Standards of Liability for Bad Faith Refusal to Pay Benefits in First Party Insurance*

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INTRODUCTION

A majority of jurisdictions, including Arizona, now recognize an independent cause of action in tort against insurance companies for bad faith refusal to pay benefits to their insureds.[1] As a basis for this tort, the courts have found that a duty of good faith, independent of the ordinary contractual duty, arises because of the unique relationship between the insured and insurer.[2]

The scope of this Note includes a discussion of the development of the bad faith tort in first party insurance, a review and comparison of the Arizona cases, and a comparison of the present standard for liability in Arizona

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1. Craft v. Economy Fire & Casualty Co., 572 F.2d 565 (7th Cir. 1978) (applying Indiana law, an insurer was held to a duty of good faith to its insured which could be breached by coercive settlement of claims tactics); Conner v. Shelter Mutual Ins. Co., 600 F. Supp. 24 (D.C. Ky. 1984). (under Kentucky law an insurance company can be held liable in tort when it unjustifiably denies payment to an insured); Rogers v. Pennsylvania Life Ins. Co., 539 F. Supp. 879 (S.D. Iowa 1982) (held that under Iowa law, an implied in law duty of good faith extends to first party insurance and that breach of this duty could justify punitive damages); Chavers v. National Security Fire & Casualty Co., 405 So. 2d 1 (Ala. 1981); United Services Auto Ass'n. v. Werley, 526 P.2d 28 (Alaska 1974); Noble v. National American Life Ins. Co., 128 Ariz. 188, 624 P.2d 866 (1981); Findley v. Time Ins. Co., 264 Ark. 647, 573 S.W.2d 908 (1978); Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 108 Cal. Rptr. 480, 510 P.2d 1032 (1973); Travelers Ins. Co. v. Savio, 706 P.2d 1258 (Colo. 1985); Grand Sheet Metal Products Co. v. Protection Mutual Life Ins. Co., 34 Conn. Supp. 46, 375 A.2d 428 (1977); Linscott v. Rainer National Life Ins. Co., 100 Idaho 854, 606 P.2d 958 (1980) (did not recognize an independent tort action but allows punitive damages if company's refusal to pay was an extreme deviation from reasonable standards performed with an understanding of its consequences); Vernon Fire & Cas. Co. v. Sharp, 264 Ind. 599, 349 N.E.2d 173 (1976) (did not recognize an independent tort cause of action but held that punitive damages could be allowed in a contract action involving an insurance claim); Gibson v. Ben Franklin Ins. Co., 387 A. 2d 220 (Me. 1978) (statutory remedies were not exclusive; therefore, plaintiffs were not barred from an independent tort action against workman compensation carrier); Travelers Indemnity Co. v. Weatherbee, 368 So. 2d 829 (Miss. 1979) (intentional withholding of coverage was a gross breach of contract, the equivalent of an independent tort); St. Paul & Marine v. Cuminsky, 665 P. 2d 223 (Mont. 1983); U.S. Fidelity & Guarantee Co. v. Peterson, 91 Nev. 617, 540 P. 2d 1070 (1974); State Farm General Ins. Co. v. Clifton, 86 N.M. 757, 527 P. 2d 798 (1974); Payne v. N.C. Farm Bureau Mutual Ins. Co., 67 N.C. App. 692, 313 S.E. 2d 912 (1984); Corwin Chrysler Plymouth v. Westchester Fire Ins., 279 N.W. 2d 638 (N.D. 1978); Hoskins v. Aetna Life Ins. Co., 6 Ohio St. 3d 272, 452 N.E. 2d 1315 (1983); Christian v. American Home Assurance. Co., 577 P.2d 899 (Okla. 1978); Bibeault v. Hanover Ins., 417 A.2d 313 (R.I. 1980); Nichols v. State Farm Mutual Ins. Co., 279 S.C. 336, 306 S.E. 2d 616 (1983); Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 271 N.W.2d 368 (1978).

2. Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 689, 271 N.W.2d 368, 374 (1978).

with other jurisdictions which recognize this tort. Also, an attempt will be made to formulate clearer standards of liability by summarizing key factors used by the courts in the cases examined.

DEVELOPMENT OF THE BAD FAITH TORT IN FIRST PARTY INSURANCE

A. *Expansion of the Duty of Good Faith Recognized in Third Party Insurance*

The Supreme Court of California, in *Gruenberg v. Aetna Insurance Company*,[3] was the first state court of last resort to expand tort liability for bad faith actions to first party insurance. The California court had previously held that liability insurers owed a duty to their insureds to accept reasonable settlements.[4] The court stated that the duty of fair dealing is imposed by law and does not arise solely from the terms of the contract.[5] Under this analysis, breach of this duty was considered the basis for an independent tort.

