

ViEWS

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Insurance and Reinsurance Bad Faith Issues in Workers' Compensation

by Merton E. Marks

No other claim in insurance law is easier to threaten and more complex to defend against than “Bad Faith.”

This paper discusses several aspects of these claims in workers' compensation cases:

1. The background of insurance bad faith actions;
2. Bad faith defined;
3. Bad faith claims by employees against employers and insurers;
4. Defenses to bad faith claims;
5. The relationship of Unfair Claims Practices Acts and Insurance Codes to Bad Faith Claims;
6. Bad faith claims by employers against insurers;
7. Bad faith claims between insurers and reinsurers;
8. Bad faith claims between retrocedents and retrocessionaires

Employee Bad Faith Claims Against the Employer: Background

The genesis of insurance bad faith claims is the covenant of good faith and fair dealing implicit in

all insurance policies. Before there were insurance bad faith claims, the sole theory of recovery against insurers lay in a breach of contract action by the insured against the insurer. This precedent was established in an 1854 English case, *Hadley v Baxendale*, 156 Eng. Rep. 145, in which the court ruled that damages over and above the foreseeable contract liability could not be awarded. That was the prevailing law for more than 100 years until the modern cause of action for insurance bad faith was established in a California third party case, *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198 (Cal. 1958). California later expanded application of the bad faith rule to first-party insurance policies in *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal.1973). These cases allowed a separate tort cause of action for alleged damages arising from breach of contract actions. It is now well established that the policyholder (first party claimant) can sue the insurer for bad faith conduct arising out of claim administration. This doctrine was imported into workers' compensation cases in which claimants are treated as first parties for bad faith purposes.

Bad Faith Defined

The definition of “bad faith” is elusive, subjective and

dependent on the applicable law. Therefore, in any given case, the statutes and case law of the state where the case is pending must be reviewed.

Insurance bad faith claims cross all lines of insurance. For example, in *Universe Life Ins. Co. v Giles*, 950 S.W.2d 48 (Tex. 1997), a health insurance case, the court defined what constitutes insurance bad faith: the insurer had exclusive control of the evaluation, processing and denial of claims and breached its duty of good faith and fair dealing when it had no reasonable basis for denying or delaying payment.

Other cases have defined what bad faith is not. In *Rawlings v Farmers Ins. Co.*, 726 P.2d 565 (Ariz. 1986), a fire policy case, the Arizona Supreme Court held that mere negligence or inadvertence is not bad faith. For a finding of bad faith and an award of punitive damages, the insurer must intend to commit the act or omission without reasonable or fairly debatable grounds. There must be an “evil motive.” Therefore, denial or delay of payment alone does not constitute bad faith. The insurer’s conduct must be “malicious, intentional, fraudulent or grossly negligent.”

Similarly, in *State Farm Fire & Casualty Co. v Brechbill*, 144 So. 3d 248 (Ala. 2013), a homeowners’ insurer denied coverage for alleged storm damage to a home on grounds that the property damage was preexisting. The policyholder premised his bad faith claim on alleged inadequate investigation. The Alabama Supreme Court stated:

“Perfection is not the standard...A bad faith refusal to investigate cannot survive where the trial court has expressly found as a matter of law that the insurer had a reasonably legitimate or arguable reason for refusing to pay the claim...State Farm repeatedly reviewed and reevaluated its own investigative facts as well as those provided by [the insured]... The facts before us do not rise to the level of bad faith, dishonesty, self-interest, or ill will inherent in bad-faith conduct. Even if State Farm improperly omitted some aspects of a complete investigation, “more than bad judgment or negligence is required in a bad-faith action.” *Singleton v. State Farm Fire & Cas. Co.*, 928 So.2d 280, 287 (Ala. 2005). “Bad faith, then, is not simply bad judgment or negligence. It imports a dishonest purpose and means a breach of known duty, i.e., good faith and fair dealing, through some motive of self-interest or ill will.” [144 So.3d 259-260] (Italics by the court)

In another homeowner’s claim, *Barnett v. State Auto Property & Cas.*, 2015 U.S. Dist. LEXIS 7193 (W.D.N.C.), the basis of the bad faith action was that only part of the claimed damaged was paid by the insurer. The court ruled that even though an insured may demonstrate aggravating conduct by showing fraud, malice, gross negligence, insult, rudeness, oppression, or reckless and wanton disregard of the insured’s rights, there must be more than an honest disagreement as to the validity of the claim.

