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BAD FAITH

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A. INTRODUCTION

Subject to specific policy terms and conditions, insurers have a contractual duty to defend and indemnify their insured. Implicit in that contractual relationship is an insurer's duty of good faith and fair dealing. Accordingly, when an insured believes he has been wronged, he may attempt to bring suit alleging both breach of contract and bad faith.

This outline will briefly address the two basic factual scenarios in which claims of bad-faith arise. The first scenario arises when an insurer fails to settle a claim against its insured within policy limits, thereby exposing the insured to excess liability. As discussed below, such failure-to-settle claims are actionable in Michigan.

The second instance in which bad faith claims are commonly brought arises when an insurer fails to timely pay claims submitted by its insured. Recovery on such claims is governed by the "penalty interest" statute, MCL 500.2006; MSA 24.12006, contained within Michigan's Uniform Trade Practices Act ("UTPA"), MCL 500.2001 et seq; MSA 24.12001 et seq.

Claims seeking damages under the UTPA commonly contain claims for various emotional damages in addition to those provided by the Act. An independent cause of action for the bad faith breach of an insurance contract does not exist in Michigan. Accordingly, damages for mental distress are not recoverable absent an allegation and proof of tortious conduct existing independent of the breach. The most common independent tort alleged in an action alleging a bad faith breach of an insurance contract is intentional infliction of emotional distress. An award for such a claim, however, has not yet been upheld on appeal.

B. FAILURE TO SETTLE

1. Existence of the Cause of Action

An insurer owes its insured a duty of good faith. In fact, insurers are held to a "universally" high standard of good faith. Frankenmuth Ins v Keeley, 433 Mich 525, 539 (1989), vacated in part, 436 Mich 375 (1990). Accordingly, Michigan has long recognized an insured's cause of action for the "bad faith" settlement of an insurance claim. Wakefield v Globe Indemnity Co, 246 Mich 645 (1929); Commercial Union Ins v Medical Protective Co, 426 Mich 109, 116 (1986). An insured has a direct cause of action against his insurer for breach of that duty which exposes him to excess liability. Wakefield, supra; Commercial Union, supra; Jones v Nat'l Emblem Ins Co, 436 F Supp 119 (ED Mich, 1977).

2. Excess Insurers are Subrogated to the Rights of the Insured

The duty of good faith that runs to the insured arises from the contract between the insurer and the insured. Commercial Union, supra at 111-112. Because no contract exists between a primary and excess insurers, no "good faith" duty arises between the insurers. In an attempt to remedy this situation, a majority of jurisdictions have recognized a cause of action based upon equitable subrogation. Equitable subrogation is a legal fiction though which a person who pays a debt for an individual who is primarily responsible, is substituted, or "subrogated," to all the rights and remedies of the primarily responsible individual. Id. at 117.

Allowing excess insurers to be subrogated to the rights of an insured and allowing the excess carrier to enforce the duty to settle in good faith serves the public interest in encouraging fair and reasonable settlements and by discouraging primary carriers from "gambling" with an excess insurer's money when potential judgments approach the primary carrier's policy limits. Id.

3. Defining Bad Faith

Although the existence of a cause of action for a bad faith failure to settle had been firmly established, conduct constituting "bad faith" was somewhat unclear until the Supreme Court's decision in Commercial Union Ins v Medical Protective Co, 426 Mich 109 (1986). In Commercial Union, the Court defined bad faith, for the purpose of instructing a jury, as "arbitrary, reckless, indifferent, or intentional disregard" of the interests of the insured. Id. at 136. In further explanation, the Court stated:

Good-faith denials, offers of compromise, or other honest errors of judgment are not sufficient to establish bad faith. Further, claims of bad faith cannot be based upon negligence or bad judgment, so long as the actions were made honestly and without concealment. However, because bad faith is a state of mind, there can be bad faith without actual dishonesty or fraud. If the insurer is motivated by selfish purpose or by a desire to protect is own interests at the expense of the insured's interest, bad faith exists, even though the insurer's actions were not actually dishonest or fraudulent. Id. at 136-137 (footnotes omitted).

In addition to providing the instructional definition of bad faith, the Court set forth twelve factors that a trier of fact may consider when determining the existence of bad faith. The following factors are not exclusive and no single factor is intended to be decisive:

1.) Failure to keep the insured fully informed of all developments in a claim or suit that could reasonably affect the interests of the insurered.