In *Gruenberg*, the court held that the duty of an insurer to act fairly and in good faith when handling the claim of an insured in first party situations was merely a different aspect of the obligation of fair dealing owed to the insured in settling the claims of third parties.[6] Further defining the duty, the court stated that the insurance company cannot withhold payments maliciously and without probable cause for the purpose of injuring its insured by depriving the insured of the benefits of the policy.[7]

The establishment of a tort action for a bad faith breach is significant because it gives the insured the possibility of being awarded punitive damages when the insurer unreasonably withholds benefits.[8] Prior to this recognition of an independent tort duty, insureds were limited by the general rule that punitive damages are not awardable in ordinary contract actions.[9] Insurers are understandably opposed to recognition of bad faith as an independent cause of action because it removes the previous limit on damages, which was the maximum amount of the insurance policy. Also, as the *Gruenberg* court noted, the duty of good faith and fair dealing of insurance companies is absolute, and a breach of good faith is not excused by mere nonperformance of a contractual duty of the insured.[10] This prevents the insurance company from asserting minor breaches of the insurance contract by the insured as justification for their dishonest conduct. A comparison may be drawn to the rule with regard to intentional torts where courts have held that contributory negligence is no defense.[11]

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3. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).
4. Communale v. Traders & General Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958), Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).
5. Gruenberg v. Aetna Ins. Co., 9 Cal. 3d 566, 575, 510 P.2d 1032, 1037, 108 Cal. Rptr. 480, 485 (1973).
6. *Id.*
7. *Id.* at 575, 510 P.2d at 1038, 108 Cal. Rptr. at 486.
8. Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 694, 271 N.W.2d 368, 377 (1978).
9. Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 916, 611 P.2d 149, 151 (1980).
10. Gruenberg v. Aetna Ins. Co., 9 Cal.3d 566, 577, 510 P.2d 1032, 1040, 108 Cal. Rptr. 480, 488 (1973).
11. PROSSER AND KEETON ON THE LAW OF TORTS, § 65, at 462 (W. Keeton, 5th ed. 1984).

B. *Rationale for Imposition of Tort Liability*

Those jurisdictions that recognize the tort of bad faith have found that there are compelling public policy reasons to justify imposition of tort liability on insurance companies for the bad faith refusal to pay benefits to their insureds. The primary justification for imposition of a tort duty is the special relationship between the insured and insurer due to the unique nature of the insurance contract. First, it is recognized that the consumer of insurance ordinarily purchases insurance for protection against calamity and not for commercial advantage.[12] Therefore, the insured is seeking peace of mind and security as part of the service being purchased.[13] It is with this fact in mind that courts have held that the insured's reasonable expectation that the insurance company will pay against the insured loss should be honored.[14]

Another aspect of the special relationship is the inequality of bargaining status between the parties in an insurance contract. Insurance companies are backed by substantial financial resources while the insured is often in an especially vulnerable economic position after the insured loss occurs. Some courts believe that without the threat of tort action, insurance companies would be encouraged to delay payment without any reasonable basis.[15] The delay in claims could be used to exert pressure on the insured to accept less than the full benefits due under the policy. It would appear that without the threat of tort liability, insurance companies would stand to lose very little and at a minimum gain the use of proceeds rightfully due to the insured.[16]

In addition to the insurance company's superior financial position, the insured is further disadvantaged by the adhesive nature of the insurance contract.[17] The insured has no input to the terms of the contract which is usually written in boilerplate language and is not understandable by most laymen. Providing the insured with a tort remedy and the possibility of punitive damages is an attempt to restore balance in the contractual relationship.[18]

Lastly, a greater obligation of good faith and fair dealing is imposed on insurance companies because of the public interest nature of the insurance industry. As a provider of a vital service in our society, the insurers hold themselves out to the consumer as a quasi-fiduciary. Therefore, the interest of the public should at least be given equal consideration to that of the insurer when claims decisions are being made.[19] Due to this characteristic, insurance companies have been subject to substantial regulation in their trade practices.[20]

12. Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 819, 598 P.2d 452, 456, 157 Cal. Rptr. 482, 486 (1979).

13. *Id.*

14. Craft v. Economy Fire & Cas. Co., 572 F. 2d 565, 571 (7th Cir. 1978) (Indiana law).

15. Nichols v. State Farm Mutual Auto Ins. Co., 279 S.C. 336, 340, 306 S.E.2d 616, 619 (1983).

16. Bibeault v. Hanover Ins. Co., 417 A.2d 313, 319 (R.I. 1980).

17. Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 820, 598 P.2d 452, 457, 157 Cal. Rptr. 482, 487 (1979).

18. *Id.*

19. *Id.*

20. Noble v. National American Life Ins. Co., 128 Ariz. 188, 189, 642 P.2d 866, 867 (1981).

C. *Courts Refusing to Recognize the Tort in First Party Insurance*

Some states have expressly refused to recognize the tort of bad faith as an independent cause of action in first party situations.[21] Many of these courts believe that the relationship and obligations in first party insurance are distinguishable from third party (liability) insurance.[22] One of the primary differences noted is that in third party insurance, a true fiduciary relationship exists between the insured and insurer because the insurer has absolute control of the trial and settlement of the claim. With first party insurance, the insured is not subject to possible judgments or other liability to third parties by virture of the insurer's exclusive control over the defense and settlement of the case.[23] Under this view there is no fiduciary or quasi-fiduciary relationship, and therefore, no basis for extending the duty of good faith recognized in third party insurance. While the above mentioned differences between first and third party insurance may justify a stricter standard for imposition of liability in first party situations, such differences should not be the basis for total rejection of tort liability.

