Ophthalmology issued an advisory that "all ophthalmologists cease providing any treatment other than urgent or emergent care immediately."

Albuquerque Ambulatory Eye Surgery Center LLC ("AAESC") is an eye surgery center in Albuquerque, New Mexico, was considered to be an essential business, and it alleges that its business was impacted by the coronavirus pandemic and the resulting government health orders, and seeks coverage from their insurer, Transportation Insurance Company ("TIC"), over the loss of the use of its premises, lost business income, extra expenses, and other business-related losses stemming from business disruptions caused by the coronavirus. TIC denied coverage under the policy and AAESC alleges that TIC failed to adequately investigate its claim. According to AAESC, the policy has no applicable exclusions" that would preclude coverage nor does it have a "virus exclusion" and, therefore, losses due to COVID-19 are covered losses under the policy to which TIC is responsible.

Under New Mexico law, an insurer who fails to pay a first-party claim is generally viewed to have acted in bad faith where its reasons for denying or delaying payment of the claim are frivolous or unfounded (See: *Sloan v. State Farm Mut. Auto. Ins*. Co., 85 P.3d 230, 236 (N.M. 2004)). The terms frivolous or unfounded in this context does not mean erroneous or incorrect, rather, it was construed to mean "an arbitrary or baseless refusal to pay, lacking any support in the wording of the insurance policy or the circumstances surrounding the claim." Therefore, an insurer may generally deny coverage without exposure to a claim of bad faith failure to pay as long as it has reasonable grounds for the denial (*Haygood v. United Servs. Auto. Ass'n*, 453 P.3d 1235, 1241 (N.M. 2019)). Generally, reasonable grounds will follow from a reasonable investigation, but where an insurer fails to make an adequate investigation, it may be liable for a bad faith denial of a claim.

However, in response to a motion by TIC to dismiss AAESC's claims for bad faith, the court denied the motion and noted:

> On one hand, claims of bad faith to pay "cannot arise unless there is a contractual duty to pay under the policy…." (quoting Charter Servs., Inc. v. Principal Mut. Life Ins. Co., 868 P.2d 1307, 1313 (N.M. 1994)). "[H]owever, a bad faith claim need not depend on the existence of coverage." Id. (emphasis added). Therefore, if bad faith is asserted as to conduct beyond a denial of coverage and the refusal to pay, the bad faith claim is actionable as to that conduct regardless of whether the contract claim survives. Id. ("Haygood might establish bad faith in a variety of ways-whether by proving Defendants failed to deal fairly in handling the claim, failed to conduct a fair investigation, or failed to fairly evaluate coverage, among other possibilities.").
>
> Here, Plaintiff plausibly alleges that Defendant failed to fairly investigate the claim. Plaintiff alleges that Defendant "did not follow up with its insured, request an interview, or visit the covered location. [Defendant] also failed to review ample publicly available and easily accessible information regarding [the] claim…." Plaintiff further asserts that "before AAESC even submitted its documentation in response to [Defendant's] May 8 inquiries, on May 22, 2020, without reviewing any facts around the claim or seeking additional information, [Defendant] denied coverage….." Finally, Plaintiff alleges that after requesting a consideration of the claim, "[i]nstead of considering the additional information, however, [Defendant] forced AAESC to chase a series of claims handlers for a response. Each time AAESC thought its claim was being reconsidered, it learned that CNA had once again changed claims handlers who were reviewing the claim…." Taking these facts as true, the Court finds that these allegations are sufficient to withstand a motion to dismiss. Plaintiff has pled a claim for bad faith independent of the failure to pay. Plaintiffs claim for bad faith is not entirely foreclosed even in the absence of coverage under the Policy. See Haygood, 453 P.3d at 1243.

Reconciling Bad Faith Claim with Contractual Time Limit to File Suit

West Beach Condominium v. Commonwealth Insurance Company of America Court of Appeals of Washington, Division 1 - 11 Wash.App.2d 791, 455 P.3d 1193 (January 13, 2020)

The West Beach Condominium Association retained a building consultant, the Amento Group, to conduct an assessment and investigation on each of its three condo buildings. On

September 8, 2015, the consultants uncovered water damage behind the exterior cladding and the buildings' envelopes. One year later, on September 26, 2016 West Beach filed a claim with their insurer, Commonwealth Insurance Company, while at the same time filed a lawsuit against Commonwealth in order to preserve any claims that may become time barred. The parties agreed to enter into a tolling agreement and West Beach dismissed its complaint without prejudice in order to allow Commonwealth time to conduct an investigation. Commonwealth retained an engineering consultant and subsequently elected to deny coverage contending that West Beach had been experiencing water intrusion issues for at least 10 years, and alleging that:

- All of the policies required suit to be commenced at least 12 months after the "occurrence" giving rise to the claim, and West Beach did not sue within that time period;

- The 2009 policy covered only direct physical loss or damage "commencing" during the policy period, and the 2010 and 2011 policies covered only direct physical loss or damage "occurring" during the policy periods. Commonwealth concluded that the losses West Beach had sustained neither commenced nor occurred during the applicable policy periods;

- The policies only covered "fortuitous risks," and none had been identified by West Beach;

- The policies did not cover faulty construction or inadequate repairs, and the Amento Group report identified numerous deficiencies that fell into this excluded category;

- The policies did not cover rust, corrosion, wear and tear, or gradual deterioration, and some of the losses fell into this excluded category; and

- The policies excluded coverage for mold, bacteria, fungi, and wet or dryrot, and some of the losses fell into this excluded category.

In May 2017, West Beach refiled its complaint, alleging breach of contract, bad faith investigation, and violations under the Consumer Protection Act (CPA) relating to the investigation of West Beach's claim and Commonwealth's denial of coverage. In order to prevail under the CPA, a plaintiff must prove (1) an unfair or deceptive act or practice, (2) occurring in trade or commerce, (3) with a public interest impact, (4) injury to the plaintiff's business or property, and (5) causation. A denial of coverage is not an unfair or deceptive act or practice if based on reasonable conduct by the insurer, even if the denial of coverage is ultimately proved incorrect. West Beach later filed an amended complaint adding a claim for violations under the Insurance Fair Conduct Act (IFCA). The IFCA provides that "[a]ny first-party claimant to a policy of insurance who is unreasonably denied a claim for coverage or payment of benefits by an insurer may bring an action…to recover the actual damages sustained."

In December 2017, the trial court held the 2009 policy did not cover any of West Beach's losses because the claimed damage commenced years before 2009. It also held that Commonwealth's 2010 and 2011 all-risk policies covered damage from faulty construction, faulty maintenance, and wind-blown rain, contrary to the position Commonwealth had taken in its denial letter. It also concluded that the policies covered damage resulting from a combination of excluded and non-excluded perils, and that Commonwealth was liable for all covered damage if any of the damage occurred during the policy periods.

Because the court found genuine issues of fact regarding the causes and timing of the claimed damages, Commonwealth moved to dismiss West Beach's breach of contract claim based on the "suit limitation" provision in the policies. The provision at issue required any lawsuit to be filed no later than twelve months after discovery of the loss. Commonwealth argued that West Beach had notice of its loss no later than September 8, 2015, the date Amento Group presented the results of its investigation, and West Beach did not file suit within one year of that date. In August 2018, the trial court granted Commonwealth's motion and dismissed West Beach's breach of contract claim.

Both parties subsequently filed motions for a legal ruling as to whether the suit limitation provision *also* barred West Beach's IFCA and CPA claims and, if not, what damages West beach could recover. Commonwealth argued that the suit limitation clause not only barred a breach of contract claim but it also voided its underlying coverage obligation under the 2010 and 2011 policies. It maintained that under *Coventry Associates v. American States Insurance Co.*, 136 Wn.2d 269, 961 P.2d 933 (1998), West Beach could not use the CPA or IFCA to obtain policy coverage that otherwise did not exist. West Beach contended that the suit limitation clause did not affect Commonwealth's obligations under the policy and that *Coventry* only addressed which damages a policyholder could recover in the absence of coverage. It asserted both IFCA and the CPA allow a policyholder to recover policy benefits when those benefits should have been paid by the insurer.

The trial court agreed with Commonwealth and dismissed the bad faith, CPA, and IFCA claims with prejudice and entered judgment for Commonwealth, ruling that

> [i]n light of [its] August 17, 2018 order granting [Commonwealth's motion to enforce the suit limitation provisions], [West Beach] cannot establish that Commonwealth's coverage denial was unreasonable. [West Beach] failed to allege any consequential damages proximately caused by Commonwealth's alleged bad faith or breach of the [CPA], and it cannot seek contract damages on its extracontractual claims.

West Beach filed an appeal arguing that, while the policies' suit limitation clause bars it from suing Commonwealth for breach of contract, it does not discharge the insurer's underlying coverage obligation. In other words, if Commonwealth violated the IFCA and the CPA by unreasonably denying West Beach's claim for coverage or payment of benefits, then West Beach can recover the contractual benefits that Commonwealth should have otherwise paid. The Court of Appeals agreed with West Beach and noted that Commonwealth's suit limitation clause says nothing about its underlying coverage obligations. It is merely a contractual modification to the statute of limitations otherwise applicable to West Beach's breach of contract claim.

> This clause does not negate coverage or extinguish Commonwealth's obligations under the all-risk policies. The trial court's dismissal of West Beach's IFCA claim was based on its determination that the suit limitation clause made Commonwealth's denial of coverage reasonable as a matter of law. Because West Beach has an independent statutory claim for failure to provide coverage and because the coverage obligation was not extinguished by the suit limitation clause, the trial court erred in concluding that Commonwealth's denial of coverage was reasonable as a matter of law. The suit-limitation clause does not affect Plaintiff's

extra-contractual claims for bad faith, violation of the CPA, and violation of IFCA.

The appellate court further noted that, in *Coventry,* the Washington Supreme Court held, that in the first-party context, coverage by estoppel is not the appropriate remedy because "the loss in the first-party situation has been incurred before the insurance company is aware a claim exists." But coverage by estoppel was at issue in *Coventry* only because the parties agreed that there was, in fact, no coverage for the claimed losses. Thus, Coventry's only allegation was bad faith in the investigation of its claim, not bad faith in the denial of coverage. It was in this context that the Supreme Court limited Coventry's damages to the amounts it incurred as a result of American States' bad faith investigation.

The court noted that in this case, West Beach contends that the Commonwealth's policies actually cover its claimed losses. In that regard, under the IFCA a claimant is entitled to actual damages sustained together with the costs of the action, and an insurer is liable for those damages proximately caused by its IFCA violations. Similarly, the CPA allows a plaintiff injured in his or her business or property" by a CPA violation to recover actual damages, and the deprivation of contracted-for insurance benefits is an injury to business or property. Thus, recoverable damages under both IFCA and the CPA can include policy benefits that were unreasonably denied, subject to the policy's limits and other applicable terms and conditions.

The Appellate Court concluded that Commonwealth's obligation to pay covered losses is triggered by the notice of loss, not the initiation of a lawsuit; that because West Beach has an independent statutory claim for failure to provide coverage and because the coverage obligation was not extinguished by the suit limitation clause, the trial court erred in concluding that Commonwealth's denial of coverage was reasonable as a matter of law; that *Coventry* does not apply unless and until a jury determines that no coverage exists under the two relevant policies, and that the trial court erred by not allowing the jury to decide whether the damage at West Beach's property was caused by covered perils and, if so, whether Commonwealth unreasonably denied coverage violated the IFCA and the CPA by failing to pay for that covered damage.