2.) Failure to inform the insured of all settlement offers that do not fall within policy limits.

3.) Failure to solicit a settlement offer or initiate settlement negotiations when warranted by the circumstances.

4.) Failure to accept a reasonable compromise offer of settlement when the facts of the case or claim indicate obvious liability and serious injury.

5.) Rejection of a reasonable offer of settlement within policy limits.

6.) Undue delay in accepting a reasonable offer to settle a potentially dangerous case within policy limits where the verdict potential is high.

7.) An attempt by the insurer to coerce or obtain an involuntary contribution from the insured in order to settle within policy limits.

8.) Failure to make a proper investigation of the claim prior to refusing an offer of settlement within policy limits.

9.) Disregarding advice or recommendations of an adjuster or attorney.

10.) Serious and recurrent negligence by the insurer.

11.) Refusal to settle a case within policy limits following an excessive verdict when the chances of reversal on appeal are slight or doubtful.

12.) Failure to take an appeal following a verdict in excess of policy limits where there are reasonable grounds for such an appeal, especially where recommended by trial counsel. [Commercial Union, 426 Mich at 138-139.]

In applying these factors, it is important to remember that the conduct under scrutiny must be considered in light of the circumstances existing at the time. The factors are not to be reviewed with "20-20 hindsight." Id. at 139.

4. Liability for Breach of the Duty of Good Faith Settlement

The measure of damages to an insured for an insurer's bad faith breach of its duty to settle can be difficult to ascertain. Most jurisdictions adhere to one of two theories: (1) the prepayment rule; or, (2) the judgment rule.

The prepayment rule, which has been adopted by a minority of jurisdictions, dictates that an insurer is only responsible for the portion of an "excess" judgment that has been paid by the insured. Frankenmuth Ins v Keeley, 433 Mich 525, 539 (1989). For example, if an insured paid $10,000 of a judgment that exceeded his insurance policy limits by $100,000, the insured’s damages for the bad faith breach is limited to $10,000. The obvious problem with this "prepayment" rule is that an insured must front payments on the judgment and may become insolvent and experience financial ruin before receiving damages. Dumas v State Farm Mutual Automobile Ins Co, 274 A2d 781 (1971). Accordingly, an insurer which has breached its good faith duty of settlement receives a windfall when it is "fortunate enough to have insured an insolvent." Id.; see also Frankenmuth, supra.

The judgment rule, adopted by the majority of jurisdictions, requires that an insurer pay the entire amount of the excess judgment, so that the insured need not make any payment, or even have the capacity to make a payment, in order to recover the excess amount from the insurer. Frankenmuth, supra. The effect of this rule is to eliminate an insurer's ability to hide behind the financial status of the insured. However, this rule can result in a recovery by the insured that exceeds the amount of his actual damages when there is no proof that the entry of the excess judgment has adversely affected the insured or his financial status. Frankenmuth, supra at 554 (Levin, J., dissenting).

Michigan has adopted a hybrid approach in an attempt to secure the benefits provided by each rule. Under this "compromise" rule, an insured is relieved of the requirement of establishing partial payment, but the insured’s recovery is limited to an amount that would have been recovered from the insured if he had been called upon to pay the excess judgment. Frankenmuth, supra at 565 (Levin, J., dissenting), adopted as majority opinion, 436 Mich 372, 376 (1990). Accordingly, the amount of recovery for a bad faith breach of the duty to settle becomes a question of fact, turning upon the amount of the excess judgment that could be collected from the insured. Id.

C. STATUTORY BAD FAITH

1. Uniform Trade Practices Act

Michigan has adopted the Uniform Trade Practices Act, MCL 500.2001 et seq; MSA 24.12001 et seq. Section MCL 500.2006; MSA 24.12006 of the UTPA assesses penalty interest against an insurer that fails to timely pay a claim that is not reasonably in dispute:

(1) A person must pay on a timely basis to its insured, and individual or entity directly entitled to benefits under its insured’s contract of insurance, or a third party tort

claimant the benefits provided under the terms of its policy, or, in the alternative, the person must pay to its insured, an individual or entity directly entitled to benefits under its insured's contract of insurance, or a third party tort claimant 12% interest, as provided in subsection (4), on claims not paid on a timely basis. Failure to pay claims on a timely basis or to pay interest on claims as provided in subsection (4) is an unfair trade practice unless the claim is reasonably in dispute. [Emphasis added.]