Another more compelling justification for nonrecognition of the tort of bad faith is deference to legislative remedies.[24] In all states which have squarely addressed the issue and declined to recognize this cause of action, there existed statutory penalties for unfair trade practices by insurance companies. Examples of these remedies include the awarding of attorney fees and penalties to the insured,[25] the possibility of being enjoined from conducting business in the state until claims are paid, minimum fines, and other

21. Thompson v. M & B Construction Corp., 585 F. Supp. 561 (N.D. Tex. 1984) (under Texas law the cause of action for breach of good faith and fair dealing in tort has been expressly rejected); Caruso v. Republic Ins. Co., 558 F. Supp. 430 (D. Md. 1983) (held that Maryland law would not recognize the tort of bad faith refusal to pay benefits in first party insurance); Industrial Fire & Casualty Ins. Co. v. Romer, 432 So. 2d 66 (Fla. Dist. Ct. App. 1984) (expressly rejected the holding of Escambia Treating Co. v. Aetna Casualty & Surety Co., 421 F. Supp. 1367 (N.D. Fla. 1976), which stated that Florida would recognize the tort of bad faith in first party insurance); Spencer v. Aetna Life & Cas. Ins. Co., 227 Kan. 914, 611 P.2d 149 (1980); Kewin v. Massachusetts Mutual Life Ins. Co., 409 Mich. 401, 295 N.W.2d 50 (1980); Duncan v. Andrew County Mutual Ins. Co., 665 S.W.2d 13 (Mo. App. 1983); Lawton v. Great Southwest Fire Ins. Co., 118 N.H. 607, 392 A.2d 576 (1978); Garden State Community Hospital v. Watson, 191 N.J. Super. 225, 465 A.2d 1225 (1982); Santilli v. State Farm Ins. Co., 278 Or. 53, 562 P.2d 965 (1977) (did not expressly reject tort of bad faith in first party situations but emphasized the differences between the relationship between the parties in first and third party insurance); D'Ambrosio v. Pennsylvania Nat'l Mutual Cas. Ins. Co., 494 Pa. 501, 431 A.2d 966 (1981).

22. Spencer v. Aetna Life & Casualty Ins. Co., 227 Kan. 914, 922, 611 P.2d 149, 155 (1980).

23. *Id.*

24. D'Ambrosio v. Pennsylvania Nat'l Mutual Cas. Ins. Co., 494 Pa. 501, 507, 431 A.2d 966, 970 (1981).

25. An example of such a statute is Article 21.21 of the Texas Insurance Code:

> Section 16. (a) Any person who has been injured by another's engaging in any of the practices declared in Section 4 of this Article or in rules or regulations lawfully adopted by the Board under this Article to be unfair methods of competition and unfair and deceptive acts or practices in the business of insurance or in any practice defined by Section 17.46 of the Business & Commerce Code, as amended, as an unlawful deceptive trade practice, may maintain an action against the company or companies engaging in such acts or practices.
>
> (b) In a suit filed under this section, any plaintiff who prevails may obtain:
>
> 1. three times the amount of actual damages plus court costs and attorneys' fees reasonable in relation to the amount of work expended;
>
> 2. an order enjoining such acts of failure to act;
>
> 3. any other relief which the court deems proper.

Art. 21.21 Texas Insurance Code Ann. § 16 (Vernon 1981).

extensive regulation and monitoring by the state insurance department.[26]

Courts recognizing the bad faith tort in first party insurance have correctly stated that the statutory or contract remedies are of negligible benefit to the insured who has sustained severe consequential damages due to the insurance company's unreasonable actions.[27] However, even courts that approve of tort liability for bad faith actions have pointed out that the insurance company's increased liability would be paid for at the cost of other insureds through higher premiums.[28] This is especially true if there are not at least some definitive standards of conduct for the insurance companies to follow. In formulating the standards of liability it should be recognized that determining the reasonableness of the insurer's actions is a question of fact for the jury.[29] The court, therefore, has the obligation of providing guidance in defining the necessary elements to support liability. Without such guidance, inconsistent outcomes, excessive litigation and increased costs to insureds will result.

THE ARIZONA CASES; WHAT IS THE STANDARD FOR LIABILITY?

A. *Comparison of* Noble *and* Sparks

The Arizona Supreme Court first addressed the issue of bad faith tort liability in first party insurance in the case of *Noble v. National Life Insurance Company*.[30] This case involved the refusal by the insurance company to pay a claim submitted by the insured under a health insurance policy. The court held that there is a legal duty implied in the insurance contract that the insurer must act in good faith when handling claims of the insured. As in *Gruenberg*,[31] the court stated that violation of the duty would be the basis for an independent tort cause of action.[32] In defining the elements of this tort the court relied on the Wisconsin case of *Anderson v. Continental Insurance Co.*,[33] another landmark case in the area. There the Wisconsin court stated:

> To show a claim for bad faith the plaintiff must show the absence of a reasonable basis for denying benefits of the policy and the defendant's knowledge or reckless disregard of the lack of a reasonable basis for denying the claim. It is apparent that the tort of bad faith is an intentional one.
>
> The tort of bad faith can be alleged only if the facts pleaded would, on the basis of an objective standard show the absence of a reasonable basis for denying the claim, i.e. would a reasonable insurer under the circumstances have denied or delayed payment of the claim.[34]

26. *D'Ambrosio*, 494 Pa. at 507, 431 A.2d at 970.
27. Nichols v. State Farm Mutual Auto Ins. Co., 279 S.C. 336, 340, 306 S.E.2d 616, 619 (1983).
28. Hoskins v. Aetna Life Ins. Co., 6 Ohio St. 3d 272, 277, 452 N.E.2d 1315, 1321 (1983).
29. Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 539, 647 P.2d 1127, 1137 (1982).
30. Noble v. National Am. Life Ins. Co., 128 Ariz. 188, 624 P.2d 866 (1981).
31. 9 Cal. 3d 566, 510 P.2d 1032, 108 Cal. Rptr. 480 (1973).
32. *Noble*, 128 Ariz. at 190, 624 P.2d 868 (1981).
33. 85 Wis. 2d 675, 271 N.W.2d 368 (1978).
34. *Id.* at 691, 271 N.W.2d at 376.