An honest mistake that is corrected when discovered can, nonetheless, constitute bad faith if remedial action is not promptly taken. In *Haney v. ACE American Ins. Co.*, 2015 U.S. Dist. LEXIS 309 (D. Ariz.), the third party claims administrator handling an Arizona workers’ compensation case, made an honest miscalculation of the claimant’s workers’ comp benefits. But, when it was discovered, it took nearly a year to pay retroactive benefits. During that time, the claimant’s attorneys sent repeated emails to the adjuster requesting the overdue payments and the Industrial Commission ordered the payments to be made. After approximately ten months, the adjuster’s supervisor became aware that the retroactive benefits had not been paid and they were sent quickly. The adjuster testified that she did not pay the back payments due to her heavy caseload.

Nonetheless, the court ruled that unreasonable conduct can include failure to conduct an immediate and adequate investigation, failure to act promptly in paying a legitimate claim, and forcing an insured to go through needless adversarial efforts to enforce its policy rights. The court further ruled that bad faith does not require intent to harm the insured, but can occur if the action is without a “founded belief.” The court determined that the adjuster knowingly failed to undertake an adequate investigation and that the delay in paying benefits was bad faith as a matter of law. The court also ruled that the third party administrator’s action did not absolve ACE of liability. As the insurer, its duty was to exercise good faith toward its insured. In other words, it could not delegate this duty to its third party claims administrator.

Summarizing these cases, bad faith is not shown where:

1. The insurer has a legitimate or arguable reason for not paying the claim;
2. There is only negligence or inadvertence or honest mistake without more;
3. There is merely a disagreement as to the validity of the claim;

4. The insurer's conduct was not perfect (whatever that is!).

For bad faith to be proved, there must be:

1. No reasonable or debatable basis for denying the claim;
2. An evil motive: malicious, intentional, fraudulent or grossly negligent conduct.

The Defense of Exclusive Remedy

In addition to the basis for denial of bad faith in the foregoing cases, there is an additional defense in workers' compensation cases: compensation is the exclusive remedy of an industrially injured worker against the employer and carrier.

The most common bad faith cases against carriers involve claim processing: improper investigation of a claim, late payment of benefits, invasive surveillance and various alleged acts of harassment and fraud. For example, in *Franks v USF&G Co.*, 718 P. 2d 193 (Ariz. App. 1985), the case that established bad faith in Arizona, the claimant sustained a back injury and received conservative treatment. The insurer ordered an IME. The doctor stated that the claimant had recovered and the carrier terminated benefits. The claimant contested the termination. The administrative law judge rejected the opinion of the defense examiner and accepted the

of them got the carrier into trouble. The court upheld a cause of action for bad faith notwithstanding the defense of exclusive remedy.

Following the *Franks* case, the Arizona Legislature enacted ARS § 23-930 giving the Industrial Commission authority to adjudicate bad faith claims administratively. The purpose of the statute was to take bad faith comp cases out of the courts and keep them in the Industrial Commission. However, the first case to challenge the new statute on appeal only compounded the insurance industry's woes. The Arizona Supreme Court ruled in *Hayes v Continental Ins. Co.*, 872 P. 2d 668 (Ariz. 1994) that the workers' compensation statute did not preempt common law bad faith actions; it merely created an alternate remedy so that henceforth, the courts and Industrial Commission now had dual jurisdiction. Subsequent legislative attempts to override the *Hays* decision and restore exclusive jurisdiction in the Industrial Commission have failed.