Texas Supports the Doctrine of Bad Faith in the Absence of Coverage

USAA Texas Lloyds Company v. Menchaca - Supreme Court of Texas - No. 14-0721 (April 13, 2018)

After Hurricane Ike struck Galveston Island in September 2008, Gail Menchaca contacted her homeowner's insurance company, USAA Texas Lloyds, and reported that the storm had damaged her home. USAA's adjuster investigated the loss but declined to pay Menchaca any benefits because the total estimated repair costs did not exceed the policy's deductible. Five months later, at Menchaca's request, USAA sent another adjuster to re-inspect the property and this adjuster generally confirmed the first adjuster's findings and, therefore, USAA again refused to pay any policy benefits. Menchaca sued USAA for breach of contract and for unfair settlement practices in violation of the Texas Insurance Code. As damages for her claims, Menchaca sought insurance benefits under the policy, plus court costs and attorney's fees. As damages for USAA's alleged statutory violations, she sought "actual damages," which include the loss of the benefits that should have been paid pursuant to the policy, court costs, and attorney's fees.

The parties tried the case to verdict and charged the jury with the following questions:

- Question one, which addressed Menchaca's breach-of-contract claim, asked whether USAA failed "to comply with the terms of the insurance policy with respect to the claim for damages filed by Gail Menchaca resulting from Hurricane Ike." The jury answered "No."

- Question two, which addressed Menchaca's statutory claims, asked whether USAA engaged in various unfair or deceptive practices, including whether USAA refused "to pay a claim without conducting a reasonable investigation with respect to" that claim. As to that specific practice, the jury answered "Yes."

- Question two separately asked whether USAA engaged in an unfair or deceptive act or practice by: "Failing to attempt in good faith to effectuate a prompt, fair, and equitable settlement of a claim when the liability under the insurance policy issued to Gail Menchaca had become reasonably clear;" "Failing to promptly provide to Gail Menchaca a reasonable explanation of the factual and legal basis in the policy for the denial of a claim(s);" "Failing to affirm or deny coverage within a reasonable time;" or "Misrepresenting to Gail Menchaca a material fact or policy provision relating to the coverage at issue." As to each of these specific practices, the jury answered "No."

- Question three asked the jury to determine the amount of Menchaca's damages that resulted from either USAA's failure to comply with the policy or its statutory violations, calculated as "the difference, if any, between the amount USAA should have paid Gail Menchaca for her Hurricane Ike damages and the amount that was actually paid." The jury answered "$11,350."

- Question three separately asked: "What sum of money ... would fairly and reasonably compensate Gail Menchaca for her damages, if any, that resulted from the failure to comply you found in response to Question number 1 and/or that were caused by an unfair or deceptive act that you found in response to Question number 2?" The question thus required the jury to determine damages resulting from either a contract breach or a statutory violation or both. The charge instructed the jury to answer Question 3 only if it "answered 'Yes' to Question No. 1 or any part of Question No. 2 or both questions." The charge then instructed the jury that the "sum of money to be awarded is the difference, if any, between the amount USAA should have paid Gail Menchaca for her Hurricane Ike damages and the amount that was actually paid." The jury found that Menchaca's reasonable and necessary attorney's fees "for representation in the trial court" totaled $130,000, and did not find that Menchaca failed to mitigate her damages or that USAA "knowingly" violated the Insurance Code.

Both parties moved for judgment in their favor based on the jury's verdict. USAA argued that because the jury failed to find in answer to Question one that USAA failed to comply with the policy, Menchaca could not recover for "bad faith or extra-contractual liability as a matter of law." Menchaca argued that the court should enter judgment in her favor based on the jury's answers to Questions two and three, neither of which required a "Yes" answer to Question one. The trial court disregarded Question one and entered final judgment in Menchaca's favor based on the jury's answers to Questions two and three. The court of appeals affirmed and the Supreme Court granted USAA's petition for review.

The Supreme Court noted that this case presented an opportunity to provide clarity regarding the relationship between claims for an insurance policy breach and Insurance Code violations, i.e., whether an insured can recover policy benefits as "actual damages" caused by an insurer's statutory violation absent a finding that the insured had a contractual right to the benefits under the insurance policy. In that regard, the Texas Insurance Code, § 541.060(a), grants insureds a private action against insurers that engage in certain discriminatory, unfair, deceptive, or bad-faith practices, and it permits insureds to recover "actual damages ... caused by" those practices, including court costs, attorney's fees, plus treble damages if the insurer "knowingly" commits the prohibited act. Id. §§ 541.151, .152; "Actual damages" under the Insurance Code are those damages recoverable at common law which include "benefit-of-the-bargain" damages representing "the difference between the value as represented and the value received." The court noted, however, that the Code does not create insurance coverage or a right to payment of benefits that does not otherwise exist under the policy. Similarly, a claim for bad faith conduct that breaches the common-law duty can potentially result in three types of damages: (1) benefit of the bargain damages for an accompanying breach of contract claim, (2) compensatory damages for the tort of bad faith, and (3) punitive damages for intentional, malicious, fraudulent, or grossly negligent conduct.

USAA contends that an insured cannot recover policy benefits for an insurer's statutory violation if the insured does not have a right to those benefits under the policy. However, the Supreme Court disagreed:

> USAA's argument overlooks the fact that—as we have clarified today—an insured need not prevail on a separate breach-of-contract claim to recover policy benefits for a statutory violation. Instead, as we have explained, the insured can prevail under the entitled-to-benefits rule or the benefits-lost rule if she establishes (1) the insurer violated the statute and (2) the violation resulted in her loss of benefits she was entitled to under the policy.

* * * * * *

Additional Cases and Articles of Interest

- *Dale L. and Georgia A. Ferguson v. USAA General Indemnity Company*, No. 1:19-cv-401, 2019 U.S. Dist. LEXIS 209579 (M.D. Pa. Dec. 5, 2019) – “Pennsylvania's bad-faith insurance statute was designed to generally regulate dishonest conduct by insurers. It is meant to encourage insurers to thoroughly investigate claims made by policyholders, respond to them promptly, negotiate reasonable claim settlements, and generally treat insureds honestly while caring for their interests. If the insurer truly has no contractual obligation to the insured, because their claim does not fall within the scope of the policy, the bad faith statute does not obligate the insurer to give coverage out of kindness of heart. It simply obligates the insurer to take all reasonable efforts to assess the validity and value of the claim before taking such actions, and, if coverage is effective, to carry out its duties honestly (Berg v. Nationwide Mut. Ins. Co., 44 A.3d 1164, 1170 (Pa. Super. Ct. 2012)) ("[A]n insurer has a duty to act with the utmost good faith towards its insured."). But an insurer's knee-jerk denial letter cannot be saved from triggering the penalties enumerated in Section 8371 merely because the insurer's lawyer is able to construct a post-hoc justification for denying coverage. See Gallatin Fuels, Inc., 244 F. App'x at 435; Newhouse, 2017 WL 4122405 at *3 (explaining that Section 8371 applies to "'insurers that unreasonably delay the evaluation of the insureds' claims, even if the insurer's ultimate assessment of the claim proves to be correct '" (quoting Ironshore Specialty Ins. Co., 319 F.R.D. at 212). Holding otherwise could potentially result in insurers taking the gamble that a denial based on a cursory review will be rescued by a clever trial lawyer.

- *Matthew Haygood v. United Services Automobile Association*, From the New Mexico Court of Appeals - Opinion Number: 2019-NMCA-074 No. A-1-CA-36158 (September 5, 2019) – Court affirms the district court's grant of summary judgment determining Haygood was not entitled to coverage and dismissing Haygood's claims for breach of contract, breach of the implied covenant of good faith and fair dealing, violations of UIPA and UPA, and bad faith based on failure to pay a covered claim. Court reverses the district court's grant of summary judgment dismissing Haygood's claim of bad faith premised on Defendants' investigation and evaluation, and remand for further proceedings consistent with this opinion.

- *Patricia E.G. Adams v. Hawaii Medical Service Association*, 145 Hawai'i 250, 2019 Haw. LEXIS 263, 450 P.3d 780 (September 30, 2019) - Tort of bad faith allows an insured to recover even if the insurer performs the express covenant to pay claims; as such, the Hawaii Supreme court found that an insurer's conduct before an actual claim is submitted can be considered in determining whether the insurer acted in bad faith.

- *Leonard Sanderson v. American Family Mutual Insurance Company*, 251 P.3d 1213 (Colorado Court of Appeals – No. 09CA1263 (2010) – The duty of good faith and fair dealing continues unabated during the life of an insurer-insured relationship, including through a lawsuit or arbitration between the insured and the insurer, although the adversarial nature of such proceedings may suspend the insurer's obligation to negotiate as a reflection of good faith.

- *Kimberly K. Zilisch v. State Farm Mutual Automobile Insurance Company*, 196, Ariz. 234 (2000), "The insurer has "some duties of a fiduciary nature," including "[e]qual consideration, fairness and honesty." Thus, "an insurer may be held liable in a first-party case when it seeks to gain unfair financial advantage of its insured through conduct that invades the insured's right to honest and fair treatment," and because of that, "the insurer's eventual performance of the express covenant-by paying the claim-does not release it from liability for 'bad faith."
- *Deborah C. Deese v. State Farm Mutual Automobile Insurance Company*, 172 Ariz. 504 (1992) - An insurance contract provides more than just security from financial loss to the insured. We said, "the insured also is entitled to receive the additional security of knowing that she will be dealt with fairly and in good faith." Thus, if an insurer acts unreasonably in the manner in which it processes a claim, it will be held liable for bad faith "without regard to its ultimate merits."

- *White v. Unigard Mutual Insurance Co.,* 112 Idaho 94, 730 P.2d 1014 Idaho Supreme Court – No. 16228 (1986) – "The tort of bad faith breach of insurance contract…has its foundations in the common law covenant of good faith and fair dealing and is founded upon the unique relationship of the insurer and the insured, the adhesionary nature of the insurance contract including the potential for overreaching on the part of the insurer, and the unique, "non-commercial" aspect of the insurance contract. Accordingly, we hold that there exists a common law tort action, distinct from an action on the contract, for an insurer's bad faith in settling the first party claims of its insured."

- Karin S. Aldama, Perkins Coie, Tred R. Eyerly, Damon Key Leong Kupchak Hastert, and Meghan E. Ruesch, Lewis, Wagner, LLP authored an excellent article, “Procedural Bad Faith—Recent Trends and Development,” that was published by the ABA in 2021. It can be found at: https://www.lewiswagner.com/9C8985/assets/files/News/Procedural%20Bad%20FaithRecent%20Trends%20and%20Developments%20MER.pdf

- Todd S. Schenk of Tressler, LLP authored an excellent compendium, “State-by-State Analysis: Bad Faith in the Absence of Coverage.” Although it was last updated in 2016, it is still a great resource. It can be found at: https://www.tresslerllp.com/docs/default-source/Publication-documents/50_state_bad_faith_in_the_absence_of_coverage.pdf?sfvrsn=0

American College of Coverage Counsel
2022 Annual Meeting

Intercontinental Chicago
May 11-13, 2022

R. Hugh Lumpkin*
Reed Smith
Miami, FL
hlumpkin@reedsmith.com

* Special thanks to Garrett Nemeroff and Maria Castro Sanchez of Reed Smith for their assistance in research and drafting for this project.