It should be noted that under this standard the insurance company may still challenge claims which are fairly debatable. The *Anderson* standard has been interpreted as requiring the plaintiff to show varying degrees of intent or wrongdoing which are usually greater than required under the *Gruenberg* view.[35]

Following *Noble*, the Arizona Supreme Court again addressed the issue of bad faith in the case of *Sparks v. Republic National Life Insurance Company*.[36] Although the court would have been able to find liability under almost any view, the standard and proof of liability enunciated in *Sparks* seems inconsistent with the previous holding of *Noble*.

It should be noted that the facts were particularly compelling for the imposition of tort liability in *Sparks*. The Sparks family was involved in a light aircraft crash and sustained severe injuries. The father was permanently brain damaged and one of the children was rendered a paraplegic. At the time of the accident, the family was covered by a health insurance policy issued by their insurer, Republic. Approximately six months after the accident, the insurance company cancelled benefits based on an ambiguous termination clause in the policy. The court stated that the policy language regarding when the policy would terminate, and any post termination coverage for injuries incurred while insured, would not be understandable by most consumers. The situation was further worsened by the fact that the Sparks had never read the policy and had purchased the insurance solely on the basis of representations in the brochure. In addition, the injuries sustained by the family members were severely aggravated by the termination of benefits by Republic. Considering these facts, it is evident that the jury could justify the finding of bad faith.

The difficulty with *Sparks* is in the court's statement of the rule in Arizona regarding the standard for liability and the court's comments regarding proof of the standard. One of the major issues on appeal to the court was the jury instruction regarding bad faith. The instruction contested by the defendants was as follows:

> Under Arizona law every insurance contract contains an implied promise of good faith and fair dealing which the insurance company owes the insured. This program imposes an obligation on the insurance company to deal fairly in handling a claim made by its insured under the policy and to not unreasonably withhold payment of promised benefits of its insured.
>
> Reasonableness is to be determined on the basis of whether the conduct of the insurer was justified and reasonable under the circumstances found herein.[37]

As argued by the appellants, these instructions do not adequately instruct the jury as to the rule in Arizona under the *Noble* case.[38] The sole mention of unreasonableness gives the impression that Arizona has adopted

35. Travelers Ins. Co. v. Savio, 706 P.2d 1258 (Colo. 1985).
36. 132 Ariz. 529, 647 P.2d 1127 (1982).
37. *Id.* at 538, 647 P.2d at 1135-36 (1982).
38. *Noble* cited Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 271 N.W.2d 368 (1978), as the model for defining standard of liability. *Noble*, 128 Ariz. at 190, 624 P.2d at 868.

a standard more like negligence than one of an intentional tort. The standard adopted in *Noble* and *Anderson* appears to require some proof of intentional conduct by the insurer, or, at a minimum, circumstantial proof of a reckless disregard of the insured's rights to payment of benefits.

The court in *Sparks* specifically held that the jury did not have to be instructed as to the necessity of an intent element to establish the tort of bad faith. The court interprets "intent" as being satisfied in almost all cases because any action taken by the insurer on a claim submitted by an insured will necessarily be an intentional act.[39] The Arizona Supreme Court's concept of intent in this case differs from the Restatement (Second) of Torts view that intent denotes, "that the actor desires to cause the consequences of his act or that he believes the consequences are substantially certain to occur."[40] There is no doubt under all views that reasonableness of the insurance company's actions is the most important issue. However, it seems that the *Anderson* court meant to establish more than a negligence standard by including a second prong in the test of liability:

> [The plaintiff must show] the knowledge or reckless disregard of a reasonable basis for a denial . . . [which may be] inferred and imputed to an insurance company where there is a reckless disregard of a lack of reasonable basis for denial or a reckless indifference to facts or proofs submitted by the insured.[41]

In *Sparks*, the court never addressed this prong of the test for liability. The court seems to rely on the all encompassing nature of the reasonableness standard. While it could be argued that the element of knowledge of lack of a reasonable basis is subsumed in the reasonableness test, it seems that the court could have done more to clarify whether they were changing the standard as adopted in *Noble* or merely interpreting it differently. The court stated that it was also unnecessary to instruct the jury that the insurer may challenge claims which are fairly debatable. The instruction of "reasonable under the circumstances" was considered adequate in informing the jury implicitly of this defense.[42]

Although the questions raised above may be somewhat academic, considering the egregious facts of *Sparks*, it seems that there remains some difficulty after this opinion in reconciling the *Sparks* and *Noble* decisions. A clearer statement of the standard is necessary for plaintiffs to properly establish their cases and for insurance companies to know what steps need to be taken in handling claims to prevent the imposition of tort liability. As one Oklahoma case has noted, the quantum of proof required is substantially greater when malice or evil intent is an element of the tort.[43]

B. *Interpretation of the Standard in Arizona after* Sparks

Two cases following *Sparks* and *Noble* involving bad faith claims illus-

39. Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 538, 647 P.2d 1127, 1136 (1982).
40. RESTATEMENT (SECOND) OF TORTS § 8A (1965).
41. Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 693, 271 N.W.2d 368, 376 (1978).
42. Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 538, 647 P.2d 1127, 1136 (1982).
43. Timmons v. Royal Globe Ins. Co., 653 P.2d 907, 914-915 (Okla. 1982).

trate the uncertainty as to the state of the law in Arizona. The 1984 Arizona Court of Appeals case of *Farr v. Transamerica Occidental Life Insurance Company of California*,[44] involved a bad faith claim against an insurance company. This case made little reference to the *Sparks* holding and primarily relied on the standard of liability as stated in *Noble*. One of the major issues on appeal was the sufficiency of evidence to support the finding of a reckless disregard of a lack of reasonable basis for refusal of benefits by the insurance company. This element of the test for liability had been disregarded by the *Sparks* court. The court of appeals emphasized that bad faith is an intentional tort.[45]

The *Farr* case is in contrast to an Arizona Supreme Court case which stated that no matter how the test is defined, it is a question of reasonableness.[46] The main issue in this case concerned discovery of the claims file which the defendant insurer refused to submit to discovery based on the work product privilege. The court held that the claims file was discoverable because of the overwhelming need for the information in the file specifically concerning the reasonableness of the insurer's conduct. This case may illustrate that the *Sparks* decision was an affirmative adoption of a less stringent standard for liability in Arizona.

