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Insurance Practice

The Bad Faith Sentinel

Standing guard on developments in the law of insurance bad faith around the country

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Court of Appeals of Wisconsin Holds That a "Fixed Third-Party Beneficiary" May Bring Bad Faith Claim Against Insurer

Meleski v. Schbohm LLC, et al., No. 2010AP2951, 2012 WL 1499859 (Wis. Ct. App. May 1, 2012)

In Wisconsin, a third-party may directly bring a bad faith claim against an insurer if the third party's rights under the policy are fixed.

Patricia Meleski alleged that she was injured when she fell on property owned by Schbohm LLC ("Schbohm"). Meleski filed suit against Schbohm and its insurance carrier, Partners Mutual Insurance Company ("Partners Mutual"), for personal-injury and medical-expense damages. Under the policy, Partners Mutual agreed to pay medical expenses for bodily injury caused by an accident on or next to premises owned by Schbohm, regardless of fault. However, Partners Mutual refused to pay Meleski's medical expense claim without reasonable proof that Schbohm was responsible for payment. Consequently, Meleski brought an action against Partners Mutual for bad faith. The circuit court dismissed Meleski's bad faith claims because she was not in privity of contract with the insurer.

On appeal, the Court of Appeals of Wisconsin noted that insurance contracts can create third-party beneficiary duties running from the insurer to a non-insured. Prior Wisconsin decisions held that a non-insured could sue an insurer once its promise to pay under a policy became fixed by a triggering event. For example, a beneficiary of a life insurance policy could sue the insurer to recover after the insured dies.

In Wisconsin, an element of a bad faith claim had traditionally been that the person asserting the claim was in a contractual relationship with the insurer. The Court reasoned, however, that third-party beneficiaries are in the class that insurance contracts were designed to benefit, and therefore should be treated as if in a contractual relationship with the insurer. The Court found that Meleski was a third-party beneficiary in that the policy was designed to benefit third-parties such as her. Additionally, in Wisconsin, the right of a third-party to maintain a bad faith claim against an insurer has been recognized where the third-party has a vested claim. Because the policy covered medical expenses regardless of fault and there was no dis-

pute that Meleski fell on property owned by Schbohm, Meleski's rights to medical expenses were fixed, or vested, once she fell. Accordingly, the Court found that Meleski could maintain her bad faith action against Partners Mutual as a fixed third-party beneficiary of the policy. The Court of Appeals of Wisconsin thus reversed the circuit court's dismissal of Meleski's bad faith claim and remanded the claim for further proceedings.

California Court of Appeals Holds No Bad Faith for Failure to Name Insured as Co-Plaintiff on Subrogation Claim

***Sedlar v. USAA Cas. Ins. Co., Inc.*, No. C066089, 2012 WL 1478777 (Cal. Ct. App. 3d Apr. 30, 2012)**

Court of Appeals for Third District of California held that absent an agreement to do so, an insurer does not act in bad faith for failing to name an insured as a co-plaintiff and confirmed that a claim for negligent spoliation of evidence is not viable.

James Sedlar bought a chair massager manufactured by Homedics-USA, Inc. ("Homedics") that caught fire and caused more than $700,000 in property damage. Sedlar had a policy issued by USAA Casualty Insurance Company, Inc. ("USAA") that covered the damaged property. USAA paid Sedlar the policy limit of $366,903.96 and hired John Ford to examine the massager for a subrogation action against Homedics. Ford determined that the massager was defective and had caused the fire and the resulting property damage.

USAA brought suit against Homedics, but did not name Sedlar as a co-plaintiff. However, because Ford subsequently lost the chair massager and USAA was unable to produce it, a stipulated judgment was entered against USAA in its action against Homedics. Sedlar then filed suit against USAA for negligence, breach of contract and bad faith. The superior court sustained USAA's demurrer without leave to amend on the three counts. Sedlar appealed to the Court of Appeal for the Third District of California.

