

KEEPING AN EYE ON BAD FAITH RULES

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I. Introduction

Any discussion of settling a claim with an insurance company warrants the consideration of bad faith. This presentation will focus on the Alabama tort of bad faith as it relates to the investigation, negotiation, and settlement of insurance claims. And then we will discuss the practical side of dealing with bad faith on the part of claimant and avoiding bad faith on the part of the insurer.

II. THE RULES: Bad Faith Denial of Insurance Claims

A. Statutory duty of bad faith

The obligation of good faith is implied in every contract under Alabama law. Alabama Code § 7-1-304 (1975) provides:

“Every contract or duty within this title imposes an obligation of good faith in its performance or enforcement.”

This statutory obligation of good faith is not unique to insurance contracts, but is a broader equitable principle that implicitly governs all contracts in Alabama. The Alabama Supreme Court has rejected causes of actions based on a breach of this statute-imposed obligation of good faith explaining that it is merely “directive” and not “remedial.” *Government Street Lumber Co. v. AmSouth Bank*, 553 So. 2d 68, 72 (Ala. 1989) (refusing to allow an action based on such a theory in tort or in contract).

B. Common Law Cause of Action for Bad Faith Failure to Pay Insurance Benefits

The tort of bad faith in Alabama is peculiar to the insurance industry. *Keeton v. Bank of Red Bay*, 466 So. 2d 937, 940 (Ala. 1985)(a “bad faith” cause of action, except in the context of a contract for insurance, is not a cognizable cause of action). The Alabama Supreme Court set forth the elements necessary for a plaintiff to establish a bad-faith claim in *National Security Fire & Casualty Co. v. Bowen*, 417 So. 2d 179 (Ala.1982); those elements are:

“(a) an insurance contract between the parties and a breach thereof by the defendant;

“(b) an intentional refusal to pay the insured's claim;

“(c) the absence of any reasonably legitimate or arguable reason for that refusal (the absence of a debatable reason);

“(d) the insurer's actual knowledge of the absence of any legitimate or arguable reason;

“(e) if the intentional failure to determine the existence of a lawful basis is relied upon, the plaintiff must prove the insurer's intentional failure to determine whether there is a legitimate or arguable reason to refuse to pay the claim.”

Id., at 183.

1. Normal Bad Faith

Requirements (a) through (d) represent the “normal” case. *Employees’ Benefits Ass’n v. Grissett*, 732 So. 2d 968, 976 (Ala. 1998). In a “normal” case the insurer is precluded from using an ambiguity in the contract as a basis for claiming a debatable reason not to pay a claim. *Id.* So basically, an insurer is liable for a “bad faith refusal to pay” a direct claim when there is no lawful basis for the refusal coupled with actual knowledge of that fact. No lawful basis “means that the insurer lacks a legitimate or arguable reason for failing to pay the claim.”

National Sec. Fire & Cas. Co. v. Bowen, 417 So. 2d 179 (Ala.1982). When a claim is “fairly debatable,” the insurer is entitled to debate it, whether the debate concerns a matter of fact or law. *Id.*

2. Abnormal Bad Faith

Requirement (e) represents the ‘abnormal’ case.” *Employees’ Benefits Ass’n v. Grissett*, 732 So. 2d 968, 976 (Ala. 1998). To recover under a theory of an “abnormal” case, the plaintiff must show “(1) that the insurer failed to properly investigate the claim or to subject the results of the investigation to a cognitive evaluation and review and (2) that the insurer breached the contract for insurance coverage with the insured when it refused to pay the insured's claim.” *State Farm Fire & Casualty Co. v. Slade*, 747 So. 2d 293, 318 (Ala. 1999).

Courts have found a bad faith refusal to pay an insurance claim in “abnormal” cases when (1) the insurer intentionally or recklessly failed to investigate the plaintiff's claim, *See Employees' Benefit Ass'n v. Grissett*, 732 So. 2d 968, 976 (Ala. 1998); *Continental Assur. Co. v. Kountz*, 461 So. 2d 802, 808 (Ala. 1984); *Mutual Service Cas. Ins. Co. v. Henderson*, 368 F.3d 1309 (11th Cir. 2004); *and National Ins. Ass'n v. Sockwell*, 829 So. 2d 111, 130 (Ala. 2002) (an insurer has the responsibility to “marshal all of the pertinent facts with regard to its insured's claim” before denying coverage); (2) intentionally or recklessly failed to properly subject the plaintiff's claim to a “cognitive evaluation or review,” *see Kervin v. Southern Guar. Ins. Co.*, 667 So. 2d 704, 705 (Ala. 1995); *Ex parte Simmons*, 791 So. 2d 371, 379 (Ala. 2000); (3) created its own debatable reason for denying the plaintiff's claim, *see United American Ins. Co. v. Brumley*, 542 So. 2d 1231 (Ala. 1989); *Jones v. Alabama Farm Bureau Mut. Cas. Co.*, 507 So. 2d 396 (Ala. 1986); *National Sec. Fire & Cas. Co. v. Bowen*, 417 So. 2d 179 (Ala. 1982); *and State Farm Fire & Cas. Co. v. Slade*, 747 So. 2d 293, 315-316 (Ala. 1999); or (4) relied on an ambiguous portion of the policy as a basis for denying the plaintiff's claim. *See Blue Cross and Blue Shield of Alabama v. Granger*, 461 So. 2d 1320 (Ala. 1984); *Blackburn v. Fidelity and Deposit Co. of Maryland*, 667 So. 2d 661, 669 (Ala. 1995); *United American Ins. Co. v. Brumley*, 542 So. 2d 1231 (Ala. 1989); *Jones v. Alabama Farm Bureau Mut. Cas. Co.*, 507 So. 2d 396 (Ala. 1986); *Employees' Benefit Ass'n v. Grissett*, 732 So. 2d 968, 977 (Ala. 1998); *Loyal American Life Ins. Co., Inc. v. Mattiace*, 679 So. 2d 229, 237 (Ala. 1996); *Taylor v. Aetna Life*