Bad Faith and Litigation Immunity

I. The role of bad faith claims in the insurer-insured relationship

The duty of good faith and fair dealing is found throughout all contractual relationship and requires that the parties act in good faith in carrying out the duties owed under the contract. And, every jurisdiction has its origin story where the implied obligation of good faith gave rise to extra-contractual obligations extending beyond contractual benefits. See, e.g., *Hilker v. Western Auto. Ins. Co*., 231 N.W. 257 (Wisc. 1930*); Comunale v. Traders & General Ins. Co.*, 50 Cal.2d 654 (Cal. 1958); *Tiger River Pine Co. v. Maryland Cas. Co*., 163 S.C. 229 (S.C. 1931); *Auto Mut. Indem. Co. v. Shaw*, 184 So. 852 (Fla. 1938). Unlike most other contracts, insurance contracts create an obligation on one party (the insured) to continually pay policy premiums, while the other party (the insurer) has a contingent duty, which may never come to fruition depending on the terms of the policy and the conditions underlying an insured's claim. The unique nature of the insurer-insured relationship creates an inherent tension between the insureds' interests in having their claims paid quickly without assuming additional costs related to litigation, and the insurers' interest in limiting their exposure by litigating debatable claims. These conflicting interests create greater difficulty in carrying out the duty of good faith and fair dealing, where the insurer has an incentive to protect its interests through litigation, even to the detriment of its insured.

These conflicting interests, coupled with the typically unequal bargaining position of insureds, has led to the widespread adoption of the bad faith remedy for insurer conduct. *See Roussalis v. Wyo. Med. Ctr., Inc.,* 4 P.3d 209, 256 (Wyo. 2000) ("Central to this Court's adoption of this tort of bad faith…. was the public service nature of the insurance business and the unequal bargaining relationship between insurer and insured"). Some states, like Florida, have codified this duty of good faith and fair dealing in statutory bad faith remedies. *See* Fla. Stat. § 624.155. Others, like Wyoming, have adopted bad faith as a tort cause of action based on the breach of an insurer's duty. *Kirkwood v. CUNA Mutual Insurance Society*, 937 P.2d 206, 211 (Wyo. 1997) ("We have, however, adopted a tort cause of action for the breach of an insurer's duty of good faith and fair dealing.").

Whether statutorily created or rooted in the common law, bad faith claims provide a remedy for insureds – incentivizing insurers to comply with their duty of good faith and fair dealing by promptly and fairly settling claims when the duty to do so becomes evident. Some courts have found that this duty extends beyond the failure to pay or denial of a claim, and extends into the litigation process, potentially allowing a bad faith claim to stem from an insurer's litigation conduct, should *that* conduct breach the duty. *See e.g.*, *Palmer v. Farmers Ins. Exchange*, 861 P.2d 895, 913 (Mont. 1993) ("An insurer's duty to deal fairly and not to withhold payment of valid claims does not end when an insured files a complaint against the insurer."); *O'Donnell ex rel. Mitro v. Allstate Ins. Co*., 734 A.2d 901, 906 (Pa. Super. Ct. 1999) ("We refuse to hold that an insurer's duty to act in good faith ends upon the initiation of suit by the insured.").

II. Litigation immunity and an insurer's continuing duty of good faith

While courts have found that an insurer's duty extends beyond their denial of a claim, the doctrine of litigation immunity, sometimes called litigation privilege,[1] often operates to functionally bar certain claims arising out of an insurers' litigation conduct. Though each jurisdiction's iteration of the privilege or immunity differs slightly,[2] generally litigation immunity prevents the use of litigation conduct or communications from forming the basis of a claim against the attorney or their client. This doctrine has been adopted in almost every jurisdiction, though, almost always, through the court systems rather than by statute.[3]

The initial purpose of judicial immunity was simply to allow attorneys the ability to speak freely in representing their clients, without fear that either they or their clients will face reprisal in the form of litigation. *See Searcy v. Esurance Ins. Co.,* 243 F. Supp. 3d 1146, 1155 (D. Nev. 2017) ("The policy behind the privilege is to grant attorneys "the utmost freedom in their efforts to obtain justice for their clients."). This immunity was originally limited to defamation claims, but has been

[1] Though these two terms are used interchangeably in the case law, where the doctrine is judge-created rather than statutory, it is properly categorized as an immunity rather than a privilege. *See* T. Leigh Anenson*, Absolute Immunity from Civil Liability: Lessons for Litigation Lawyers,* 31 PEPP. L. REV. 915, 916 n.2 (2004) (noting differences between litigation privilege and immunity, but using the terms interchangeably in analyzing its use).

[2] Compare the immunity under Nevada law, which provides, "communications uttered or published in the course of judicial proceedings are absolutely privileged, rendering those who made the communications immune from civil liability," *Greenberg Traurig v. Frias Holding Co*., 331 P.3d 901, 903 (Nev. 2014) with California's privilege statute which provides that "[a] privileged publication or broadcast is one made: [i]n any (1) legislative proceeding, (2) judicial proceeding, (3) in any other official proceeding authorized by law, or (4) in the initiation or course of any other proceeding authorized by law and reviewable pursuant to Chapter 2." Cal. Civ. Code § 47 (Deering, Lexis Advance through Chapter 6 of the 2022 Regular Session).

[3] *See* Marc I. Steinberg & Logan J. Weissler, *The Litigation Privilege as a Shelter for Miscreant Legal Counsel*, 97 OR. L. REV. 1, 18 (2018) ("Of the forty-eight states that recognize the Litigation Privilege, forty-two have done so through their court systems, while the remaining six states codified the Privilege by statute")

expanded to apply broadly, including in the bad faith insurance context. *White v. W. Title Ins. Co.*, 710 P.2d 309, 318 (1985) ("No cases apply that [litigation] privilege in the present context, but defendant relies generally on decisions which have extended the absolute privilege beyond defamation….").

The flexibility and expansion of this doctrine stems, at least partially, from the fact that this doctrine is largely judicially created. Since almost every court has an uncodified litigation immunity doctrine, the application of this doctrine varies throughout jurisdictions. Even where not specifically asserted, the concerns and policies underlying this privilege are evident in the bad faith litigation context.

III. Conflict between litigation immunity and enforcement of bad faith actions

Both bad faith litigation and litigation immunity address issues raised by the very nature of the insurer-insured relationship. On the one hand, the insured will attempt to rely on what he or she will label bad faith litigation conduct to bolster allegations that the insurer breached its duty of good faith which exists even through litigation. The insurer, however, has an interest in litigating debatable claims, which may be chilled by having its conduct in litigation scrutinized as the possible basis for a bad faith claim. Indeed, this is a primary consideration taken up by courts in considering whether bad faith claims may cite to litigation conduct as support for a claim that the insurer failed to act in good faith. While litigation immunity may shield insurers from any potential chilling effect from these kinds of bad faith claims, if applied carte blanche, it could operate as an incentive for insurers, encouraging them to shield their otherwise actionable conduct through the litigation process by benefitting from complete immunity of their litigation conduct.

Attempts to reconcile these countervailing considerations has led to much debate regarding the application of litigation immunity in bad faith claims. There are three main approaches taken by courts to address and balance the interests of litigation immunity and bad faith litigation.

First, some courts take the approach that the duty of good faith extends only to the insurer's denial of a claim. These courts foreclose the possibility of litigation conduct from informing a bad faith claim without considering litigation immunity, instead finding that litigation conduct cannot form the basis of a bad faith claim because it occurs (at least in the first party context generally) after a claim has been denied. *See e.g. Roussalis v. Wyoming Medical Center, Inc.*, 4 P.3d 209, 257

(Wyo. 2000) (holding that post-filing conduct is controlled by the Rules of Civil Procedure and disallowing the bad faith claim based on such conduct); *Parker v. S. Farm Bureau Cas. Ins. Co.*, 935 S.W.2d 556, 562 (1996) (determining that Arkansas' bad faith tort stems from the denial of a claim, and thus post-litigation conduct occurring *after* the denial of the claim could not be the basis of a bad faith claim).

Next is the approach that many courts have deemed the "majority approach." This approach bars evidence of an attorney's litigation conduct except in "rare cases involving extraordinary facts." *See Sinclair v. Zurich Am. Ins. Co.*, 129 F. Supp. 3d 1252, 1258 (D.N.M. 2015) ("I believe that New Mexico courts would follow what appears to be the majority view that allows evidence of an attorney's litigation conduct to be admissible as evidence of bad faith in rare cases involving extraordinary facts."). Courts adopting this approach typically conduct a balancing test, considering the probative value of the proposed evidence and weighing it against any potential prejudice to the insurer. *Masters v. Safeco Ins. Co. of Am.,* Civil Action No. 20-cv-00631-PAB-NRN, 2021 U.S. Dist. LEXIS 181822, at *24-25 (D. Colo. Sep. 23, 2021) *Timberlake Constr. Co. v. United States Fid. & Guar. Co*., 71 F.3d 335, 341 (10th Cir. 1995).

Finally, some courts have carved out specific exceptions to the litigation privilege for bad faith insurance cases. This allows for the admission of evidence of litigation conduct which is probative of an insurers' bad faith. Rather than applying a balancing test, these courts will generally consider the type of litigation conduct asserted and the role played by the insurer in ratifying or approving such conduct, and whether the immunity could impact the very purpose of the bad faith remedy, before determining whether the information regarding the litigation conduct may be admitted. *See Kafie v. Nw. Mut. Life Ins. Co.,* 834 F. Supp. 2d 1354, 1369 (S.D. Fla. 2011); *Barefield v. DPIC Cos.,* 215 W. Va. 544 (2004); *White*, 710 P.2d at 317 (Cal. 1985).

a. Some courts decline to apply litigation immunity when it is indicative of an insurer's bad faith

Courts in West Virginia, Florida and California have ascribed to the more limited view of litigation immunity. These courts have first determined that insurers have a continuing duty of good faith and fair dealing which extends beyond the denial of a claim and into the litigation process. *Venn v. St. Paul Fire & Marine Ins*. Co., 99 F.3d 1058, 1065 (11th Cir. 1996) ("In short, an insurer owes under Florida law a continuous duty to negotiate and settle in good faith");

Barefield v. DPIC Companies, Inc., 215 W. Va. at 554 ("We therefore must conclude that the language of the UTPA does not restrict the scope of the conduct that is proscribed by the Act to that which occurred prior to the filing of a lawsuit."). Given this duty, these courts have found that evidence of litigation conduct should not necessarily be excluded from bad faith claims. While these courts acknowledge the role of litigation immunity and the chilling effect that permitting evidence of the insurer's litigation conduct may have, they nevertheless find that evidence of such conduct may form the basis of a bad faith claim given the purpose of the bad faith remedy, as a tool to enforce an insurer's duty to act in good faith throughout the claim process.

Two factors play prominently in the determination that litigation conduct can be used in bad faith litigation. First, these courts have determined that the scope of the litigation privilege cannot be read as completely immunizing insurers from the import of their post-litigation conduct given the nature of the bad faith remedy and the continuing duty that insurers have towards their insureds. As set out by the District Court for the Southern District of Florida in *Kafie v. Nw. Mut. Life Ins. Co*., "litigation privilege should not attach to the initial dispute serving as the condition precedent to a bad-faith action, as the insurer's handling of the claim, including its defense at trial, would seem to be at the very heart of the bad-faith action." 834 F. Supp. 2d at 1369. *See also Pin-Pon Corp. v. Landmark Am. Ins. Co*., No. 20-14013-CV, 2021 U.S. Dist. LEXIS 248495, at *9 (S.D. Fla. May 7, 2021) ("given the nature of a bad faith claim, which is incredibly fact-intensive as to the insurer's handling of the claim, including its defense at trial, an insurer's litigation conduct strikes me as relevant to, and perhaps even at the very heart of, the bad faith claim."). Thus, completely barring the use of litigation conduct would allow insurers to abort their continuing good faith duties, which are at the heart of bad faith litigation claims, by commencing litigation proceedings and "would provide a disturbing incentive for insurance companies to push meritorious litigation." *Barefield v. DPIC Cos*., 215 W. Va. at 555.