The determination as to what is "reasonably in dispute" is to be determined by the court. Jones v Jackson Nat'l Life Ins, 819 F Supp 1372, affirmed 27 F3d 566 (1994).

This "penalty interest" statute is intended to provide a penalty to be assessed against insurers who, in bad faith, procrastinate or are dilatory in paying meritorious claims. Commercial Union Ins Co v Liberty Mutual Ins Co, 426 Mich 127, 136 n 5 (1986); McCahill v Commercial Ins Co, 179 Mich App 761, 779 (1989). Because this statute is intended to punish insurers that act in bad faith in failing to pay claims, a higher standard of liability is required to establish "bad faith" under the UTPA, than is required to establish "bad faith" in failure to settle claims. Commercial Union, supra. For purposes of the UTPA, "bad faith" is defined as "conscious doing of a wrong because of dishonest purpose or moral obliquity." Id. (citing Medley v Canady, 126 Mich App 739, 748 (1983)).

The Michigan Legislature has specifically provided that an award of penalty interest under this statute shall be offset by any other award of interest that is payable to the insured as a result of the award. MCL 500.2006(4); MSA 24.12006(4). Accordingly, any award for penalty interest must be offset by statutory judgment interest, MCL 600.6013; MSA 27A.6013. McCahill, supra at 777-778.

2. Michigan No-Fault Act

Under the Michigan No-Fault Act, an insured is permitted to recover both statutory and penalty interest when an insurer unreasonably refuses to promptly pay personal protection benefits. MCL 500.3142; MSA 24.13142; McCahill v Commercial Ins Co, 179 Mich App 761, 779 (1989). Specifically, MCL 500.3142; MSA 24.13142 provides:

(1) Personal protection insurance benefits are payable as loss accrues.

(2) Personal protection insurance benefits are overdue if not paid within 30 days after an insurer receives reasonable proof of the fact and of the amount of loss sustained. If reasonable proof is not supplied as to the entire claim, the amount supported by reasonable proof is overdue if not paid within 30 days after the proof is received by the insurer. Any part of the remainder of the claim that is later supported by reasonable proof is overdue if not paid within 30 days after the proof is received by the insurer. For the purpose of calculating the extent to which benefits are overdue, payment shall be treated as made on the date a draft or other valid instrument was placed in the United States mail in a properly addressed, postpaid envelope, or, if not so posted, on the date of delivery.

(3) An overdue payment bears simple interest at the rate of 12% per annum.

D. BAD FAITH BREACH OF CONTRACT

Michigan does not recognize a cause of action for the bad faith breach of an insurance contract. Burnside v State Farm, 208 Mich App 422, 425 n 1 (1995); Runions v Auto-Owner Ins Co, 197 Mich App 105 (1992). Damages for mental distress are not recoverable in breach of contract action absent an allegation and proof of tortious conduct existing independent of the breach of contract. Kewin v Massachusetts Mutual, 409 Mich 364 (1980); Isagholian v Transamerica Ins, 208 Mich App 9, 17 (1994).

In Kewin, the Michigan Supreme Court addressed a claim that the plaintiff suffered mental anguish as a result of his insurer's failure to pay all his claims. In addressing plaintiff's claims, the Court observed that an insurance contract was commercial in nature and that all damages arising from a breach of that contract could be adequately determined by reference to the terms of that contract. Id. at 417. In accordance with that observation, the Court held that the mere breach of a commercial insurance contract does not give rise to a right to recover damages for mental distress, Id. at 419, and specifically declined to acknowledge a cause of action for the bad faith breach of an insurance contract:

We decline . . . to declare the mere bad-faith breach of an insurance indemnity contract an independent and separately actionable tort and to thereby open the door to recovery for mental pain and suffering caused by breach of a commercial contract. Id. at 423.

In an attempt to recover mental distress damages in actions for breach of an insurance contract, plaintiffs have alleged that insurers have committed the tort of intentional infliction of emotional distress by failing to pay claims in bad faith. An award on such a claim has not yet been upheld on appeal. The appellate courts have struck down the awards, holding that the mere failure to pay a claim falls short of the conduct necessary to establish a separately actionable tort of intentional infliction of emotional distress. See Roberts v Auto-Owner Ins Co, 422 Mich 594, 605 (1985); Isagholian , supra; Runions, supra.