There is at least one court of last resort which seems to think this is what Arizona has done. In *Farmers Group Inc. v. Trimble*[47] the Colorado Supreme Court cited *Sparks* for the proposition that the reasonableness standard alone is the test for bad faith. The court went one step further in *Trimble*, stating that since the tort of bad faith is actually characterized by a standard of reasonableness akin to that of negligence, the assertion of two distinct claims of bad faith and negligence in the pleadings was inappropriate.[48] An important distinction between *Trimble* and *Sparks* lies in the nature of the claims. In *Trimble* the claim involved liability to a third party under homeowners and automobile insurance policies, while *Sparks* and *Noble* involved first party insurance. The use of the negligence standard in the context of third party insurance by the Colorado court is consistent with the other courts. In the earlier cases on which *Gruenberg* was founded, the California Supreme Court stated that the test with third party liability insurance is whether a prudent insurer without policy limits would have accepted the settlement offer.[49]

It is important to note that when the Colorado Supreme Court directly addressed a bad faith claim in the first party context, in *Travelers Insurance Company v. Savio*,[50] the negligence standard was expressly held to be inap-

44. 145 Ariz. 1, 699 P.2d 376 (Ct. App. 1984).

45. *Id.* at 5, 699 P.2d at 380 (The court upheld compensatory damages but reversed the award of punitive damages. The comment at the end of the holding adds some confusion to the court's position on the level of conduct necessary to rise to bad faith: "Distilled, what happened here amounted to bungling and negligence on the part of Occidental." *Id.* at 10, 699 P.2d at 385).

46. Brown v. Superior Court In and For Maricopa County, 137 Ariz. 327, 670 P.2d 1138 (1982).

47. 691 P.2d 1138 (Colo. 1982).

48. *Id.* at 1143.

49. Crisci v. Security Ins. of New Haven Conn., 66 Cal. 2d 425, 426 P.2d 173, 176, 58 Cal. Rptr. 13, 16 (1967).

50. 706 P.2d 1258, 1275 (Colo. 1985).

plicable. In this case the court made a clear distinction between the relationship among the parties in third party insurance. The court stated that the second element of the *Anderson* standard—reckless disregard of a reasonable basis—is necessary to establish liability in first party insurance bad faith claims.[51]

COMPARISON OF STANDARDS OF LIABILITY IN OTHER JURISDICTIONS

A. *A Standard Similar to Negligence for Bad Faith*

There is no doubt that it has been difficult to establish a clear standard for bad faith. In many states there has been no attempt to define bad faith other than recite the language from the *Gruenberg* or *Anderson* cases. Some courts, such as the Arizona Supreme Court in the *Sparks* case, have upheld jury instructions which merely state that unreasonableness is the equivalent to bad faith or state that recovery by the plaintiff only requires a determination that the defendants did not deal fairly and in good faith.[52]

It seems the California Supreme Court has interpreted *Gruenberg* as applying the negligence standard adopted in liability cases to first party insurance.[53] In *Egan v. Mutual of Omaha Ins. Co.*[54] the insurer refused to classify plaintiff's injury as a permanent disability based on its investigation. Also, the insurer's agent attempted to persuade the insured to settle his claim for a lesser amount in exchange for the insured surrendering his policy. The court rejected the insurer's argument that the covenant of good faith is violated only if the insurance company wrongfully denies a claim knowing no reasonable basis exists for doing so.[55]

The court upheld the claim of bad faith based on what it considered an inadequate investigation of the insured's claim. Testimony at trial indicated that normal practice of the insurer was to have the insured examined by a doctor of its choice or consult personally with the plaintiff's surgeons instead of merely reviewing the hospital records.[56] Although this decision seems to be based on conduct which could be considered closer to negligence, it is important to note that the insurer did engage in conduct that the court considered malicious and with the intent to unduly coerce the insured.[57]

Other cases in California have pointed out that the standard necessary to establish bad faith is distinct from conduct which must be proven for there to be an award of punitive damages.[58] Under a California statute, the plaintiff must prove malice, fraud or oppression to obtain punitive damages. These elements of proof are not necessary for compensatory damages in a

51. *Id.* at 1275.
52. Timmons v. Royal Globe Ins. Co., 653 P.2d 907, 915 (Okla. 1982).
53. W. SHERNOFF, S. GAGE, H. LEVINE, INSURANCE BAD FAITH LITIGATION § 5.02 at 5-9 (1984).
54. 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979).
55. *Id.* at 819, 598 P.2d at 457, 157 Cal. Rptr. at 487.
56. *Id.*
57. *Id.* at 822, 598 P.2d at 458, 157 Cal. Rptr. at 488 (1979).
58. *E.g.*, Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 462, 521 P.2d 1103, 1110, 113 Cal. Rptr. 711, 718 (1974).