Sedlar claimed that USAA was liable for bad faith because it did not name him as a co-plaintiff and by stipulating to a judgment that extinguished his claims against Homedics. The Court of Appeals found that USAA fulfilled its contractual duties to Sedlar when it paid the policy limits. By paying Sedlar, USAA acquired subrogation rights against Homedics. Sedlar, having only been partially compensated by USAA for his damages, retained the right to sue Homedics for the remainder of his loss. Sedlar, however, contended that USAA had a fiduciary duty to litigate on his behalf in USAA's subrogation action against Homedics. The Court of Appeals held that just as an insurer must preserve its subrogation rights by interpleading itself into extant litigation by the insured against the tortfeasor, the insured must also interplead or join litigation initiated by the insurance company against the tortfeasor. USAA had no duty to name Sedlar as a co-plaintiff absent an agreement to the contrary. Thus, because the covenant of good faith and fair dealing is based on the contractual relationship between the insurer and the insured, Sedlar's bad faith claim against USAA failed.

Sedlar also claimed that USAA acted in bad faith by stipulating to a judgment that extinguished his right to damages against Homedics. Sedlar, however, failed to provide the Court of Appeals with the stipulated judgment and accordingly, his argument was deemed forfeited for failure to provide an adequate record to allow review of the claim.

As to Sedlar's claim of negligence against USAA for spoliation of evidence, the Court of Appeals first noted that there were several binding California decisions that expressly held that a tort cause of action for negligent spoliation of evidence cannot be maintained. Sedlar asked that the Court of Appeals reconsider based on *Cooper v. State Farm Mut. Auto. Ins. Co.*, (Cal.

Ct. App. 4th 2009). In *Cooper*, the insurer, State Farm Mutual Automobile Insurance Company ("State Farm"), took possession of an allegedly defective tire to prepare its $15,000 subrogation claim. State Farm expressly promised the insured that it would preserve the tire. However, State Farm subsequently lost the tire and as a result, the insured could not prove that $41,000 of medical expenses was caused by the product. The Cooper court held that State Farm's express promise gave rise to an action for breach of contract, however it did not impose a general tort duty of care on State Farm to preserve the evidence. The Court of Appeals found that unlike *Cooper*, Sedlar did not allege that there was an express promise by USAA to preserve the evidence. Accordingly, the Court of Appeals affirmed the superior court's dismissal of Sedlar's cause of action for negligence and bad faith.

Eastern District of Kentucky: Insurer Cannot Split Claim of Privilege When it Relies on Advice of Counsel to Defend Bad Faith Claim

***Lee v. The Medical Protective Co.*, No. 10-123, 2012 WL 1533388 (E.D. Ky. Apr. 30, 2012)**

Where insurer pled defense of advice of appellate counsel, it waived attorney-client privilege as to both appellate and trial counsel.

Harlan and Penny Lee sued their physician for negligence in delivering their baby, who died three weeks after birth. The physician was insured by The Medical Protective Co. ("Medical Protective") and refused to authorize settlement until shortly before trial. However, the case was not settled for policy limits until after a jury awarded plaintiffs $617,888.03, post-trial motions were denied, the Kentucky Court of Appeals found for the plaintiffs, and the Supreme Court of Kentucky declined to review the case. The Lees filed an action against Medical Protective for bad faith failure to timely settle.

Medical Protective asserted the defense of advice of counsel and waived its attorney-client privilege with respect to its appellate counsel. However, Medical Protective refused to waive its privilege with its trial counsel. The Magistrate Judge for the Eastern District of Kentucky held that the insurer could split its claim of privilege and denied a motion to compel production of trial counsel's file. The Lees objected and the District Judge reviewed the decision.