Ins. Co., 54 F. Supp. 2d 1076 (M.D. Ala. 1999). See also *State Farm Fire & Cas. Co. v. Slade*, 747 So. 2d 293 (Ala. 1999) (holding that the question of whether a contract is ambiguous is for the court to decide).

3. Duty to Defend

Sometimes an insured will get sued for an incident that is covered by its insurance policy. An insurer's duty to defend its insured at the beginning of a lawsuit is generally broader than its duty to indemnify the insured for a judgment that ends the lawsuit. *Universal Underwriters Ins. Co. v. Youngblood*, 549 So. 2d 76 (Ala. 1989); *United States Fid. & Guar. Co. v. Armstrong*, 479 So. 2d 1164 (Ala. 1985). The insurer's duty to defend is determined by the language of the insurance policy and the allegations of the complaint. *Ajdarodini v. State Auto Mut. Ins. Co.*, 628 So. 2d 312 (Ala. 1993). In Alabama, an insured may recover against an insurer for the failure to defend it in a lawsuit growing out of the insured incident. *Ladner & Co., Inc. v. Southern Guaranty Ins. Co.*, 347 So. 2d 100, 102 (Ala. 1977). This failure to defend may be an actual or constructive denial of its duty to defend. *Blackburn v. Fidelity and Deposit Co. of Maryland*, 667 So. 2d 661, 668 (Ala. 1995). But when an insurance company undertakes a defense pursuant to a reservation of rights (preserving the opportunity to later dispute coverage), it does so under an "enhanced obligation of good faith" towards its insured in conducting such a defense. See *L & S Roofing Supply Co., Inc. v. St. Paul Fire & Marine Ins. Co.*, 521 So. 2d 1298, 1306 (Ala. 1987) (setting forth the criteria the insurer must meet in order to fulfill its "enhanced duty of good faith"). When the criteria of an enhanced duty are not met, the insurer cannot deny coverage. *Aetna Cas. & Sur. Co. v. Mitchell Bros., Inc.*, 814 So. 2d 191, 198 (Ala. 2001). And if the insured decides to settle the claim, the insurer is bound by any reasonable and good faith settlement of a claim a court later determines falls under the policy's coverage. *Liberty Mut. Ins. Co. v. Wheelwright Trucking Co., Inc.*, 851 So. 2d 466, 478 (Ala. 2002).

The standard automobile liability policy obligates the insurer to pay on behalf of the insured all sums that the insured becomes legally obligated to pay as damages because of bodily injury, sickness, or disease, including death there from, and injury to or destruction of property, including the use thereof, arising out of the ownership, maintenance, or use of the owned

automobile, or any non-owned automobile. *American Liberty Ins. Co. v. Soules*, 288 Ala. 163, 167, 258 So. 2d 872, 876 (1972). However, this obligation to “defend any suit” refers not only to the type of coverage, but also to the amount of coverage, and the duty to defend is limited by the amount of liability coverage afforded by the policy. It follows that the insurer is not required to defend remaining claims and suits after it has exhausted the policy limit in settling suits arising from the same accident. *See Waters v. American Cas. Co. of Reading, Pa.*, 261 Ala. 252, 73 So. 2d 524 (1953). So an insurer’s duty to defend its insured- while somewhat broad and subject to an “enhanced” duty of good faith- is nevertheless confined to the language and limits of the subject policy.

C. Insurance Trade Practices Law

Alabama Code § 27-12-24 (1975) provides:

“No insurer shall, without just cause, refuse to pay or settle claims arising under coverages provided by its policies in this state and with such frequency as to indicate a general business practice in this state, which general business practice is evidenced by:

- (1) A substantial increase in the number of complaints against the insurer received by the insurance department;
- (2) A substantial increase in the number of lawsuits against the insurer or its insureds by claimants; and
- (3) other relevant evidence.”