bad faith suit under the *Gruenberg* standard.[59]

The South Carolina Supreme Court, in *Nichols v. State Farm Mutual Automobile Insurance Company*,[60] seemed to adopt a stance similar to the California court in *Egan*. In *Nichols*, the insurance company refused to pay the insured's claim in full on theft loss coverage in the insured's auto policy. The court held that South Carolina would recognize the tort of bad faith which must be proven by showing that the insurance company refused to pay benefits without reasonable cause. The court also upheld the propriety of the trial court's jury instructions, which stated that the insured can recover in a bad faith suit if the insurer was negligent in handling the claim.[61] The court stated that under its view of bad faith the jury is entitled to consider negligence on the issue of unreasonable refusal to pay benefits.[62]

B. *Stricter Standards for Bad Faith*

On the other side of the spectrum there are courts which recognize the tort of bad faith but refuse to impose liability for mere nonfeasance. The Arkansas Supreme Court adopted such a position in *Aetna v. Broadway Arms*.[63] This case involved a claim of bad faith against the insurance company for its actions in handling an insured loss under a fire policy. The court held that to rise to the level of bad faith the insurance company must have committed affirmative misconduct without a good faith defense. In addition, the conduct must be dishonest, malicious or oppressive. A claim of bad faith cannot be based on honest misjudgment or negligence.[64] This view appears to be similar to the standard for punitive damages in other states. The court did note however that bad faith may be inferred from the surrounding circumstances.[65]

The Ohio Supreme Court adopted a similar but not as extreme view in *Hoskins v. Aetna Life Ins. Co.*[66] This case involved the termination of benefits by the insurer under a hospitalization policy. The insurance company ceased paying benefits because of their belief that the insured's treatment was convalescent care. Payments for convalescent care were to terminate under the policy after 365 days. The court stated that bad faith consists of more than bad judgment or negligence and imports some dishonest purpose or conscious wrongdoing.[67] The court qualified this apparently stringent standard by stating that the insurer's asserted justification for nonpayment cannot be arbitrary or capricious and must have some reasonable basis.[68]

The Ohio court in *Hoskins* emphasized that the standard of malice required to establish a claim for compensatory damages in bad faith is less than that necessary to uphold an award of punitive damages. Ohio adopts a

59. *Silberg*, at 462, 521 P.2d at 1110, 113 Cal. Rptr. at 718.
60. 279 S.C. 336, 306 S.E.2d 616 (1983).
61. *Id.* at 342, 306 S.E.2d at 620 (1983).
62. *Id.*
63. 281 Ark. 128, 664 S.W.2d 463 (1984).
64. *Id.* at 133, 664 S.W.2d at 465.
65. *Id.*
66. 6 Ohio St. 3d 272, 452 N.E.2d 1315 (1983).
67. *Id.* at 276, 452 N.E.2d at 1320.
68. *Id.* at 277, 452 N.E.2d at 1321.

view similar to other states. In order to make a claim for punitive damages the plaintiff must prove that the defendant was guilty of oppression, fraud or malice and had some degree of intent to injure the plaintiff.[69]

The Alabama courts have adopted one of the most stringent standards for bad faith. In *Chavers v. National Security Fire and Casualty Co.*, the court seemed to adopt a standard similar to the Wisconsin court in *Anderson*:

> An actionable tort arises for an intentional refusal to settle a direct claim where there is either (1) no lawful basis for the refusal coupled with actual knowledge of that fact or (2) intentional failure to determine whether or not there was any lawful basis for such refusal.[70]

This court expressly rejected the imposition of liability based on the insurer's negligence in handling direct claims.[71] As with the *Anderson* standard, a necessary element of proof is the intentional disregard of the basis of the insured's claim. The Alabama Supreme Court, in a later case, stated that the plaintiff must show that he is entitled to a directed verdict on the contract claim to make a *prima facie* case of bad faith.[72] The court emphasized that the plaintiff has a heavy burden in a bad faith refusal of payment case. The Alabama court seems to be saying that the insurance company may avoid tort liability if there is *any* factual issue asserted by the insurer regarding the contract claim. As one commentator points out, it would be difficult to conceive many cases when *some* factual issue would not exist regarding the insured's right to payment.[73] This writer also explains that the Alabama rule allows the insurance company to avoid liability even when a factual dispute asserted is unjustified.[74]

C. *A Moderate Standard of Liability*

The Wisconsin courts appear to be the most consistent in their analysis of bad faith. Both elements of the standard adopted in *Anderson*, refusal to pay benefits with no reasonable basis and knowledge and disregard of a lack of reasonable basis, have been analyzed in all the cases examined.[75] While the court recognizes that an objective standard of reasonableness must be met, it is clear that the other element of a reckless disregard of the validity of the insured's claim must be found. The Wisconsin court has plainly stated that mere negligence without more is inadequate to support a claim for bad faith.[76] The real question concerns the degree of unreasonableness which must be evident for insurer's actions to rise to the level of bad faith. It seems

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69. *Id.*
70. 405 So. 2d 1, 7 (Ala. 1981).
71. *Id.* at 5-6.
72. National Savings Life Ins. Co. v. Dutton, 419 So. 2d 1357, 1362 (Ala. 1982).
73. W. SHEROFF, S. GAGE, H. LEVINE, *supra* note 53, § 5.02 at 5-10.7 (1984).
74. *Id.*
75. Warren v. American Family Mutual Ins. Co., 122 Wis. 2d 381, 361 N.W.2d 724 (1984); Fehring v. Republic Ins. Co., 118 Wis. 2d 299, 347 N.W.2d 595 (1984), James v. Aetna Life & Casualty Co., 109 Wis. 2d 363, 326 N.W.2d 114 (1982), Poling v. Wisconsin Physicians Service, 120 Wis. 2d 603, 357 N.W.2d 293 (Ct. App. 1984).
76. Warren v. American Family Mutual Ins. Co., 122 Wis. 2d 381, 385, 361 N.W.2d 724, 727 (1984).