The Lees first argued that there is no attorney-client privilege between an insurer and the attorney retained by it to defend the insureds. The District Judge held that both an insurer and its insured are the clients of an attorney hired by a liability insurer to represent the insured. Accordingly, the rules applicable to joint representation apply. While there is no privilege between the insured and the insurer as to any matters of common interest, there is a privilege with respect to third-parties. Where the interest of the insurer and insured diverge, such as coverage, the insurer is the primary client, so advice given to the insurer on such an issue by the attorney is privileged as to the insured. If a conflict of interest arises, the attorney must advise the insured of the right to retain the insured's own attorney. Thus, the insurer may invoke the attorney-client privilege as to the file maintained by the attorney it retained to defend the insured. Medical Protective, however, waived its privilege by asserting its advice of counsel defense.

In Kentucky, when a party asserts the defense of advice of counsel, it must demonstrate that it has disclosed all pertinent facts to counsel. All pertinent facts would include the entire trial case file, including the history of negotiations. Furthermore, trial counsel was co-counsel in the appeal. A party may not have two attorneys and claim advice of counsel

by only one. Consequently, Medical Protective waived its attorney-client privilege as to both its trial and its appellate counsel when it asserted its defense of advice of counsel.

Moreover, although state law still controls the existence of privilege in a diversity case, under Federal Rule of Evidence 502, federal law controls waiver. Under Rule 502, when disclosure is made in a federal proceeding and waives the attorney-client privilege or work-product protection, the waiver extends to undisclosed communications or information only if (1) the waiver is intentional; (2) the disclosed and undisclosed communication or information concern the same subject matter; and (3) they ought in fairness to be considered together. The Eastern District of Kentucky held that Medical Protective waived the attorney-client privilege by having its appellate counsel testify to privileged matters. Medical Protective could not disclose selective communications by appellate counsel while concealing communications from trial counsel on the same subject. When a party puts privileged matter at issue as evidence in a case, it waives the privilege as to all related privileged matter on the same subject. Accordingly, because Medical Protective waived its attorney-client privilege, the Court ordered it to produce trial counsel's file.

Court of Appeals of Arizona Orders $55 Million Bad Faith Punitive Damages Award to be Reduced to $155,000

Nardelli v. Metropolitan Group Property and Cas. Ins. Co., No. 1 CA-CV 10-0350, 2012 WL 11514671 (Ariz. App. May. 1, 2012)

Judgment as to bad faith claims was upheld where there was substantial evidence of bad faith in deciding to repair instead of totaling vehicle, sending a check for an amount less than repair costs and failing to advise insured of relevant policy provisions. However, based on Supreme Court precedent, the punitive damages award was reduced to a 1:1 ratio with compensatory damages.

On September 3, 2002, the 2002 Ford Explorer owned by Kenneth and Tammy Nardelli was stolen. The Nardellis reported the theft to their insurers, Metropolitan Group Property and Casualty Insurance Company and Metropolitan Property and Casualty Insurance Company (together, "MetLife"). On September 18, 2002, the Explorer was found abandoned in Mexico and MetLife arranged to have it towed to Arizona where an appraiser initially estimated the damage would cost $815 to repair.

The Nardellis towed the Explorer to the Earnhardt Ford body shop, where the body shop manager "Mike" and the MedLife field appraiser, Jerry Proctor, inspected the vehicle. After Mike finished the inspection, he concluded that it needed a new engine and other repairs. Proctor estimated the total cost to repair the damage was $11,009 and informed the Nardellis that MetLife would not total the Explorer. The Nardellis disagreed and felt the Explorer should be totaled based on the additional damage that continued to be discovered.

Under the policy, MetLife was to pay the lesser of (1) the actual cash value of the Explorer at the time of the loss, or (2) the cost to repair or replace the Explorer "with other of like kind and quality." Ken Nardelli spoke with two MetLife managers and their supervisor in the claims department who told him that the Explorer would not be totaled and that the check for repair would arrive in the mail. Thereafter, MetLife issued a joint check to the Nardellis and their lender for $10,759.13 (the estimated repair cost less a $250 deductible).

