Understanding Reverse Bad Faith

Recent court decisions have cracked open the door to a reverse bad faith cause of action against policyholders.

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Claims Management
May 2016

The duty of good faith and fair dealing is a centuries-old concept. It implies a covenant in every contract that both parties will act fairly and not interfere with the other's performance or reasonable expectations. Over the past few decades, however, courts have eroded the duty of insureds to act in good faith with their insurers under these insurance contracts. Some policyholders have exploited the protections afforded to them by the courts and have developed practices to "set up" their insurance carriers for a bad faith action. Recognizing these abuses, some recent court decisions have cracked open the door to a reverse bad faith cause of action against policyholders when they act in bad faith against their insurers.

History and Basis for Reverse Bad Faith

Courts first adopted bad faith laws in response to a tactic used by insurers where they would refuse to settle a claim when the demand was at or near the policy limit, with the knowledge that, at worst, they would have to pay no more than the policy limit plus defense costs. Courts addressed this by creating a bad faith cause of action, which allowed for extra-contractual damages. While this provided protection for insureds against dilatory tactics by their insurers, it left insurers exposed to a remarkably similar form of abuse by corporate insureds with self-insured retentions (SIRs) or large deductibles.

For example, a corporation with a $100,000 SIR may be presented with a bodily injury claim where the claimant is willing to settle for that amount. The insured knows the full value of the damages is in excess of $100,000 but believes it would have a slight chance of a defense verdict if the case were to proceed to trial. As a result, the insured rejects the settlement offer knowing that the insurance carrier will be responsible for any amount over its SIR if the jury does not find in its favor on liability. This scenario mirrors the same concerns that led the judiciary to create bad faith causes of action, yet courts have been reluctant to permit the insurer to seek redress for the bad faith actions of its insureds.

Another example of bad faith conduct on the part of insureds is the bad faith setup. A common scenario involves a time limit demand, which is made for what may be a reasonable settlement figure but expires before the insurance carrier has sufficient opportunity to investigate the claim. In an uninsured/underinsured motorist claim, for example, the insurer may be given 10 days to respond to a $15,000 policy limit settlement demand but not provided with the necessary medical records until after it expires. The insurer later agrees to the $15,000 settlement but is told that the demand now exceeds the policy limit, along with the threat of a bad faith action.

This bad faith setup has become increasingly common, particularly when low policy limits make the prospect of extra-contractual damages more attractive than a prompt resolution of the personal injury claim itself. Even when the bad faith claims are meritless, the cost of defending against them can increase cost-of-defense settlement value. Without the ability to argue reverse bad faith, insurers are

left with no recourse against this tactic unless the conduct is so egregious as to meet the standard for fraud or malicious prosecution.

In the 1990s, insurers began to push back against policyholder bad faith tactics by pleading counterclaims alleging bad faith against the insureds or, alternatively, comparative bad faith as an affirmative defense. Several courts acknowledged the potential viability of such claims on the basis that the duty to act in good faith should apply to both the insurer and insured. As time went on, however, state courts began to curtail the reverse bad faith cause of action by finding that the claim did not sound in tort, that fraud or abuse of process causes of actions already provided the requested relief, or in simply finding that there was no legal authority for such a claim.

Even the affirmative defense of comparative bad faith has met resistance, with some courts finding that the defense sounds in contract and not tort, where comparative fault can be assessed. With the exception of Tennessee, which has a statutory cause of action for reverse bad faith, it is, at best, an open question whether reverse bad faith is a viable cause of action. In the past few years, however, some court decisions have suggested that this defense could re-emerge.