that bad faith will be found only when the insurer has made no reasonable effort to determine the nature and extent of liability.[77]

The Wisconsin courts have taken the most workable approach in imposing liability for bad faith. A similar analysis should be used by the Arizona court as initially adopted in the *Noble* decision. The standard does not present an insurmountable burden to the plaintiff as does the Alabama rule which requires that the plaintiff be entitled to a directed verdict on the contract claim before recovery is possible on the bad faith action.[78] At the same time, the Wisconsin court recognizes that the insurer should not be subject to liability if it challenges a claim which is fairly debatable. Several courts have qualified their recognition of the bad faith tort, stating that there can be disagreement between the insurer and insured on a variety of matters and, therefore, resort to a judicial forum is not per se bad faith or unfair dealing regardless of the outcome of the suit.[79] The Wisconsin opinions make it clear that the insurance company can avoid liability by making a reasonable investigation of the facts and law, weighing the probabilities in a fair and honest way, and promptly responding to the insured's claim.[80]

PROOF OF BAD FAITH

A. *Comment by the Arizona Court in* Sparks *on Proof of Bad Faith*

The Arizona court in *Sparks*, as have many other courts recognizing bad faith action, held that the focus of the inquiry in a bad faith claim is whether a reasonable insurer under the circumstances would have denied or delayed the payment.[81] The court stated that under the particular circumstances of that case, evidence of industry standards as to claims processing was irrelevant because each insurance company follows varying practices regarding the payment of doubtful claims.[82] This statement then raises the question: what type of proof is relevant to prove bad faith actions by the insurer?

B. *Investigation of the Claim and Weighing of the Facts and Law*

One of the most important factors in the determination of bad faith is the investigation of the facts supporting the insured's claim. It seems evident from the nature of the relationship of the parties in an insurance contract that the insurer has the affirmative obligation to assess claims by an appropriate and careful investigation.[83] The Wisconsin cases indicate that when investigation is not as extensive as a reasonable insurer would conduct, the court may find that the insurer recklessly ignored the facts necessary to evaluate the insured's claim, thereby meeting the second prong of the *Anderson* analysis.[84] Such a finding also seems to go a long way toward establishing

77. *Id.*
78. Chavers v. National Security Fire & Casualty Co. 405 So. 2d 1, 7 (Ala. 1981).
79. Christian v. American Home Assurance Co., 577 P.2d 899 (Okla. 1978).
80. Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 693, 271 N.W.2d 368, 377 (1978).
81. Sparks v. Republic Nat'l Life Ins. Co., 132 Ariz. 529, 538, 647 P.2d 1127, 1136 (1982).
82. *Id.* at 539, 647 P.2d at 1137.
83. Fehring v. Republic Ins. Co., 118 Wis. 2d 299, 313, 347 N.W.2d 595, 602 (1984).
84. *Id.*

that there was no reasonable basis for refusal or delay of payment to the insured. The Wisconsin cases seem to say that the insurance company cannot assert that denial of benefits was "fairly debatable" unless a reasonable investigation was the basis for such a determination.[85] If a reasonable investigation is made and if the facts reasonably appear to conflict, the insurance company can contest the claim.

In cases involving health and disability insurance the insurer's investigation has been held inadequate and in reckless disregard of the insured's rights in three common factual situations: 1) the investigation consisted solely of reviewing hospital records of the insured without any direct consultation with the insured's doctor;[86] 2) the insurance company told its insured that more information would be required but never made any affirmative steps to follow up on the claim;[87] and 3) the insurer refused to pay its insured even though it could have recovered the payment from a workers' compensation carrier if the insured was determined to be eligible for such benefits.[88] Courts have also found bad faith when the insurer has refused to pay benefits without making the basis of refusal known to the insured.[89] With property and casualty insurance, the insurer has been found to have acted in bad faith when it relied on an unrealistically low estimate of property damage from its investigator after the insured had submitted substantially higher estimates[90] and when the insurer's investigative practices and handling of the claim were deceptive.[91]

Another important factor in the proof of bad faith is the law applicable to the insured's claim on the insurer.[92] The lack of any definitive controlling authority on a particular legal point, which is the basis for the insurer's nonpayment of benefits, may constitute reasonable justification for the insurance company's actions.[93] Again, the point is emphasized that the probabilities of prevailing must be weighed in a fair and honest way by the insurer.[94]

C. *Actual Proof of Reasonableness*

As far as actual proof of reasonableness, it seems that evidence of the defendant insurer's normal practices as well as evidence of industry practices is relevant. The Arizona court erroneously relies on the case of *Silberg v. California Ins. Co.*,[95] for the proposition that evidence of the industry standard is not relevant. The *Silberg* court actually held that the scope of the insurer's duty cannot be *entirely* delineated by custom of the industry.[96] In