The Nardellis sued MetLife for breach of the implied covenant of good faith and fair dealing, and a jury awarded the Nardellis $155,000 in compensatory damages and $55 million in punitive damages. The superior court upheld the award of compensatory damages, but reduced the punitive damages to $620,000. The Nardellis appealed the superior court's reduction of the punitive damages. MetLife cross-appealed and argued that the evidence did not support the bad faith or punitive awards. Alternatively, MetLife argued that the punitive damages should match the amount awarded for compensatory damages.

In Arizona, the test for bad faith is comprised of an objective and a subjective component. An insurer acts in bad faith if it unreasonably investigates, evaluates, or processes a claim (the "objective" component) and either knows it is acting unreasonably or acts with such reckless disregard that such knowledge may be imputed to it (the "subjective" component). The Court of Appeals of Arizona found that there was substantial evidence from which a reasonable jury could find that MetLife acted in bad faith in at least three decisions.

First, the Nardellis presented substantial evidence that the Explorer could not be repaired to pre-loss condition and that MetLife ignored information that the Explorer was coming close to a total loss. Mike testified that theft recovery vehicles are one of the worst types of vehicles to repair and such vehicles may require multiple repairs. The first subsequent owner of the Explorer had repair records nearly every month after the initial repair, and the second subsequent owner described it as "a lemon." MetLife also never obtained a salvage bid, and never accurately determined whether the repair costs came close to a total loss (75% of the actual cash value). Consequently, the Court determined that a reasonable jury could find that MetLife was objectively unreasonable in deciding to repair the Explorer and that it was subjectively unreasonable in ignoring information that indicated the Explorer should be totaled.

Second, the Nardellis presented evidence that the check that did not cover all repair costs and that MetLife attempted to force the Nardellis to abandon their claim that the Explorer should be declared a total loss. Under the policy, if MetLife paid for the loss in money, it was required to pay the Nardellis for the full amount needed to repair the Explorer to its pre-loss condition. Proctor's estimate of $11,009 did not include the additional $2,000 to $3,000 in repairs that Proctor expected would be found by Earnhardt during the repair process. The estimate also did not take into account the actual cost of a new engine or the actual labor rates of Earnhardt. Instead, Proctor's estimate discounted the estimate of a new engine from between $4,000 and $5,000 to $3,300 and discounted Earnhardt's labor rate of $73-per-hour to $40-per-hour. MetLife employees asserted that this discounting was standard practice. MetLife employees also admitted that they knew the Nardellis would never receive the full repair costs if they chose not to repair the Explorer. MetLife sent the check addressed to the Nardellis and their lender as joint payees anticipating that the lender would force the Nardellis to authorize the repairs. The Nardellis thus presented substantial evidence from which a reasonable jury could find that it was objectively unreasonable to send a check for less than the total repair costs and that MetLife subjectively knew it was unreasonable because it attempted to force the Nardellis to authorize the repairs.

Third, the Nardellis showed that MetLife failed to advise the Nardellis of two policy provisions that could have provided them with additional benefits. The first provision was an endorsement that provided additional benefits if, in the event of a total loss, the vehicle was less than one year old and had fewer than 15,000 miles. The endorsement could have been applicable to the 2002 Explorer, which was purchased in December 2001 and stolen in September 2002. The second provision was an appraisal provision, under which each party could trigger an appraisal process to determine the amount of loss. MetLife argued that it had no duty to point out the two provisions. The Court acknowledged than an insurer is not required to explain every fact and provision, however, it noted that the duty of good faith includes an obligation to inform the insured of the extent of coverage and the insured's rights under the policy and do so in a way that is not misleading. Furthermore, Arizona law requires that "no insurer shall fail to fully disclose to first party claimants all pertinent benefits, coverages or other provisions of an insurance policy or insurance contract under which a claim is presented." MetLife's employees admitted that they should have alerted the Nardellis to the provisions if they applied, and the internal training manuals specifically stated that appraisal rights should be communicated to an insured. Thus, the Nardellis presented substantial evidence that it was objectively unreasonable to not alert them to the two provisions and that MetLife subjectively knew it was acting unreasonably.