These courts also consider the type of litigation conduct asserted and whether such conduct goes to the heart of what litigation immunity seeks to protect. To this end, California courts have distinguished between an insurers' post litigation conduct as the *entire* basis of a bad faith claim, or as evidence of a continued course of bad faith conduct which may create liability. *See Evanston Ins. Co. v. OEA, Inc., No. CIV-S-02-1505 DFL PAN,* 2005 U.S. Dist. LEXIS 34671, at *11 (E.D. Cal. Dec. 20, 2005)("In California, an insured can introduce evidence of the insurer's conduct during the litigation to support a claim of bad faith, but the claim cannot be based exclusively on the insurer's pleadings").[4] This approach acknowledges that, though litigation immunity was meant to provide a shield against liability based on litigation conduct, it was not meant to operate to bar its use as evidence of an insurer's bad faith conduct.

Courts have also considered whether the type of litigation conduct is one which is fully within the discretion of legal counsel and goes to the heart of an attorney's independent legal considerations, or is conduct which is ratified or controlled by the insurers. *See Barefield*, 215 W. Va. 544, at 559. While bad faith litigation may not put at issue or consider litigation strategy that is within an "attorney's independent, professional discretion," it may consider litigation conduct which bears the imprimatur of the insurer's own intent and decisions with regard to the insured's claim. *Id.*

In fact, even jurisdictions which typically exclude evidence of litigation conduct, will admit evidence of settlement offers, which are exactly the kind of litigation conduct which must be ratified by insurers and which may demonstrate an insurer's intent. *See e.g.*, *Kirtos v. Nationwide Ins. Co.,* 2008-Ohio-870, ¶ 36 (Ct. App.) (" In a case of bad faith regarding whether an insurer negotiated with its insured in bad faith, evidence as to the settlement negotiations is highly relevant."); *Leiserv, LLC v. Summit Entm't Ctrs., LLC*, No. 15-cv-01289-PAB-KLM, at *18 (D. Colo. Feb. 6, 2017) ("evidence of settlement discussions is admissible to show that a party acted in bad faith in carrying out its obligations under a contract so long as it is not used to prove or disprove liability on the claim being settled or the amount of that claim."); *In re State Farm Mut. Auto. Ins*. Co., 629 S.W.3d 866, 877 (Tex. 2021) ("[I]n the trial of bad-faith claims, the settlement offer is generally admissible as evidence of the insurer's good-faith (or bad-faith) efforts to resolve the claim.").

b. The majority approach only permits the introduction of litigation conduct in extraordinary circumstances

The majority approach will only permit the use of litigation conduct in bad faith claims where extraordinary facts justify the consideration of such evidence. *See Sinclair,* 129 F. Supp. 3d at

[4] Other courts have adopted a similar approach. *See Tucson Airport Auth. v. Certain Underwriters at Lloyd's,* 186 Ariz. 45, 48, 918 P.2d 1063, 1066 (Ct. App. 1996) ("Applying that distinction, the litigation privilege would preclude the former action [based entirely on litigation conduct] but would not bar evidence of the communications to prove the latter [based on other, pre-litigation conduct]"); *Searcy v. Esurance Ins. Co*., 243 F. Supp. 3d at 1155 (suggesting that while litigation conduct, such as asking embarrassing questions to the insured-witness, was barred by litigation immunity, conduct undertaken by the insurer, evidenced through what was done by counsel in litigation could be admissible).

1258 Though no court has set out any bright-line standard for what constitutes the extraordinary circumstance which may merit the use of an insurers' litigation conduct in bad faith cases, the Court in *Homer v. Nationwide Mut. Ins. Co.*, suggested that, at a minimum, the conduct must exceed "simple discovery abuses." No. 15-1184, 2016 U.S. Dist. LEXIS 114548, at *13 (W.D. Pa. Aug. 26, 2016). "[M]ore egregious conduct, such as filing a baseless counter claim in a coverage action" could form the basis of a bad faith claim, however. *Id.* at *19. The court analogized such conduct as the difference between "defending a claim," which cannot form the basis of a bad faith claim, and conduct "which suggests 'that the conduct was intended to evade the insurer's obligations…" *Id.* at *14-15 (internal citations and quotations omitted).

Jurisdictions which largely bar the use of litigation conduct in bad faith litigation consider the relevance of the conduct, the possible chilling effects of the evidentiary use of litigation conduct and the possible prejudicial effect of including such evidence. The approach taken in *Timberlake Constr. Co. v. United States Fid. & Guar. Co.,* fairly represents the sorts of considerations taken into account by the jurisdictions taking this approach to the admission of litigation conduct. 71 F.3d 335 (10th Cir. 1995). The 10th Circuit considered whether litigation conduct could be relied upon to demonstrate bad faith. *Id.* at 340. The *Timberlake* Court first suggested that litigation conduct is not probative of an insurer's bad faith, as it does not bear on whether "[an insurer] in bad faith denied the contractual lawsuit" given that it is animated by the attorney's strategies. *Id.* The court next considered the possible chilling effects of permitting claims to proceed on this basis. *Id.* at 340-341. It found that such claims could affect how insurers' counsel would approach claims to the detriment of their clients. *Id.* at 341. It further suggested that rules of procedure could and would remedy any improper litigation conduct. *Id.* Finally, taking into account the above, the court found that litigation conduct would not be admissible on the issue of bad faith as it could be prejudicial and was not sufficiently probative. *Id.*

In a more recent decision, another court approached this same issue, taking into account similar considerations and using a balancing test to weigh the countervailing considerations. In *Masters v. Safeco Ins. Co. of Am.*, the Court required "extraordinary facts" to permit the use of litigation conduct in bad faith claims. No. 20-cv-00631-PAB-NRN, 2021 U.S. Dist. LEXIS 181822, at *23 (D. Colo. Sep. 23, 2021). The court reiterated the policy rationales from *Timberlake*, noting that evidence of litigation conduct "carries a substantial danger of unfair prejudice and jury confusion." *Id.* (citations omitted). The court then used a balancing test, weighing the probative weight of the evidence as compared to the potential prejudice, to determine whether there were "extraordinary facts" which would warrant the use of litigation conduct. *Id.* The insured argued that the evidence it sought to admit would only "touch on the conduct of counsel to the limited extent they reflect the conduct of [d]efendant," thus bearing more on the insurer's intent than the litigation strategy. *Id.* at *26. The court nevertheless found that probative value of the insurer's litigation strategy, including evidence of the insurer hiring an expert "to provide a false description of Colorado law," did not outweigh the possible prejudice and thus implicated no "extraordinary facts" which would permit the use of the evidence. *Id.* at *27.

IV. The role of policy rationales over statutory construction

The focus of the majority of cases is on public policy, particularly the potential prejudice to insurers, and pays little attention to the language of applicable bad faith law or litigation privilege statutes. *Berg v. Nationwide Mut. Ins. Co.*, 235 A.3d 1223, 1268 (Pa. 2020) (noting that "in the absence of clear statutory direction" many courts adopted the rule that evidence of litigation conduct was inadmissible based on policy considerations). Cases which *have* undertaken a thorough analysis of the language of bad faith statutes or their own privilege laws have *not* found that litigation conduct or strategy is inadmissible or may only be admitted only upon extraordinary facts. Rather, these cases have found that the nature of the bad faith laws impose continuing duties of good faith, such that post litigation conduct should be admitted, considering the nature of the litigation conduct asserted and the role of the insurer in the litigation conduct.

In *Barefield*, the West Virginia Supreme Court of Appeals analyzed the Uniform Trade Practices Act under which the bad faith action against the insurer was brought. 215 W. Va. at 553. The court addressed the two "differing views of public policy" which have persisted throughout different courts' analyses of the admission of litigation conduct. *Id.* Rather than adopting either policy approach, the court found that UTPA itself should guide how these two policy considerations should play into the question of the use of litigation conduct in bad faith claims. *Id.* The court stated that UTPA was intended to require insurers to fulfill their duties of good faith and fair dealing in resolving their insureds' claims, regardless of whether litigation had begun. *Id.* Nevertheless, UTPA was not intended to "interfere with the exercise of an attorney's zealous, independent, professional judgment in the defense of a client." *Id.*

The court first determined that the use of the word "claim" was broad and could not be limited to simply pre-litigation conduct. *Id.* at 553-554. Looking to the language overall, the Court could "find no caveat in the UTPA" which limited consideration of the insurer's duty only to conduct "prior to the filing of a lawsuit by a party." *Id.* at 554. The Court also acknowledged that nothing in UTPA addressed or altered the litigation immunity rules as applied to the attorney's specific conduct. *Id.* at 556. While litigation conduct stemming purely from an "attorney's independent, professional discretion" could not form the basis for a bad faith claim, conduct "relied upon or ratified by the insurance company" *could* be the basis. *Id.* at 559.

V. Policy rationale and the majority approach

As discussed above, the two noted approaches rely on policy rationales and the impact of allowing litigation conduct as evidence in bad faith cases. The majority approach focuses on the potential harm to the insurers. *Timberlake*, 71 F.3d at 341. As discussed above, the potential harm to insurers stems from jury confusion regarding the probative value of litigation conduct and fear of the use of litigation conduct as hampering the zealous defense of an insurer's interests. As to the first consideration, juries can and often do fathom and properly apply complex issues of law. Issues of jury confusion can and often are "dealt with through the use of well crafted jury instructions rather than by excluding relevant evidence" *United States v. Crocker*, 788 F.2d 802, 807 (1st Cir. 1986). The second concern, which deals more closely with the policy purposes underlying litigation immunity generally, may be resolved through the court's consideration of the type of litigation conduct asserted. Litigation conduct which is based entirely on an attorney's strategic and discretionary decisions may be excluded, while conduct and decisions of the insurer, which may be evidenced by an attorney's litigation conduct, should be considered in bad faith cases.

The majority approach also suggests that any improper litigation conduct may be curbed through the rules of procedure and the court's ability to sanction or otherwise regulate attorney conduct. *Timberlake*, 71 F.3d at 341. While the courts do have wide control over litigation conduct and may curb the worst of an attorney's improper conduct, this does not account for the standards of good faith which are enforced through bad faith litigation. This standard does not require that an insurer's conduct reach the level of improper litigation strategies; rather, that the insurer "deal fairly and in good faith" with its insureds. Litigation conduct may indicate an insurer's failure to meet this standard, while not implicating *attorney* conduct which may be controlled by the courts.

For example, an attorney may in good faith file a complaint alleging fraud on the part of the insured as a bar to bar recovery. This alone, is not conduct which would be regulated by the court under its rules of procedure or through its inherent and statutory powers. It may be indicative, however, of an insurer's bad faith where the insurer knew that such allegations were false or of questionable validity. In this case, the litigation conduct may evidence an insurer's bad faith without implicating any conduct that a court would regulate. *See Krisa v. Equitable Life Assurance Soc'y,* 109 F. Supp. 2d 316, 321 (M.D. Pa. 2000) (finding that this very kind of conduct could be the basis of an insured's bad faith claim).

