Committee News

TORT TRIAL & INSURANCE PRACTICE

ABA Defending Liberty Pursuing Justice

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Insurance Coverage Litigation Committee

CAN AN INSURER DEFEND A BAD FAITH CLAIM USING INFORMATION IT WAS UNAWARE OF WHEN DENYING COVERAGE?

By: Alex Potente and Tyler Gerking[1]

There are times when an insurer declines coverage in either a first- or third-party context and, later, a court determines that this declination was in error and that coverage existed. On some occasions under these circumstances, the policyholder asserts that the insurer did not conduct a complete investigation prior to the declination.

Interesting questions are presented when, during discovery in the ensuing policyholder versus insurer litigation, the insurer discovers new facts that tend to support the denial of coverage:

- Can the insurer rely on these new facts that tend to show no coverage in arguing that its denial was reasonable and in good faith?
- Can these new facts be considered as part of a genuine dispute doctrine analysis, which provides that certain disputed issues of coverage are per se reasonable, and, if so, does this still hold true when the dispute involves a third-party insurance policy?

In this article, we review possible answers to these questions from the perspective of both insurers and policyholders in both first- and third-party contexts. With the law not entirely settled, insurers and policyholders may reach different conclusions. As the departure point for our analysis, we briefly review the requirements of the covenant of good faith and fair dealing implied in every insurance policy.

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[1] Collectively assisted by Kimberly Jackanich.

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Editors Column


Dear Friends, Colleagues, and New Members,

It is amazing that winter is already upon us – where has the year gone? We hope you are enjoying the crisp weather, football victories and upsets, and getting ready for the new year, as 2011 draws to a close.

In this issue, we start off with an article written by Alex Potente, Tyler Gerking, and Kimberly Jackanich raising issues that seem to come up all the time: can a carrier who has made a coverage denial use information learned later on in the insured v. insurer coverage litigation that actually supports its prior denial? The answer may surprise you. Next, Madeleine "Nikko" Fischer and Sara Valentine explore the enforceability of anti-concurrent clauses. Following that commentary, Copernicus Gaza and Brian Margolies have written an excellent article about a recent New Jersey Supreme Court decision about fee-shifting that has been making some ripples nationwide.

We know you will find these articles as engaging as we have, and hope to see you at an upcoming ABA event. Until 2012, we bid you our very best regards.

Sincerely,

Co-Editors
Rabeh Soofi and
Brian Margolies

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Disasters Caused by Acts of Negligence

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ABA Midyear Meeting
February 3, 2012
New Orleans Marriott Hotel
New Orleans, LA

Throughout our history, past and recent, we have been plagued by disasters caused by negligence. If you were to Google this subject today, the search results would include "Katrina Flooding Caused by Army Corps of Engineers' Negligence", "Three Causes of BP's Oil Disaster", and among others "Readying for Trouble: Yearlong Initiative By TIPS Focuses On..." Please register today and join us for this educational, timely and extremely worthwhile program during the ABA Midyear Meeting.

Welcome and Introductory Remarks: **Randy Aliment**, Williams Kastner, Chair, ABA/TIPS

BP and Beyond: Litigation and Claims Following Mass Disasters
2:00pm-3:30pm

Moderator:
Allan Kanner, Kanner & Whiteley, L.L.C., New Orleans, LA

Speakers:
Theodore R. Henke, Senior Vice President and General Counsel, The OIL Group of Companies, Hamilton, Bermuda
Allan Kanner, Kanner & Whiteley, L.L.C., New Orleans, LA
Professor Francis McGovern, Duke University, Durham, NC
Honorable Lee Rosenthal, United States District Court, Houston, TX

This program will discuss the management of litigation which often is the result of Disasters caused by Negligent Acts. The panel features panelists with a depth of experience in the tools and techniques of managing the mass torts and class action litigation filed as a result of man-made disasters. The panel will discuss the litigation and claims arising out of the Deepwater Horizon oil spill that occurred in 2010 in the Gulf of Mexico. The oil spill resulted from an explosion that killed eleven men and injured several more. The after-effects of the spill were extensive and resulted in significant litigation as well as the creation of a compensation fund, the Gulf Coast Claims Facility, that is funded by BP and administered by Kenneth Feinberg. This panel will address the claims administration process and litigation arising from the spill, including a look at insurance coverage issues.