State Unfair Claims Practices Acts and Insurance Laws

Both state Unfair Claims Practices Acts and Insurance Codes contain prohibitions against certain conduct by insurers that might constitute bad faith. But, do these Acts apply to workers' compensation claims? In *Texas Mutual Insurance Co. v Ruttinger*, 381 S.W. 3d 432 (Tex. 2012) the Texas Supreme Court ruled that the Texas Insurance Code ("TIC") and the Texas Deceptive

Trade Practices Act ("TDTPA") do not apply to workers' comp cases. In that case, the claimant reported an industrial injury, but investigation showed that he had been injured in an earlier softball tournament, had come to work on the day of the alleged accident with a limp and had "... bragged [to a co-worker] about getting it paid by workers' comp..." The carrier accepted compensability, but denied

surgical benefits. The claimant sued the carrier for violations of the TIC and TDTPA alleging: breach of the covenant of good faith and fair dealing; failure to have investigative standards; failure to investigate; failure to explain the denial; failure to promptly settle when liability was reasonably clear; and misrepresentation of the insurance policy provisions.

The jury returned a verdict for the claimant finding that the carrier had breached the covenant of good faith

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attending doctor's opinion that the claimant is in need of further treatment. Benefits were reinstated. Shortly after, the carrier ordered a second IME with the same scenario as previously. Benefits were again ordered reinstated. Shortly after, the carrier ordered a third examination. Benefits were terminated and a third award in the claimant's favor was issued. A bad faith action was filed—the first of its kind—in Arizona. Note that each of the actions taken by the carrier was allowed by law. But, the cumulative effect and frequent timing

and fair dealing and had knowingly engaged in unfair and deceptive acts. The Texas Supreme Court reversed and ruled that the TIC and TDTPA do not apply to comp cases; compensation is the exclusive remedy.

Advice of Counsel Defense

Another defense is “advice of counsel.” Claims personnel often consult counsel for advice in the course of administering a claim. Does this insulate the carrier from a bad faith claim? In a 2015 decision, *Everest Indemnity Insurance Co. v Rea*, (Ariz. App. 2015), the Arizona Court of Appeals held that in a bad faith case against an insurer, the carrier must not only prove that it sought and received the advice of counsel, but also that it depended on the advice in forming its decision as to action.

Avoidance of Bad Faith Comp Claims and Defenses: 11 Points to Keep in Mind

1. Denial or delay of payment alone does not constitute bad faith. The insurer’s conduct must be “malicious, intentional, fraudulent or grossly negligent” or something close to that. Mere negligence is not bad faith. Perfection is not required.
2. Conduct a thorough investigation.
3. Denial or closure of a claim must be based on reasonable or fairly debatable grounds supporting the employer’s or insurer’s action.
4. Consult counsel when necessary, but keep in mind that the attorney must be given all of the information. The insurer must rely on advice of counsel in taking action. Keep in mind that asserting the “Advice of Counsel” defense may waive the attorney-client privilege.
5. Use common sense in what goes into the claims file.
6. Watch for early storm signals. Little problems become big ones unless nipped in the bud.
7. Be prompt in answering communications from the claimant, his or her lawyer and doctors.
8. Do not threaten the claimant with closing the case unless he or she accepts a settlement.

9. Do not condition payment of an undisputed claim on settlement of a disputed one.

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10. Do not misinterpret or conceal coverage.
11. If there has been a mistake in administration of the claim, correct it ASAP and promptly take remedial action in reinstating benefits and/or paying past due benefits.

Bad Faith Claims by Employers Against Insurers and Their Third Party Claims Administrators

Employees are not the only parties who can and do assert workers’ comp bad faith claims. *Notrica v State Compensation Insurance Fund*, 83 Cal. Rptr. 2d 89 (Cal. App. 1999) was a California bad faith case in which the employer, not an employee, sued the comp carrier, the State Insurance Fund, for over reserving comp claims thereby allowing it to charge higher premiums to the employer. The California Court of Appeal upheld a jury verdict for bad faith against the carrier holding that the carrier’s practice was an “unfair business practice under the Business & Professions Code.

Comp claims can give rise to a bad faith claim by the employer/policyholder. The writer was an arbitrator in a case in which a large corporate employer that was insured with a carrier for workers’ comp sued the carrier’s third party claims administrator for mishandling its employees’ comp claims thereby subjecting the employer to uninsured exposure for medical expenses and bad faith claims by employees. The case was settled before the arbitration hearing.

Bad Faith Claims by Carriers Against Employers

The writer was the umpire in several arbitrations in which the comp carrier alleged fraud by the employers in the underpayment of premiums. The employers, in

turn, alleged in counterclaims that the premiums were excessive because they were based on the carriers' alleged bad faith in conducting inadequate audits. The cases were settled prior to arbitration hearings.