Finally, the majority approach fails to account for the perverse incentives that may be caused by immunizing insurers from bad faith claims stemming from litigation conduct. As noted in *White,* preventing litigation conduct from being considered as evidencing bad faith may "encourage insurers to induce the early filing of suits, and to delay serious investigation and negotiation until after suit was filed" *White v. Western Title Ins. Co.*, 40 Cal. 3d 870, 886 (Cal. 1985), in order to cloak itself with the protection of litigation immunity. In direct contravention to the considerations underlying the bad faith remedy — to encourage the quick resolution of meritorious insurance claims – the unbridled use of litigation immunity will encourage litigation of insurance claims which should otherwise be paid, delaying the resolution of these claims.

VI. Additional considerations

Courts frequently consider the competing interests of an insured, in seeking redress for unfair claims adjustment practices taking place once litigation has commenced, and an insurer, whose zealous defense of claims may be chilled by the possibility of litigation based on its defense of a case. Generally, however, courts, especially those applying a broad exclusion of litigation conduct, tend to disregard the nature of the case or the stage of the proceedings in analyzing the fitness of litigation immunity to bar probative litigation evidence.

First, some states allow for a direct action by an injured party against both the tortfeasor and the insured, particularly in UM and UIM claims. In such a procedural setting, the insurer is discharging its fiduciary obligation to properly defend the insured while simultaneously defending its own choices in settling or resisting the claim by the injured party. In this setting, application of litigation privilege or immunity makes more sense as the insurer would otherwise be faced with the rudest of Hobson's dilemmas. Second, courts rarely distinguish between the role litigation immunity should play in third party liability cases versus first party cases. While courts frequently distinguish between these two kinds of cases in establishing the extent of the duties owed, or even in determining what evidence may be relevant to a bad faith litigation,[5] they observe the impact of litigation immunity stemming from these differences only in the breach. While fiduciary obligations are owed the insured in the liability context making admission of litigation conduct more relevant, such an obligation does not typically inhere in the first-party relationship. With the latter, the failure to pay is usually tethered to failures to investigate, or to consider information coming into the insurer's hands even after litigation commences.

Courts adopting the majority approach have also failed to consider the role that insurers may play in ratifying or indeed directing litigation conduct. In the related discovery context, courts have created exceptions for attorney-client privilege in bad faith cases where the insurers' defense is based in good faith tied to following the advice of attorneys. These courts have found that such reliance waives the attorney client privilege in that it puts the attorney's communications "at issue" in the bad faith claims. *City of Myrtle Beach v. United Nat'l Ins. Co.*, No. 4:08-1183-TLW-SVH, 2010 U.S. Dist. LEXIS 89725, at *14-15 (D.S.C. Aug. 27, 2010) ("There is no per se waiver of the attorney client privilege simply by a plaintiff making allegations of bad faith. However, if a defendant voluntarily injects an issue in the case, whether legal or factual, the insurer voluntary waives, explicitly or impliedly, the attorney-client privilege."). Similarly, insurers may affirmatively approve or even direct attorney litigation conduct in a way that violates their good faith duties to their insureds. In this way, the insurers themselves voluntarily inject the litigation conduct into the basis for a bad faith claim. Thus to the extent that insurers ratify or direct the litigation conduct which may form the basis of a bad faith claim, they have put such conduct at

[5] Courts frequently make distinctions regarding the scope of an insurer's duty to its insured in the first versus third party setting. *See e.g, Sessoms v. Allstate Ins. Co*., 634 So. 2d 516, 519 (Miss. 1994) ("The duty of an insurer to an insured arising out of a first-party insurance claim is different from that arising out of a third-party claim."). They also distinguish between what may be relevant for discovery purposes based on whether a claim is a first or third party claim for bad faith. *See e.g.*, *Seabron v. Am. Family Mut. Ins. Co.*, 862 F. Supp. 2d 1149, 1157 (D. Colo. 2012) ("Colorado courts treat the insured's right to obtain discovery of the insurer's reserves or settlement authority differently in a first-party bad faith case than in a third-party bad faith case.").

issue such that any litigation immunity should not be used to prevent courts from considering this conduct.

Stated simply, the insured's focus should not be on what the lawyer hired by the insurer did or did not do in defending the insurer's interests. Rather, the focus should be on what the insurer did or did not do which it should have done or resisted doing, with the attorney merely being the tool used to advance a position where the weight of legal authority as an example suggested a different course. Invariably, if the right questions are asked in deposition of the insurer's representatives, the insurer will freely admit that counsel's actions were approved of, ratified and directed by the insurer.

VII. Emerging trends in applying litigation immunity to bad faith claims

While the stage of the proceedings has not been thoroughly discussed in most cases dealing with bad faith and the admission of litigation conduct, courts recently have suggested that striking pleadings or dismissing bad faith cases alleging litigation conduct is not appropriate in certain early stages of bad faith claims. Rather, allegations of bad faith stemming from litigation conduct may properly be resolved at later stages in the litigation. *See Webcore-Obayashi Joint Venture v. Zurich Am. Ins. Co*., No. 19-cv-07799-SI, 2021 U.S. Dist. LEXIS 150161, at *3-4 (N.D. Cal. Aug. 10, 2021) (the question of whether litigation privilege barred certain allegations in the complaint should more properly be addressed through a motion *in limine* and not in a motion to dismiss); *Symetra Life Ins. Co. v. JJK 2016 Ins. Tr*., No. 18-12350 (MAS) (ZNQ), 2021 U.S. Dist. LEXIS 37256, at *25 (D.N.J. Feb. 28, 2021) (finding that a claim for breach of good faith and fair dealing based on an insurers' filing of a complaint was not subject to dismissal at the early stage of litigation, regardless of the insurers' assertions of litigation privilege); *Krausman v. Liberty Mut. Ins. Co.*, No. FSTCV176030945S, 2022 Conn. Super. LEXIS 145, at *19 (Super. Ct. Feb. 4, 2022) (motion to strike allegations of litigation conduct as a basis for a bad faith claim was inappropriate at the early stage of litigation as it required the court to consider facts outside of the complaint to determine whether the conduct actually fell within the litigation privilege).

In many states, bad faith claims can be prosecuted along-side a claim for breach of the insurance contract. This too presents issues in the assertion of litigation immunity, as the insurer craves a free hand in defending its contractual defenses to coverage without fear that the defense mounted is fodder for the companion bad faith case. Often-times, the bad faith aspect of the case is stayed or bifurcated for later treatment, in part to forestall the broad discovery afforded in bad faith cases and the cost associated with that type of discovery. Practitioners should consider the merits of seeking bifurcation, as informing the availability of litigation immunity. It is far less difficult to link litigation conduct to the merits of a bad faith claim if an antecedent breach of the insurance policy has been proven. And, it is far less likely that such proof with be found unduly prejudicial if the insurer has already had its day in court on the issue of contractual breach.

VIII. Conclusion

Litigation immunity or privilege must carefully be considered by jurisdiction – once again inserting choice of law into the calculus of where and when to file suit. While there are jurisdictions which have crafted significant hurdles to allowing evidence of litigation conduct, others have assumed the nature of the action requires consideration of such evidence by the trier of fact. Careful management of the case including framing the focus of the inquiry are key to successful use of litigation conduct. And, equally to its exclusion.

BIFURCATION OF BAD FAITH CLAIMS

Bryan M. Weiss
Selman Breitman LLP

I. INTRODUCTION

The vast majority of actions against insurers seeking damages for alleged wrongful denial of claims or alleged improper claims handling include causes of action for both breach of contract and breach of the covenant of good faith and fair dealing ("bad faith.") In the former, the insurer has the burden of establishing that the insurer breached the contract of insurance by failing to pay benefits owed or otherwise violating the terms of the insurance contract. To prevail in its bad faith claim, most jurisdictions require the insured to establish not only that the insurer withheld benefits due under the policy, but that such withholding was "unreasonable"' or "without proper cause." (see, e.g., *Gruenberg v. Aetna Ins. Co.* (1973) 9 Cal.3d 566; *Dakota Girls, LLC v. Philadelphia Indemnity Insurance Company* (6th Cir. 2021) 17 F.4th 645 [under Ohio law, a mere denial of benefits does not establish bad faith; rather, "[a]n insured must prove that the insurer's refusal to pay a claim was totally arbitrary and capricious and without reasonable justification;"] *Currie v. Auto-Insurance Company,* 2021 WL 4354188 (N.D. GA 2021) [bad faith under Georgia law means any "frivolous and unfounded refusal in law or in fact to comply with the demand of the policyholder to pay according to the terms of the policy.") A finding of bad faith can lead to the recovery of extra-contractual damages.

As discussed in another section of this paper, most courts hold that there can be no bad faith in the absence of a breach of contract, i.e., if no policy benefits are due, there cannot be a finding of bad faith (*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 Cal.4th 1 [bad faith claim cannot be maintained unless policy benefits are due under the contract.] The theory behind bifurcation is that typically, unless and until the court determines there is coverage for the claim at issue, the insured's bad faith claim fails as a matter of law and therefore it makes no sense to proceed on the latter until there has been a determination of coverage. For this reason, insurers often seek to bifurcate the breach of contract claims from the bad faith claims, either at the inception of the case (in order to minimize impact of discovery) or at trial (in order to avoid prejudice from the jury.) From the insurer's perspective, ordering separate trials of the breach of contract and bad faith claims prevents the jury from hearing evidence that could taint its determinations. The fear is that jurors will allow evidence of the insurer's alleged "bad conduct" to guide their conclusions as to whether benefits were in fact owed by the insurer.

This portion of the paper will address the standards employed by both federal and state courts in response to such bifurcation motions.

II. BIFURCATION UNDER FEDERAL RULES

FRCP Rule 42 provides, in pertinent part:

> (b) Separate Trials. For convenience, to avoid prejudice, or to expedite and economize, the court may order a separate trial of one or more separate issues, claims, crossclaims, counterclaims, or third-party claims. When ordering a separate trial, the court must preserve any federal right to a jury trial.

The key phrase in the Rule, of course, is "may order." As that phrase suggests, bifurcation is up to the discretion of the trial judge – it is not mandatory. The district court is vested with "broad discretion to decide whether [bifurcation]under Rule 42(a) would be desirable...." 9A C. Wright & Miller, Federal Practice & Procedure § 2383 (3d ed. 2019.) Rule 42 "confers broad discretion upon the district court to bifurcate a trial, thereby deferring costly and possibly unnecessary proceedings." *Hangarter v. Provident Life & Acc. Ins. Co.*, 373 F.3d 998, 1021 (9th Cir. 2004); *United States ex rel. Bahrani v. ConAgra, Inc.*, 624 F.3d 1275, 1283 (10th Cir. 2010). The decision "to bifurcate . . . is a matter to be decided on a case-by-case basis and must be subject to an informed discretion by the trial judge in each instance." *Lis v. Robert Packer Hospital*, 579 F.2d 819, 824 (3d Cir.1978) The party requesting bifurcation has the burden of showing it is warranted. *Estate of Chapman v. Bernard's Inc.*, 167 F.Supp.2d 406, 417 (D.Mass. 2001)

The issue of bifurcation is guided by consideration of several factors: (1) whether a separation of the issues for trial will expedite disposition of the action; (2) whether such separation will conserve trial time and other judicial resources; (3) whether such separation will be likely to avoid prejudice to any party at trial that may occur in the absence of separation; and (4) whether the issues are essentially independent of each other so that there will be no need to duplicate the presentation of significant areas of the evidence in the separated proceedings. *McKellar v. Clark Equip. Co.*, 101 F.R.D. 93, 94 (D.Me.1984) Bifurcation is particularly appropriate when resolution of a single claim or issue could be dispositive of the entire case. *Hirst v. Gertzen*, 676 F.2d 1252, 1261 (9th Cir. 1982). "Bifurcation may be appropriate where the evidence offered on two different issues will be wholly distinct, or where litigation of one issue may obviate the need to try another issue." *Athridge v. Aetna Cas. & Sur. Co.*, 604 F.3d 625, 635 (D.C. Cir. 2010). "[T]he question of bifurcation centers on whether resolution of a single claim would be dispositive for the entire case." *Smith v. Allstate Ins. Co.*, 403 F.3d 401, 407 (6th Cir. 2005). Bifurcation may be appropriate where the evidence relevant to the coverage and the bad faith claims is not so interwoven that it requires duplication, and where bifurcation simplifies complex issues for the jury. *Westchester Specialty Ins. Servs., Inc. v. U.S. Fire Ins. Co.*, 119 F.3d 1505, 1512 n.14 (11th Cir. 1997).