Reverse Bad Faith Resurgence

A federal court case out of Pennsylvania exemplifies the manner in which some courts are reconsidering reverse bad faith as a viable instrument for insurers to defend against abuse of bad faith litigation by policyholders. In Shannon v. New York Central Mutual Insurance Company, the insurance carrier was sued for bad faith after the plaintiff's counsel orchestrated a bad faith setup in the underlying lawsuit seeking first-party benefits. Specifically, the plaintiff's counsel made a time-limit settlement demand early in the case, followed by a quick closing of the window to accept before information relevant to the claim was provided. In the bad faith litigation, the insurer raised an affirmative defense describing the plaintiff's bad faith actions, and the plaintiff filed a motion to strike this affirmative defense on the basis that the plaintiff's comparative bad faith toward the insurer was not relevant to whether the insurer itself acted in bad faith.

The court in Shannon did not go as far as to explicitly find that comparative bad faith was a viable defense under Pennsylvania law, but it did hold that, at the very least, the bad faith actions of an insured could form the basis for an "avoidance" defense under F.R.C.P. 8(a). That is, even if the factual allegations set forth in a complaint are assumed to be true, the insured's violation of his own duty to act in good faith could preclude recovery. By allowing the defense to survive the pleadings stage, the court acknowledged that reverse bad faith could be a viable defense and opened the door to its revival.

A review of cases around the country addressing reverse bad faith over the last few years has shown a common theme: Most courts are just as hesitant to rule out a reverse bad faith counterclaim or defense as they are to accept it. Court opinions from the past few years out of Louisiana, Massachusetts, New York, Pennsylvania, and Washington have suggested, without explicitly finding, that reverse bad faith could be viable as a counterclaim or defense. Except for states that have specifically rejected it—California, Hawaii, Iowa, Montana, New Jersey, Ohio, Oklahoma, Oregon, and Rhode Island—the status of reverse bad faith remains an open question. As a result, insurers must be cautious of how and when they present the defense.

Public Policy and Strategic Considerations

Those opposing the application of reverse bad faith argue that the public policy concerns weighing in favor of courts allowing extra-contractual damages against insurers do not exist with regard to bad faith behavior by insureds. For instance, in most cases, the

insurance policy is considered a contract of adhesion and insurance carriers are considered to be more sophisticated as to their ability to interpret these policies—although both of these points are debatable, particularly when pertaining to large corporate insureds. The counterargument to this, however, is that a court's adoption of a reverse bad faith counterclaim or affirmative defense will not in any way reduce the ability of insureds to bring legitimate bad faith claims. Reverse bad faith is merely a check against an abuse of process. Moreover, the remedies presently available to insurers—fraud and malicious prosecution—require higher burdens of proof than bad faith claims and, as a result, are costly and impractical.

Insurers also must be mindful that, even if they are successful in convincing the court to allow reverse bad faith as a defense, there are advantages and disadvantages to asserting such a defense. The advantages are clear—it forces plaintiff's attorneys to face consequences for deceptive bad faith setups and permits insurers to recover their costs in defending against frivolous bad faith allegations.

The disadvantages are less clear but equally important. For instance, asserting a reverse bad faith counterclaim when it is not sufficiently supported by the evidence could be perceived by a judge or jury as bad faith by the insurer in and of itself. Additionally, bringing such a claim, even when properly supported, comes with increased discovery costs to prosecute the counterclaim or support the comparative bad faith defense. For these reasons, insurers should discuss the viability and benefits of a reverse bad faith claim before making such allegations against their insureds.

After years of dormancy following the push for reverse bad faith in the 1990s, the doctrine has seen new life through recent court decisions. Its full-fledged acceptance still seems years away but appears to be gaining in popularity. Courts are increasingly acknowledging the brazen violations by some policyholders and their attorneys of the duty to act in good faith as they seek to manufacture bad faith windfalls through deceptive practices.

The old maxim stands true that bad facts make bad law (and vice versa), so insurers should take care to push a reverse bad faith counterclaim or defense only when there is ample evidence to support it. Utilizing the doctrine as a means to put pressure on plaintiffs without proper support risks backfiring and could lead courts to foreclose its use.

On the other hand, a case with particularly egregious violations of the duty by a policyholder could serve as the springboard to more widespread acceptance of reverse bad faith. With its viability an open question in so many states, the pleading of reverse bad faith remains a high-risk but potentially high-reward proposition.

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