The current pocket part of the Alabama Code contains the following annotation: Alabama’s cause of action of bad faith is limited to the insurance industry and is, therefore, exempt from ERISA preemption. *Hill v. Blue Cross Blue Shield*, 117 F. Supp. 2d 1209 (N.D. Ala. 2000). Please note that the *Hill* case does not represent the current state of the law in the Eleventh Circuit. *See Gilbert v. Alta Health & Life Ins. Co.*, 276 F.3d 1292 (11th Cir. 2001)

(holding that Ala. Code § 27-12-24 (1975) does not “regulate insurance” within meaning of ERISA savings clause and is thus preempted by ERISA.)

D. Damages available for Bad Faith

Because the violation of the duty of good faith and fair dealing is tortious in nature, punitive damages, as well as compensatory damages, are recoverable in a proper case. *Gulf Atlantic Life Ins. Co. v. Barnes*, 405 So. 2d 916 (Ala. 1981). Even if the defendant insurer has intentionally breached his duty of good faith, punitive damages are not to be awarded unless the plaintiff shows that he suffered, at least, nominal damage and that the acts complained of were committed with malice, willfulness, or wanton and reckless disregard of the rights of others. *Id.* The damages recoverable in an action for bad faith refusal to pay a claim may also include mental distress and economic loss. *Chavers v. National Sec. Fire & Cas. Co.*, 405 So. 2d 1 (Ala. 1981). *See also Gulf Atlantic Life Ins. Co. v. Barnes*, 405 So. 2d 916 (Ala. 1981).

III. Insurer: Practical tips for Avoiding Bad Faith

Almost all insurance companies that do business in Alabama are familiar with the tort of bad faith and how to avoid it. And none of these companies have the audacity, or stupidity, to establish formal guidelines that equate to an intentional blanket refusal of claims without considering their merit. So avoiding bad faith most often boils down to an insurer simply practicing due diligence in its claims adjusting process. An insurance company’s practice of avoiding bad faith conduct, however, is only as strong as the actions of its individual claims adjuster. Here is a checklist of practical ways for an insurance company to avoid bad faith:

- Keep a detailed and well-documented claims file for every claim. (pattern and practice)
- The adjuster should document every single action taken on a claim’s file by entering a description of the action into the company’s log note system.
- Make sure that you have “Layers” of people manning the file so an investigation does not get ignored. (Adjuster, Supervisor etc.)
- Return phone calls and correspondence promptly.

- Always err on the side of providing coverage for a claim, rather than denying a claim.
- The claims adjuster should promptly notify his or her supervisor and/or the company's internal legal counsel when faced with potential pitfalls.
- When necessary, the insurer should consult competent outside legal counsel.
- Have periodic training and lunch seminars for adjusters instructing them and reminding them of the importance of avoiding bad faith conduct.

The claims department of an insurance company that has infused the above-listed items into its culture and operations will have very few problems defending against allegations of bad faith. And, hopefully, the company will be able to avoid bad faith allegations altogether.

IV. Plaintiff: Guarding Against Undue Delay and Other Unreasonable Actions

There is no question that an insured can be put in a desperate situation when an insurer refuses to pay a valid claim. For example, when a valid auto claim is denied, the insured can be left without a way to get to work. Even worse, if an insurance company wrongfully denies a homeowner's claim for a fire loss, the family can literally be left homeless. Or, as a last example, unpaid medical bills can force an insured into bankruptcy when its insurer withholds coverage under the policy. These are reasons why Alabama courts have shown a willingness not only to compensate the insured for the insured loss, but to punish the insurer for its bad faith in situations like these. *See, generally, National Ins. Ass'n v. Sockwell*, 829 So. 2d 111, 140 (Ala. 2002).

However, the more common scenario- which can sometimes be equally as damaging as an outright denial of a claim as discussed above- is where the claims adjustment process takes too long. The "abnormal" case of bad faith cause of action discussed earlier in this lecture is designed to provide a legal remedy for this kind of behavior (when intentional), but is by no way a swift or easy means to recovery. So an insured should be well-advised of practical ways to speed along the claims adjustment process and, hopefully, get a check from the insurance company so the insured can quickly resume life as it was prior to the loss. Some of these practical ways are discussed below:

- Always notify the proper authorities (i.e. police, fire department) immediately when an accident occurs. Their report will be important to the claims process.
- Be completely honest. Adjusters are not easily fooled.
- Don't be too greedy. You should expect to be made whole- not to be put in a better position than you were prior to the accident.
- Stress your emotional points to appeal to the "human" side of the claims adjuster.
- Create a paper trail. Send follow-up emails or letters following your phone conversations with the adjuster.
- Don't give a statement to the adjuster until you have properly prepared.
- Get multiple estimates for property damage.
- When you are being unreasonably ignored, use words that get attention (i.e. "lawyer", "bad faith", "supervisor").
- Don't be afraid to consult an attorney during the claims process.

Hopefully you will never find yourself in a prolonged adversarial role with any insurance company. If you do, however, keep the above-listed tips in mind when negotiating a settlement. And you will put yourself in the best position possible to receive a favorable amount of money for your claim.

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