These factors naturally lend themselves to attempts by insurers to seek bifurcation of the breach of contract claims from the bad faith claims. In light of the fact that the burden is on the insurer to establish the need for bifurcation and given that "[t]he piecemeal trial of separate issues in a single lawsuit or the repetitive trial of the same issue in severed claims is not to be the usual course," (Wright & Miller, *supra*) federal courts appear to favor insureds when it comes to bifurcation motions. A few examples are worth noting.

A. Bifurcation Denied

In *Jimenez v. GEICO General Insurance Company*, 448 F. Supp. 3d 1108 (D. Nev. 2020,) the insured sued her insurer for breach of contract and bad faith arising out of UIM claim. GEICO moved to bifurcate the two claims at the outset of the coverage litigation. The court denied the motion, holding: "There is no reason to bifurcate or stay Jimenez's bad faith claims at this stage. Jimenez's claims are intertwined, so separating and staying at this time would unnecessarily prolong the process and waste judicial resources supervising two phases of discovery. I therefore deny GEICO's motion to stay and bifurcate." The court did, however, note GEICO's right to seek bifurcation at some later stage of this case if it feels bifurcation is prudent.

The trial court's ruling in *American Steel & Stairways, Inc. v. Lexington Insurance Company* 2013 WL 4425704 (N.D CA 2013) offers a valuable insight into how court apply the Rule 42(b) factors. Defendants filed a motion to bifurcate the breach of contract/bad faith claims for the purposes of discovery and trial, and to stay the bad faith claims pending resolution of the breach of contract claim. The court separately analyzed the factors of (1) "convenience"; (2) "to avoid prejudice"; or (3) "to expedite and economize." As to the possibility of prejudice, defendant argued that if the issues of breach of contract and bad faith are tried together they will be prejudiced in presenting their defense because first, there may be a risk of jury confusion since jurors must differentiate the two claims, and second, the fact that it made a settlement offer in the underlying action will show its "good faith" yet at the same time may be seen as an admission of coverage. The court rejected those arguments, concluding that "[t]he risk of jury confusion, if any, can be addressed by specific jury instructions and a special verdict form. Clear limiting instructions will allow the jury to differentiate evidence related to coverage liability and evidence related to damages for bad faith." It refused to bifurcate simply because of "a mere possibility of prejudice."

As to judicial economy/convenience, defendant argued that because there can be no bad faith without coverage, if it is determined there is no coverage under the policies, the second claim of bad faith will be moot. Again, the court rejected that argument, noting that while "[s]ome limited efficiency will be achieved if it turns out that Plaintiffs are unable to demonstrate coverage under the policy," there will be "substantial inconvenience to the Court and jurors if the claims are bifurcated and Plaintiffs prevail on the first claim." The court observed that some of the individuals whose testimony is relevant to the coverage claim will also have relevant testimony regarding the bad faith claim. It therefore makes "little sense to require those witnesses to testify twice, when once would be sufficient." The court further held that "the two claims are not wholly distinct from each other, and bifurcation would likely lead to unnecessary repetition in evidence and arguments."

In *Norfolk Transmission & Muffler Service v. Owners Ins. Co.*, No. 16-489 (D. NE May 25, 2017,) a magistrate judge in Nebraska denied an insurer's motion to bifurcate and stay discovery on plaintiff's bad faith claim. The underlying claim was a first party property claim based on a loss due to a hailstorm suffered at a small business. The insured contended that the insurer did not recognize the severity of the damage, failed to pay the amounts necessary to properly remediate the loss, and failed to conduct a proper investigation into the loss. The court initially noted that bifurcation may not be appropriate where discovery on the claims "substantially overlaps," in which case an order of bifurcation would lead to "inefficiency, inconvenience and the unnecessary expenditure of resources." The court ruled that "[bifurcation] would unduly prolong and complication this litigation," thus thwarting the purposes of bifurcation. It then held:

> "It appears that the outcome of each of the causes of action hinges upon Defendant's evaluation and investigation of the amount owed under the policy. It seems that many of the same witnesses and documents will be used to prove each claim. In fact, Plaintiff anticipates calling the same witnesses to testify on both issues at trial. The claims are so interrelated that it would be burdensome to try to determine what particular evidence is solely relevant to the breach of contract claim. Moreover, the creation of two phases of discovery would lead to duplication of efforts and further delay."

Yet another instructive case is *Creatore v. Assurance Co. of America*, 2010 WL 4366093 (N.D. Ohio 2010.) Assurance moved to bifurcate Creatore's claims for bad faith and punitive damages in accordance and "to stay all discovery as to [Creatore]'s claims for bad faith and punitive damages until [Creatore]'s breach of contract claim has been resolved." Assurance argued that it will be forced to argue that it properly declined coverage for the insured's claim while simultaneously arguing that even if it did wrongfully decline coverage it acted reasonably in doing so. It argued that if the bad faith claim is not bifurcated, even if it was "wrong" on the contract issues, whether it was "right enough" to be deemed to have acted with reasonable justification so as not to be liable in bad faith." Finally, it argued that judicial economy will be served because a trial on bad faith/punitive damages would be moot if the insured does not prevail on his claim for breach of contract.

The insured argued in response that there would be a significant overlap in discovery pertaining to the two claims. The same witnesses would need to be deposed for each claim, and having to depose them more than once "to ask only slightly different questions" would be highly prejudicial to Creatore, as well as inefficient.

The court ultimately denied the motion, first noting that "[b]ifurcation is the exception to the general rule that disputes should be resolved in a single proceeding," and should be ordered only in exceptional cases. In addition, "[t]here is no absolute rule that a coverage claim should always be bifurcated from bad faith claim." The court cited a litany of cases in which bifurcation motions were denied where the insurer had not demonstrated "how it will be prejudiced by simultaneous discovery beyond merely asserting that allowing discovery of the bad faith claim will prejudice its ability to defend the coverage claim." The courts in those cases observed that the scenario proposed by the insurer would result in the following sequence: 1) discovery on coverage; 2) trial on coverage; 3) discovery on bad faith; and 4) trial on bad faith, thereby resulting in protracted and duplicative discovery and in increase in both discovery and trial costs, extension of the case management timeline of the case and wasted judicial resources. Ultimately the court ruled that Assurance had failed to sustain its burden on the bifurcation motion and that judicial economy would be better served by the resolution of the entire controversy in one proceeding.

The takeway from these cases is that under Federal law, trial courts are vested with a high degree of discretion when it comes to bifurcating issues and claims. The preference is to avoid piecemeal litigation and multiple trials and thus an insurer has a heavy burden in establishing that the Rule 42(b) factors apply. If a trial court can avoid prejudice to the insurer by appropriate instructions to the jury or in otherwise managing the case appropriately through discovery orders, it will more likely land in favor of judicial economy and deny the bifurcation motion.

B. Bifurcation Granted

Of course, as is the case with many legal issues, courts have come down on the opposite side of the fence. There is no shortage of cases in which courts have held that it was proper to order bifurcation of the breach of contract and bad faith claims in order to avoid prejudice to the insurer, even at the expense of "judicial economy." Again, a few illustrative examples are presented below.

In *Dippin' Dots, LLC v. Travelers Property Casualty Company of America*, 322 F.R.D. 271 (W.D. KY 2017), Dippin' Dots sought coverage under its policy with Travelers for losses associated with spoliation of its ice cream that resulted from a power outage. Travelers denied coverage and Dippin' Dots sued Travelers for both the benefits it claimed it was entitled to under the policy and for bad faith based on Travelers' handling of the property damage claim. Travelers moved to bifurcate the trial of the first party bad faith claims, arguing that bifurcation is more efficient because under Kentucky law, plaintiff's bad faith claims depend on a threshold determination that Travelers had an obligation to pay under the policy. This determination, will involve the interpretation and application of policy language to the undisputed facts regarding plaintiff's loss, whereas the bad faith claims will rely on defendant's motives, conduct, and knowledge when it denied coverage. Plaintiff argued that bifurcation is inappropriate because the conflicting opinions between plaintiff's and defendant's experts regarding causation of the loss and interpretation of the policy are "inextricable intertwined" with the evidence which may support their contract claim (which plaintiff claimed resulted in Travelers' "bad faith" investigation.) Plaintiff further argued that the case would not simply require a jury to "apply undisputed facts to simple policy language" but instead would require a jury to determine if the opinions offered by Travelers regarding their claim denial are "credible and accurate" and in order to make that determination the jury must know the "backstory" as to why it denied their claims.

The court granted the motion to bifurcate, finding that judicial economy would be advanced by the bifurcation. In addition, the court also stayed discovery on the bad faith issues until the contract claim was decided. First, the court held that bifurcation would help to prevent prejudice to Travelers "by avoiding significant time and money litigating a bad faith claim that may never arise." The court expressed concern over the vast amount of time, resources and money that would be spent on the issue of Travelers' motive, conduct, and knowledge, issues that would be moot upon a finding of no coverage. By the same token, "bifurcation would not unduly prejudice the Plaintiff. Litigation of the coverage claim involves the interpretation and application of the policy language to the facts regarding the product loss." Ultimately, the court held that plaintiff's bad faith claim would be rendered moot if its contract claim is unsuccessful. Bifurcation will allow "the jury to focus on a single issue at a time" and, therefore, will avoid the introduction of irrelevant evidence and additional, potentially unnecessary discovery and avoid jury confusion which could potentially prejudice Travelers.

In *SCF, LLC v. Hartford Fire Insurance Company*, 2021 WL 4206624 (W.D. Tenn. September 15, 2021,) the coverage dispute involved a claim by SCF for storm damage to its commercial buildings. In its complaint, SCF alleged that Hartford breached the insurance contract by failing to pay the full $25,803,878.07 it demanded. Plaintiff further alleged that Hartford intentionally delayed its investigation and that its refusal to pay amounted to bad faith. The insurer contended that its investigation was stalled due to SCF's repeated delays in providing the information it had requested as well as the impact of the COVID-19 pandemic.

Defendant moved to bifurcate the claims and stay plaintiff's bad faith and punitive damage assertions under Rule 42(b). A magistrate judge granted the motion and plaintiff appealed to the District Court. Plaintiff argued that the bifurcation order would not be convenient, expedient, or economical because it would force the parties and the court to conduct two multi-week trials that are essentially the "same case." The District Court disagreed, noting that there would only be a second trial if the jury found that defendant breached the contract.