The writer also was special master in an Arizona state court action in which the insured was a professional employer organization ("PEO"). The insurer alleged that the PEO intentionally and fraudulently underreported employee payrolls in order to secure lower premiums. Based on a court appointed CPA's audit of the employer's books a judgment in favor of the insurer was issued. Thereafter, the PEO filed a bad faith-breach of contract action against the insurer in a Federal Court in Arizona. This action was dismissed.

Bad Faith Claims by Self Insured Employers and Primary Carriers Against Reinsurers and Reverse Claims

Although these decisions involved non-workers' comp cases, the principles would be equally applicable in disputes between compensation carriers and their reinsurers.

These cases often involve settlement of claims. In *Employers Reinsurance Corp. v Massachusetts Mutual Life Ins. Co.*, 654 F. 3d 782 (W.D. Mo 2007), the issue was the extent to which the reinsurer was obligated to reimburse the primary carrier for a settlement of the underlying case that the cedent had made. The court applied the well established reinsurance principle that if the reinsurance agreement contained a "follow the settlements" clause, the reinsurer would be bound by the cedent's settlement. However, this principle is not without limitations. In *Commercial Union Ins. Co. v Seven Provinces Ins. Co. Ltd.*, 217 F. 3d 33 (1st Cir. 2000), cert. den., the court held that the reinsurer's conduct in trying to pressure the reinsured into settling the underlying claim amounted to extortion-like conduct and allowed double damages.

But, the reinsured must exercise reasonable care in evaluating the case before settling it and does so at its own risk. It cannot make a quick settlement and then, in effect, tell the reinsurer "it's your problem now." In *Suter v General Acc. Ins. Co. of America*, 2006 U.S. Dist. LEXIS 48209, the court stated that if the reinsured did not undertake reasonable investigation or make a reasonable determination as to whether the loss was covered under its excess policies, the reinsured's settlement was grossly negligent and amounted to bad faith conduct toward the reinsurer. However, if the reinsured has used due care before settling the underlying case, the reinsurance principles of "follow

the fortunes" and "follow the settlements" bind the reinsurer. In *International Surplus Lines Ins. Co. v Certain Underwriters and Underwriting Syndicates at Lloyd's of London*, 868 F. Supp. 917 (S.D. Ohio 1994), the court applied both principles in ordering the reinsurer to reimburse the reinsured for a good faith payment within the insurance coverage.

Bad Faith Claims by Retrocedents Against Retrocessionaires

How far up the reinsurance ladder does the implied covenant of good faith go? In *Munich Reinsurance America, Inc. v American National Insurance Company*, (D. NJ 2014) the primary workers' comp insurer reinsured with Munich. Munich retroceded with American, another reinsurer. In ensuing litigation, Munich sued American for breach of contract and bad faith for refusing to pay certain claims submitted by Munich. The court stated:

"...a claim based on breach of the duty of utmost good faith premised on improper claims handling in the reinsurance context is no different than a claim based on the duty of good faith attendant to any other contract under New York law...[but] does not provide a cause of action separate from a breach of contract claim..." (Opinion, pages 75-76).

About the author:

Merton Marks is with the law firm of Gordon & Rees LLP and practices in the firm's Insurance Group. His insurance and reinsurance practice includes litigation and arbitration of coverage disputes, bad faith claims, underwriter, agent, broker and third party administrator liability, premium fraud and audit disputes in workers' compensation cases. He has represented employers in regulatory matters before the Industrial Commission of Arizona and was counsel for the National Council on Compensation Insurance in rate hearings before the Arizona Insurance Department. He previously served as Counsel for the Industrial Commission of Arizona and State Compensation Fund. He was Assistant Attorney General of Arizona and a temporary judge on the Arizona Court of Appeals.

He is a member of the AMCOMP Board of Directors, a Certified Arbitrator in ARIAS-US and an arbitrator on the Reinsurance Panel of the American Arbitration Association. He is also a member of the American Board of Trial Advocates, the Federation of Defense & Corporate Counsel and The International Association of Defense Counsel.