85. Poling v. Wisconsin Physicians Service, 120 Wis. 3d 603, 609, 357 N.W.2d 293, 297 (Ct. App. 1984).
86. Egan v. Mutual of Omaha Ins. Co., 24 Cal. 3d 809, 598 P.2d 452, 157 Cal. Rptr. 482 (1979).
87. Farr v. Transamerica Occidental Life Ins. Co., 145 Ariz. 1, 699 P.2d 376 (Ct. App. 1984).
88. Silberg v. California Life Ins. Co., 11 Cal. 3d 452, 521 P.2d 1103, 113 Cal. Rptr. 711 (1974).
89. Christian v. American Home Assurance Co, 577 P.2d 899 (Okla. 1978).
90. Fehring v. Republic Ins. Co., 118 Wis. 2d 299, 347 N.W.2d 595 (1984).
91. Timmons v. Royal Globe Ins. Co., 653 P.2d 907 (Okla. 1982).
92. Duckett v. Allstate Ins. Co. 606 F. Supp. 728, 731 (D.C. Okla. 1984).
93. *Id.*
94. Anderson v. Continental Ins. Co., 85 Wis. 2d 675, 688, 271 N.W.2d 368, 377 (1978).
95. 11 Cal. 3d 452, 462, 521 P.2d 1103, 1109, 113 Cal. Rptr. 711, 717 (1974).
96. *Id.*

Silberg, the insurance company refused payment on a medical policy pending the determination of their insured's eligibility for worker's compensation benefits. The court actually heard evidence from both the plaintiff and defendant regarding customary practices of other insurance companies in similar circumstances of that case. The court's holding is consistent with the common view that although evidence of custom is rarely conclusive in establishing the standard, it is usually relevant except in extreme cases where the defendant has clearly acted unreasonably.[97] In several of the cases it appears that evidence of the insurer's normal claims practices is given substantial probative value.[98]

CONCLUSION

The Arizona court has joined a growing majority recognizing the independent tort of bad faith in first party insurance. Liability for bad faith is adequately justified by the special relationship between the parties in an insurance contract. This unique relationship has several aspects including the inequality in bargaining power between the parties, the reasonable expectations of the insured when purchasing insurance, and the public interest nature of the insurance industry.

Although insurers should have a strict duty to act in good faith when handling claims of the insured, it should be recognized that the validity of some claims is reasonably debatable. If some clear criteria regarding this duty are not established, the insurers could face possible liability and certain litigation whenever claims are denied no matter how justified their action. Other insureds will certainly pay the price for these added costs. The standard should be followed as originally adopted by the Arizona court in *Noble*; liability should be imposed for bad faith if the insurer denies payment with no reasonable basis and the lack of a reasonable basis is known or recklessly disregarded by the insurer. This standard will not permit an insurer to escape tort liability when the facts and law supporting the claim have not been reasonably investigated nor fairly and honestly evaluated. On the other hand, the insurer will not be held liable in excess of the contract damages when it has made an adequate investigation of the facts and law and merely reaches the wrong outcome in its evaluation of the validity of the claim.

The Arizona court in *Sparks* seems to have deviated from the original standard as adopted in *Noble*. The court was correct in focusing the inquiry on the reasonableness of the insurer's conduct, although the omission of the second element of the *Anderson* test seems to lower the requisite standard of proof.

It seems that more specific criteria can be used to give guidance to the jury and aid in their determination of bad faith. Some of these criteria can be summarized from the cases and are useful in analyzing both elements of

97. PROSSER AND KEETON, *supra* note 11, § 33 at 195 (1984).

98. *Compare* Egan v. Mutual of Omaha Ins. Co. 24 Cal. 3d 809, 598 P.2d 452, 455, 157 Cal. Rptr. 482, 485 (1979) *and* Farr v. Transamerica Occidental Life Ins. Co. 145 Ariz. 1, 3, 699 P.2d 376, 379 (Ariz. Ct. App. 1984) *with* Travelers Ins. Co. v. Savio, 706 P.2d 1258, 1275 (Colo. 1985) (The first prong of the standard of liability will be determined by an objective proof *requiring* evidence of the standards of conduct in the industry.)

the *Anderson* standard. The following considerations are not necessarily conclusive of bad faith but should almost always be relevant in its determination.

1. Did the insurer fulfill its duty to conduct a neutral and prompt investigation into underlying facts of the insured's claim?

The reasonableness of this investigation can be determined by evidence of the insurer's usual practices, evidence of industry practices regarding claims in similar circumstances and ultimately, application of the general community standard of reasonableness by the jury.

2. Did the applicable law provide a probable answer as to the validity of the insurer's justification for nonpayment?

To prove the reasonableness of this investigation and the resulting decision it may be necessary to call expert witnesses from the legal field to testify as to the action other professionals would have taken given the same set of facts and law.

3. Did the insurer, after actively pursuing investigation of the law and facts supporting the claim, reasonably conclude that the insured was not entitled to payment?

In the final determination, the reasonableness standard must be applied using the applicable law and relevant facts to determine if the insurer made a fair and honest evaluation of the bases for its denial of benefits. Also in this analysis the question must of course be asked whether the insurer's conduct was free from actions which could be determined as deceptive, malicious, oppressive or fraudulent. It seems that in most of the cases examined there was some element of deceit, malice or oppressive action by the insurance company.

It appears evident, after reviewing the case law in Arizona, that the bench and bar need more guidance than currently exists in determining the standard of liability for bad faith. If the Arizona Supreme Court intends to disregard the *Anderson* standard as adopted in *Noble*, it should explicitly state what the rule should be.[99]

99. In the case of Rawlings v. Apodaca, 151 Ariz. 149, 726 P.2d 565 (1986), the Arizona Supreme Court clarified the standard of conduct necessary to constitute bad faith and resolved, at least to some extent, many of the issues raised in this Note.