With respect to the prejudice issue, SCF argued that there will be no prejudice to Hartford because the evidence it will present to prove that Hartford breached its contract will be the same as it will utilize to support its claims for bad faith and punitive damages. Again, the District Court disagreed. It noted that the factual and legal issues for the breach of contract claim are different from those for bad-faith and punitive-damages, specifically, the extracontractual claims focus on Hartford's motives, its alleged bad faith in the investigation, and its denial of the claim. On the other hand, the breach of contract claim turns on the terms of the underlying insurance policy contract, specifically, whether the loss is covered under the policy, and whether SCF fulfilled its obligations under the insurance contract. Moreover, if plaintiff is allowed to introduce evidence of Hartford's purported bad faith in its handling of the claim, "the jury could hold that against Defendant when considering the issue of coverage. . . . And as such, bifurcation would aid in avoiding prejudice to Hartford while also streamlining litigation and furthering the convenience of the parties."

Lastly, the insured argued that any potential juror confusion could be alleviated by evidentiary rulings and jury instructions that clarify the different tests for liability and for punitive damages. The District Court rejected that argument, noting that the bifurcated trial will actually simplify the issues for the jury. In short, the court concluded that bifurcation is more likely to increase judicial economy as it could relieve the court from having to rule on discovery issues and preside over an extended trial that involves unnecessary claims. Moreover, by bifurcating the trial into the two stages and staying discovery on the claims, the court will ensure a more orderly discovery process and promote judicial efficiency.

The court's decision in *Briggs v. State Farm Fire & Casualty Company*, 673 Fed.Appx. 389 (5th Cir. 2016) provides another useful example as to how courts navigate through these issues. The insured made a claim with State Farm for property damage following tornado damage to their home. A dispute arose between the Briggses and State Farm as to the value of the loss. The insureds claimed that claimed that the damage to their home exceeded the policy limit of the

State Farm policy and that their home needed to be demolished and rebuilt. State Farm contended the home damage could be repaired. The Briggses filed suit against State Farm, claiming that State Farm breached the insurance policy by not paying the full value of their claim, that such a breach had no arguable basis and that they were entitled to compensatory and punitive damages.

Prior to trial, State Farm filed a motion to bifurcate the trial between the Briggses' breach of contract claim ("Phase One") and their remaining claims for extra-contractual and punitive damages ("Phase Two"). The district court granted State Farm's motion and the 5th Circuit affirmed on appeal. The court held that the insured's claims for extra-contractual and punitive damages required a showing that State Farm lacked an arguable basis for its claim position, unlike their breach of contract claim. The appellate court also noted that the district court correctly identified Federal Rule of Evidence 403 concerns in trying breach of contract and non-breach of contract claims together.

Finally, in *Taslid Interests, Inc. v. Arch Specialty Insurance Company*, 2019 WL 2085775 (S.D. Texas, January 28, 2019) the district court granted Arch's motion to bifurcated under Rule 42(b). The coverage dispute involved a claim for property damage to plaintiffs' motel that allegedly occurred during Hurricane Harvey. Arch partially denied the claim based on exclusions and limitations in the policy. Plaintiffs asserted a contract claim for alleged breach of the policy and extra-contractual bad faith claims. The court held that bifurcation of trial between the contract and all other claims is appropriate because:

1. Separate trial of the contract claim will avoid an unnecessary expenditure of resources in trying the bad faith claims if there is a finding of no coverage.

2. Arch will be prejudiced by evidence of settlement offers and bad faith during trial of the contract claim unless trial is bifurcated.

3. Bifurcation will serve efficiency by assisting the jury in focusing on engineering evidence relevant to the issue of coverage, and coverage is a separate and distinct issue so that bifurcation will not require duplication if tried separately.

The court held that "[b]ifurcation will serve the interest of economy by limiting trial to the predicate issue of coverage and potentially eliminating the need to present evidence of bad faith claims that may be disposed of by the coverage determination." Perhaps more importantly, the court concluded that if trial is not bifurcated between the contract claim and extra-contractual claims, "Arch will suffer prejudice in trying its contract claim because evidence of settlement offers and alleged acts of bad faith will taint the jury's determination of coverage." In conclusion:

> "The issue of whether a covered or excluded cause of loss resulted in the water intrusion determines whether coverage existed in this case. Trial of the contract claim does not require extensive evidence of the claims handling process or presentation of evidence relevant to alleged bad faith. The bad faith claims, which arise from after-the-fact conduct in the course and handling of the claim, can be

> tried, if necessary, in a subsequent trial without extensive duplication of the evidence. Bifurcation will allow the jury to consider the engineering testimony regarding causation without interjecting the separate and independent issues of bad faith."

These cases demonstrate the court's emphasis on the fact that if there is no breach of contract, the bad faith issues are moot. As such, judicial economy weighs in favor of a "phased" approach in which the trial of a more simpler issue with less evidence may serve to eliminate the need for a much for expansive and unwieldly trial on what would have been a moot issue. These courts also recognize the different types of evidence that will be introduced in the breach of contract claims vs. the bad faith claims thereby meriting a separation of these issues both at trial and during discovery.

III. Bifurcation Under State Law

It is beyond the scope of this paper to present a 50 state survey of how the courts in each state address bifurcation issues. This is a very jurisdiction-specific matter. However, a few cases are worth pointing out.

A. California

California courts have held that it is within the court's discretion "to bifurcate issues or order separate trials of actions, such as for breach of contract and bad faith, and to determine the order in which those issues are to be decided." (<u>Royal Surplus Lines Ins. Co., Inc. v. Ranger Ins. Co.</u> (2002) 100 Cal.App.4th 193, 205.) To that end, Code of Civil Procedure §598 provides:

> "The court may, when the convenience of witnesses, the ends of justice, or the economy and efficiency of handling the litigation would be promoted thereby, on motion of a party, make an order…that the trial of any issue or any part thereof shall precede the trial of any other issue or any part thereof in the case…"

Code of Civil Procedure §1048(b) provides as follows:

> "The court, in furtherance of convenience or to avoid prejudice, or when separate trials will be conducive to expedition and economy, may order a separate trial of any cause of action, including a cause of action asserted in a cross-complaint, or of any separate issue or of any number of causes of action or issues, preserving the right of trial by jury required by the constitution or a statute of the state or of the United States."

The appellate court in *Shade Foods, Inc. v. Innovative Products Sales & Marketing, Inc.*, 78 Cal.App.4th 847 (2000) held that the trial court did not abuse its discretion in denying bifurcation of insurance liability and coverage issues before separate juries. The appellate court held that bifurcation is a question to be determined on a case-by-case basis. The appellate court upheld the trial court's denial for bifurcation holding that the jury would have already been aware of the involvement of an insurance policy and a limiting instruction to the jury would be sufficient to prevent its existence to bear on any issue in the case:

> "Again, since Shade had already made the settlement payment, the adjudication of Shade's liability to General Mills involved circumstances that would almost inevitably allow the jury to speculate that insurance was involved - the adjudication would be meaningless except as one step in the determination of the insurer's liability to Shade.
>
> Moreover, the question of Shade's liability to General Mills represented a small portion of the case, involving the same factual determinations as were involved in the question of IPS's liability to Shade. A separate trial of this issue before a different jury would involve duplicative adjudications with a consequent waste of judicial time. Though considerations of judicial economy should not dictate an unfair procedure, they are entitled to some consideration in the trial court's exercise of discretion. It is worth noting that such considerations tended to favor consolidating the issue of Shade's liability to General Mills with other necessary adjudications. The possibility of prejudice in the present case was minimized by instructing the jury that "[w]hether insurance exists for the claim by General Mills or for the claim by Shade Foods has no bearing upon any issue in this phase of the case. [P] You must not discuss or consider the existence or nonexistence of coverage for any purpose."

B. Other Jurisdictions

1. Ohio

In *DeVito v. Grange Mut. Cas. Co.,* 996 N.E.2d 547 (2013), the insurer denied plaintiff's property damage claim arising out of a roof damage claim. The insured sued for breach of contract and bad faith. The insurer filed a motion to bifurcate the bad faith claim from the contract claim and a motion to stay the bad faith claim. The trial court granted the motion in part and denied the motion in part, ordering that although the trial of the bad faith action would be stayed pending the conclusion of the breach of contract claim, discovery would proceed on all issues. The insurer appealed the order denying stay of discovery.

The court of appeal reversed the decision of the trial court insofar as it denied a stay of discovery on the bad-faith claim, holding that

> "[t]his action relates to a single claim and involves a single homeowner; the claims are straightforward and interrelated, and resolution of the breach-of-contract claim may dispose of the bad-faith claim. Further, allowing discovery to proceed on the bad-faith claim will inhibit the insurer's ability to defend on the underlying claims and will be highly prejudicial to Grange and Zito."

The court relied on the decision reached in *Ferro Corp. v. Continental Cas. Co.*, 2008 WL 5705575 (N.D. Ohio, Jan. 7, 2008), where the court granted the insurers' motion to bifurcate and to stay discovery on the bad faith claims pending a determination of the coverage issues. With regard to the stay of discovery, the court found as follows:

> "While the Court is sensitive to Plaintiff's concerns regarding efficient allocation of resources and judicial economy, the Court finds that such concerns clearly are outweighed by the danger of unfair prejudice to Defendants. Furthermore, the Court finds that bifurcation would be ineffective to prevent prejudice to Defendants if not coupled with a stay of discovery on the bad faith issues. Because of the facts of this case and the manner in which these claims were handled by the parties, it is clear, as explained previously, that any of Defendants' attorney-client communications relating to the bad faith issue are interrelated with coverage issues. . . . Failure to impose a stay would result in manifest prejudice to Defendants' ability to defend the coverage issues."

2. New Jersey

New Jersey Rule 4:38–2 provides that the trial court may order a separate trial of any claims or issues "for the convenience of the parties or to avoid prejudice [.]" In *Procopio v Government Employees Ins. Co.*, 433 N.J. Super. 377, 80 A.3d 749 (App.Div. 2013), plaintiff filed a complaint against GEICO, asserting claims for UIM benefits under his own policy as well as bad faith refusal to pay the claim, breach of contract, and violations of the New Jersey Consumer Fraud Act (bad faith claims). During discovery, plaintiff sought, among other things, his carrier's entire claim file and other information specifically related to prosecution of plaintiff's bad faith claims. GEICO moved to sever the bad faith claims and hold them in abeyance pending resolution of the UIM benefits matter. The motion judge bifurcated the claims for trial, held the bad faith claims in abeyance, but compelled simultaneous discovery on all claims, reasoning that defendant would not be prejudiced by compelling discovery of the bad faith claims contemporaneously with discovery of the UIM claim.

On appeal, GEICO argued that the motion court abused its discretion by compelling discovery on the bad faith claims to proceed before resolution of the UIM claim. The appellate division agreed, first noting "we discern very little benefit in allowing discovery to proceed simultaneously since a claim for UIM benefits is separate and distinct from a claim of bad faith and the evidence used to establish each claim is very different . . . " It then held that:

> "The toll on judicial economy by allowing full disclosure up front, on the other hand, is obvious. Requiring simultaneous discovery on both claims will result in a significant expenditure of time and money, generally rendered needless if the insurer prevails on plaintiff's UM or UIM claim. Such premature discovery may also jeopardize the insurer's defense of the UM or UIM claim by the disclosure of potentially privileged materials. Indeed, if an insured attempting to prove the validity of his or her claim against an insurer could obtain the insurer's investigative files—showing exactly how the company processed the claim, how thoroughly it was considered and why the company took the action it did—merely

> by alleging the insurer acted in bad faith, then there would be an open invitation to all plaintiffs to include such allegations with every breach of contract claim."