The Court of Appeals also found that the Nardellis presented clear and convincing evidence they were entitled to punitive damages. Indifference to facts or failure to investigate are sufficient to establish bad faith, but are not sufficient to establish entitlement to punitive damages. To recover punitive damages in a bad faith tort action, the facts must establish that the insurer's conduct was aggravated, outrageous, malicious or fraudulent. The Nardellis presented evidence that by November 2011, MetLife had instituted an aggressive company-wide goal of making at least $155 million profit in 2002 (the year of the Nardellis' claim). MetLife put on "roadshows" in which it informed employees that it had adopted a policy to be "tougher" on claims. MetLife also told its employees that if the auto and home division did not meet these goals, the division would be put up for sale. The employees were told that the $155 million goal was "not optional." The performance reviews of the claims managers reflected that in the year of the Nardellis' claim they consistently met goals in maintaining proper control of severities, the same area where they fell short the year before the Nardellis' claim. Although MetLife's CFO and its expert testified that each claims decision must be made on the merits and without influence of monetary incentive, the Court found that a jury could have concluded that MetLife's directive to work toward the $155 million goal, combined with its bonus compensation measures, disregarded those principles. Furthermore, there was no evidence to show that MetLife had made reasonable mitigation efforts to prevent employees from improperly assessing claims based on MetLife's $155 million profit goal. Accordingly, the Nardellis presented sufficient evidence to support the jury's decision to award punitive damages.

The Court of Appeals, however, determined that the punitive award should be reduced. MetLife argued that under constitutional principles of due process, the punitive damages should be at a ratio of no more than 1:1 to the compensatory damages. The Court agreed that a 1:1 ratio was appropriate under the three guideposts identified by the United States Supreme Court: "(1) the degree of reprehensibility of the defendant's misconduct; (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award; and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases."

The Court of Appeals determined the harm to the Nardellis was largely economic, and MetLife's misconduct fell to, at most, the middle range of the reprehensibility scale. The Court also determined that the evidence did not support the 355:1 ratio between punitive and compensatory damages imposed by the jury, nor the 4:1 ratio imposed by the superior court. Furthermore, the Court noted that legislature capped civil penalties for unfair claims settlement practices at $50,000 per six-month period, which would not have given MetLife notice that its practices could result in a $55 million punitive award. Accordingly, the Court remanded the case to the superior court and directed it to reduce the punitive damage award to $155,000.

California Court Holds Suit Limitation Provision Barred Claims Despite Language Barrier

***Sanchez v. State Farm Gen. Ins. Co.*, B231113, 2012 WL 1560455 (Cal. Ct. App. May 4, 2012)**

California Court rejects equitable estoppel argument based on an insurer's failure to translate insurance provisions cited in denial letter into Spanish.

In 2005, Carmen Sanchez purchased a single-family home in the city of Long Beach, California. Sanchez had some form of homeowner's insurance coverage with an insurer other than State Farm until May 2007. The prior insurer denied coverage for a claim for rotted and decayed wood on Sanchez's front porch. In May 2007, State Farm issued a homeowner's insurance policy to Sanchez.

Sometime in late 2007, Sanchez noticed that several tiles on the bathroom wall were loose or buckling. There was also

some buckling of the exterior stucco on the same wall. Sanchez hired Carlos Alvarez to assess the problems and to repair the wall. On February 1, 2008, while Alvarez was beginning his demolition, a large portion of the wall around the bathroom window collapsed, leaving the window hanging in the framing and exposing extensive wet and rotted wood studs and drywall. Alvarez also noted termite damage. Sanchez reported the bathroom wall damage to State Farm on February 29, 2008 (the "Wall Claim"). A State Farm claims representative spoke with Sanchez about the wall on March 4, 2008 and another representative came to the house to inspect the damage a few days later. The State Farm representative told Sanchez that the interior wall damage could extend further into the house. At the time of the inspection, a portion of the wall had been rebuilt by Alvarez a few feet back from the original location and the wet, decayed construction materials were in a debris pile in the yard.