In short, "[w]hatever, therefore, the benefits of simultaneous discovery, they are substantially outweighed by the burdens exacted both institutionally and individually."

3. Texas

The Supreme Court of Texas recently issued a bifurcation ruling "with a twist." In *In re State Farm Mutual Automobile Insurance Company*, 629 S.W.3d 866 (2021), the underlying action was a UIM action but the insured did not sue its insurer for breach of contract. Although they sought recovery of the amount they claim to be owed under their policies, they brought only extracontractual statutory bad faith claims. They argued that because they brought only statutory claims, there were no breach of contract claims to sever and try first, therefore no bifurcation of trial is required. The Court disagreed. To begin with, the only damages claimed by the insureds were predicated on State Farm's obligation to pay them under their UIM policies, as opposed to some independent act of bad faith distinct from the claim for benefits. Therefore, "they must establish their rights to policy benefits in order to recover on their Insurance Code claims . . . . " From there, the Court applied the general rule in Texas that "extra-contractual claims must be [bifurcated] until the underinsured motorist breach of contract claim is determined."

The Court offered at least two justifications for this rule. First, bifurcation preserves judicial resources. The plaintiffs' Insurance Code claims cannot be resolved without first determining whether State Farm has a contractual duty to pay UIM benefits. "The rationale for requiring [bifurcation] of these types of [statutory] claims is that they may be rendered moot by a determination of underlying [non-]liability." The insureds' statutory claims need not be considered at all if State Farm has no duty to pay under their policies. Like any other litigant, "[i]nsurers have a substantial right not to undergo the expense of litigating and conducting discovery on issues that ultimately may be unnecessary because of the result of the underlying tort case."

Second, bifurcation of trial is proper because evidence of the insurer's settlement offer may be admissible in one phase of the trial but inadmissible in the other. When determining whether an insurer has breached its UIM policy by failing to pay, courts frequently exclude evidence of a settlement offer because the offer "creates prejudice" by suggesting the insurer has already admitted some liability. On the other hand, in the trial of bad faith claims, the settlement offer is generally admissible as evidence of the insurer's good-faith (or bad-faith) efforts to resolve the claim. "Absent [bifurcation], an insurer is presented with a 'Catch-22' in that its decision to admit or exclude evidence of a settlement offer jeopardizes the successful defense of the other [issue]." "[I]n this situation, the trial court can only reach one decision which adequately protects the parties' rights and that is to order [bifurcation] of the [issues]."

Thus, the Court sided with the consensus view of the courts of appeals on this issue. "Requiring State Farm to litigate its liability for UIM policy benefits alongside its liability for extracontractual claims would unduly prejudice the insurer and amounts to an abuse of discretion by the trial court." It rejected the insureds' argument that its election not to sue for breach of contract somehow distinguished the application of this rule, concluding that “the logic of the commonly applied sever-and-abate rule applies with equal force here, although the procedural machinations may be slightly different.”

4. Connecticut

In *Stonebridge Advisors, LLC v. Liberty Insurance Underwriters, Inc.*, 2019 WL 3780451(July 12, 2019), the trial court denied an insurer’s motion to bifurcate. In that action, plaintiff sued Liberty for breach of contract and bad faith arising out of its handling of a liability claim. Liberty moved to bifurcate discovery on plaintiff's bad faith claims from its declaratory judgment and contract claims on the grounds that bifurcation was necessary to prevent prejudice to it and to promote judicial economy. It argued that resolution of the coverage claims turned primarily on the issue of whether plaintiff was permitted to settle the underlying action without obtaining Liberty's consent under the facts and circumstances presented by that action. It further argued that bad faith discovery involving its handling of the underlying action, other lawsuits against it alleging bad faith and its claims-handling manuals and policies, was not relevant to the narrow issue of whether Liberty breached the policy under the specific circumstances at issue in this action. In the event the court were to find that Liberty did not breach the policy, plaintiff’s bad faith claims fail as a matter of law.

The insured argued that Liberty unreasonably withheld consent to settle the underlying claim within the policy limits in breach of the policy, and that those actions, in addition to breaching the insurance contract, were done in bad faith and in violation of Connecticut's Unfair Trade Practice and Unfair Insurance Practice statutes.

The trial court declined to grant the bifurcation motion, noting that “it appears from the pleadings and submissions of the parties that many of the facts relating to the contract claims overlap with the bad faith claims although different principles of law apply. It is arguable that bifurcation of discovery at this stage could result in unnecessary discovery, duplication and delay.” Indeed, the court noted that if the plaintiff were to prevail in the breach of contract phase and discovery on the defendant's actions and policies been precluded, “even more time and resources would be expended.”

In summary, courts are more likely to sever claims or bifurcate issues when the trial of one issue or claim may potentially dispose of the entire case or when evidence admissible for some limited purpose would likely prejudice the jurors if known to them during their decision of some other issue. This may arise in situations where the insurer, while denying benefits are owed, nevertheless made a settlement offer. It may wish to introduce that offer as evidence of its “good faith,” yet in so doing, a jury may deem that to be an admission by the insurer that benefits were owed. Federal Rule of Evidence 408 provides that an insurer's offer of settlement cannot be offered as evidence to prove the insurer's liability under a contract claim. However, settlement offers are relevant to rebut the bad faith allegations. The existence of a settlement offer prejudices the insurer's ability to argue to a jury that the claim was not covered under the contract. *Houston McLane Co., Inc. v. Connecticut Gen'l Life Ins. Co.,* 2006 U.S. Dist. LEXIS 77653 (S.D. Tex. October 24, 2006). It is not uncommon for the parties in the underlying action to participate in a mediation and for the insurer to extended settlement offers to the plaintiffs in that action, despite its position that it bears no liability, in effort to compromise and avoid litigation. Such offers are relevant to the issues of bad faith, but if presented at trial of the contract claim, would violate Rule 408 and prejudice the defense of no coverage.

Whether to bifurcate or sever remains within the trial court's broad discretion – appellate courts normally do not interfere with a trial court's exercise of that power absent an abuse of discretion.

Ultimately, motions to bifurcate are more likely to succeed where there is not significant overlap of issues relevant to both the underlying contractual and bad faith claims, the potential prejudice to the insurer is significant, and the insurer is able to demonstrate that separate witnesses and materials would be necessary to defend a contemporaneous trial.

IV. Scope of Bifurcation – Bifurcated Discovery vs. Bifurcated Trial

One issue that emerges from these cases is the distinction between a bifurcation motion which seeks only to bifurcate/sever the breach of contract claims from the bad faith claims at trial, as opposed to a complete severance and stay of the bad faith claims, including all discovery as to the latter. As evidenced from the above, it is a common practice of insurers to seek a complete severance of the breach of contract claims from the bad faith claims, coupled with a discovery stay as to the later. "Bifurcation of the trial does not necessarily require bifurcation of discovery." *Hirst v. Gertzen*, 676 F.2d 1252, 1261 (9th Cir. 1982)

Where the bifurcation motion is limited to trial only, the parties are permitted to conduct discovery as to all aspects of their case, leaving only the trial to be bifurcated. If the insurer is found to have breached the insurance contract, the trial can then proceed directly to the bad faith phase. But if discovery on the bad faith claim has been stayed, then discovery is re-opened. It is therefore no surprise that courts have held that even where bifurcation at trial is appropriate, bifurcation of discovery may not be. Some courts appear to consider the need to delay discovery on the bad faith claim, such as to limit access to the insurer's claims file, in determining that bifurcation is required. In *Cook v. United Serv. Auto Ass'n*, 169 F.R.D. 359, 362 (D.Nev. 1996) the court noted:

> "With joint discovery, the plaintiffs will be better informed and therefore better prepared in the event of settlement negotiations or alternative dispute resolution. . . . Moreover, the court, by not staying discovery on bad faith claims, can avoid hearing discovery disputes over which documents pertain to the contract claim and which relate to the bad faith claims. . . . Also, joint discovery may expedite resolution of the entire matter by permitting the second trial, if it is necessary, to commence immediately after the first."

Many of the insurers' arguments relate more aptly to bifurcation of a trial as opposed to bifurcation of discovery. In fact, where courts have bifurcated trial of issues in the interests of avoiding prejudice and promoting judicial economy, it does not necessarily follow that discovery should be bifurcated and stayed. The negative aspects of bifurcated discovery include duplicative depositions of claims and underwriting personnel, multiple sets of written discovery requests, and courts forced to resolve discovery disputes in a piecemeal fashion. Of course, in an appropriate case, these negatives are outweighed by the efficiency of first determining coverage, and if there is none, ending the matter expeditiously by avoiding unnecessary discovery regarding a meritless bad faith claim.

This was addressed by the court in *Dippin Dots, supra.* The court there held that there was good cause to stay discovery on plaintiff's bad faith claim until its breach of contract claim has been resolved. First, because plaintiff's bad faith claim turns on the success of its breach of contract claim, failure to issue a stay might result in needless discovery (and added expense). Second, issuing a stay protects the parties from battling over the production of defendant's investigatory files, which would undoubtedly result in the spending of additional time and resources for both the court and the parties. As such, staying discovery on Plaintiff's contingent claims promotes judicial economy and the legitimate interests of the parties while allowing discovery to go forward on the dispositive contract coverage claim. Thus, the court held that “inquiry into the basis for the Bad Faith Claims should be stayed until the necessity for such discovery is certain.”

Staying discovery of the bad faith claim can be a crucial issue. As a practical matter, information and documents pertaining to coverage also relate to bad faith. For example, the claim file likely will contain documents evidencing the carrier’s coverage analysis and/or the reasons behind a denial, some of which may evidence bad faith. These documents include internal communications within the claims departments and with underwriters as well as communications with brokers and agents. These communications may have no bearing on the strictly legal issue of policy interpretation and whether benefits are owed. Courts have also stayed bad faith claims where the information relevant to a bad faith inquiry may be confidential and proprietary in nature and prejudice the insurer during the litigation of the underlying contract claim. *Dunkelberger v. Erie Ins. Co.*, No. 2010-01956 (Lebanon County, Jan. 24, 2011). Other courts have further denied bifurcation motions where discovery requests for the contract and bad faith claims overlapped, ruling that issues concerning the proprietary nature of information discovered could be addressed with a confidentiality agreement. *Frederick v. Emily’s Inc. v. Westfield Grp.*, 2004 U.S. Dist. LEXIS 17274 (E.D. Pa. Aug. 27, 2004).

In *Omni Health Solutions, LLC v. Zurich American Insurance Co.*, 2018 WL 4701791 (DC Ga. October 1, 2018), a Georgia trial judge ruled that claims notes claims notes prepared in anticipation of litigation are discoverable for a bad faith claim, but not for a breach of contract claim, resulting in the bifurcation of the two claims. Judge Self held that the insured may have a substantial need for the claims notes, but only as to its claim for bad faith, not to the claim for breach of contract. According to the court, bad faith claims can only be proved by discovering how an insurer handled the claim, and therefore, the information in claims files is “not only substantial, but overwhelming.” As a result, Judge Self ordered bifurcation of the breach of contract claim and the bad faith claim. Once the breach of contract claim is resolved, “and not before that time” would the claims notes, which were created in anticipation of litigation, be produced but not until the parties proceed with the bad faith claim.