On March 11, 2008, State Farm denied the claim, stating that the investigation revealed the loss was not covered by the policy because the predominant cause was repeated seepage and leakage of water. The letter also advised Sanchez of the policy's suit limitation provision, which required that any action against State Farm be commenced within one year after the date of loss or damage. Because Sanchez was a native Spanish speaker, State Farm included a copy of the letter translated into Spanish. The translation included the English-language versions of the policy provisions upon which State Farm relied.

After receiving the denial letter, Sanchez hired a contractor to complete the repairs to the bathroom, to determine if there was further decay inside more walls and to perform some additional remodeling work at the subject property. The scale of the job was too large for Alvarez, so Sanchez hired Remy Construction to perform the work. Remy Construction demolished most of the home, leaving only the converted detached garage and then began rebuilding the home. In May 2008, a building inspector from the city of Long Beach cited the project for construction defects, including a failure to place anchor bolts in the foundation. Sanchez then learned that Remy Construction had not paid for or obtained the requisite building permits. On May 25, 2008, Remy Construction demolished all of the new construction and abandoned the project.

Sanchez hired an attorney and filed suit against the sellers from whom she purchased the property, the home inspection company and the termite inspection company involved in the 2005 sale. Sanchez alleged that the defendants willfully failed to disclose material defects in the property, including termite infestation, dry rot and mold. Sanchez's attorney wrote a letter to State Farm advising that he represented Sanchez and requesting a copy of the claims file. The letter did not refer to or advise State Farm of the pending lawsuit. State Farm also received a subpoena from one of the other parties to the suit requesting the claims file.

In August 2009, over a year after the demolition of the house, Sanchez contacted her insurance agent and inquired about her premium payments on the policy in light of the fact the house had been demolished. This inquiry was referred by the agent to State Farm and State Farm subsequently contacted Sanchez to inquire whether she was attempting to give notice of a claim. Sanchez confirmed that she wished to make a claim (the "Whole House Claim"). State Farm again inspected the property and reviewed copies of documents related to the work by Remy Construction. State Farm denied coverage for the claim due in part to the fact that the house was demolished by government order for defective construction, the loss was not the result of an accidental loss, and for failure to timely report the claim or comply with the suit limitation provision.

Sanchez sued State Farm for bad faith, breach of contract, intentional infliction of emotional distress and negligence. State Farm moved for summary judgment on the grounds, *inter alia*, that the action was time-barred under the one-year suit limitation provision. Sanchez asserted that her action was timely for numerous reasons. First, she argued that the Wall Claim and the Whole House claim were essentially just one claim, submitted twice, based on the same hidden defects and that the limitation period was tolled between the initial date of notice and the 2009 denial. Sanchez also argued that the limitation period was equitably tolled during the time she was pursing her lawsuit against the former property owners and other entities. Finally, Sanchez contended that State Farm must be equitably estopped from asserting the time bar as a defense because it misled her into delaying the filing of an action by failing to translate pertinent provisions of the policy into Spanish.

The court rejected each of Sanchez's arguments and held that the suit was time barred. As a preliminary matter, the court acknowledged that suit limitation provisions are valid in California. The court then examined the language of the provi-

sion, citing California law which has clarified that the "date of loss," as used in such provisions, is the point in time when appreciable damage occurs and is or should be known to the insured. The time begins to run even if the full extent of damage is unknown. Because the dates of loss for both the Wall Claim and Whole House Claim were undisputed and were more than two years before the suit was filed, the court found that the limitation provision barred the claim. The Court further rejected Sanchez's argument that State Farm's failure to translate the policy provisions into Spanish in its correspondence with Sanchez estopped State Farm from relying on the limitations provision. The court explained that this failure to translate was not enough to induce Sanchez to delay her filing of the lawsuit and thus could not be the basis for an equitable estoppel argument.

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