When the Levees Broke: Lessons Learned From Judicial and Governmental Response to Hurricane Katrina
3:30pm-5:00pm

Moderator:
Jennifer Kilpatrick, Degan, Blanchard & Nash, New Orleans, LA

Speakers:
Honorable Madeleine Landrieu, Judge, Civil District Court for the Parish of Orleans, State of Louisiana
Honorable Karen Wells Roby, Magistrate Judge, United States District Court for the Eastern District of Louisiana
Lieutenant General Russel L. Honoré, U.S. Army (Ret) and Commander of Joint Task Force Katrina (Invited)
Mitch Landrieu, Mayor, City of New Orleans (Invited)

Federal, state and local governments face unique challenges when faced with a disaster, as do members of the judiciary. This program will include speakers who have faced these issues in the wake of Hurricane Katrina and will discuss what they learned in the process.


ANTI-CONCURRENT CAUSE CLAUSES: ARE THEY ENFORCEABLE?

By: Madeleine Fischer and Sara Valentine

I. Introduction

This article will examine the treatment of anti-concurrent cause clauses in a variety of jurisdictions. After reviewing the genesis of these clauses, the article reviews the majority and minority views concerning their validity and the extent to which they are enforced.

II. Efficient Proximate Cause Doctrine

All-risk property insurance policies provide coverage for losses caused by all risks or perils, unless specifically excluded. If a covered peril causes a loss, the policy covers the loss. If an excluded peril causes a loss, the loss is not covered. In order to determine coverage when a loss is caused by a combination of a covered peril and an excluded peril, courts created the efficient proximate cause doctrine. Under the efficient proximate cause doctrine, the predominating or efficient cause of the loss alone determines coverage. The peril that sets all others in motion is deemed the efficient proximate cause of the loss, no matter what peril occurs later in the chain. If that peril is covered, then the entire loss is covered.

The California Supreme Court case of *Sabella v. Wisler*[1] is generally credited with creating and applying the efficient proximate cause doctrine to first party property cases. In *Sabella*, plaintiffs sued their insurance carrier when major cracks appeared in the foundation and walls of their home. The insurer denied coverage contending that the loss was caused by "settling" which was excluded by the policy. Discovery revealed that the house was constructed without a proper soil inspection, which would have shown that the land was unfit for building. However, the house exhibited no problems until four years later when someone negligently ruptured a nearby sewer line and sewage leaked into the unstable earth beneath the house. Only then did subsidence damage begin to appear.

To determine what caused the loss, and whether that loss was covered or excluded, the California Supreme Court looked for the efficient proximate cause, which it defined as "the one that sets others in motion . . . the cause to which the loss is to be attributed, though the other causes may follow it, and operate more immediately in producing the disaster."[2] The court concluded that the virtual absence of damage to the home before the sewer line break "clearly indicate[d] that the broken pipe was the predominating or moving efficient cause of the loss."[3]

Following the ruling in *Sabella*, courts in many other jurisdictions adopted the efficient proximate cause doctrine. For example, the Washington Supreme Court applied the efficient proximate cause doctrine in *Graham v. Public Employees Mutual Insurance Company*[4] to find that damage to a home caused by mudflow and flood could be covered because, despite exclusions for earth movement and flood, the efficient proximate cause of the loss might be the volcanic eruption of Mount St. Helens, a covered event. The court held that the determination of the efficient proximate under these circumstances was a jury question.

Similarly, in *Burgess Farms v. New Hampshire Insurance Group*,[5] an Idaho Appeals Court left it to the jury to determine whether the efficient proximate cause of damage to potatoes was an excluded flood or covered vandalism to a dike which led to the flood in the first place. The court noted that the efficient proximate cause

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1 377 P.2d 889 (Cal. 1963). The doctrine was first articulated in the late 1800s in the context of a marine fire insurance policy. *The Howard Fire Insurance Company v. Norwich and New York Transportation Company*, 79 U.S. 194, 199 (1870) ("[W]hen there is no order of succession in time, when there are two concurrent causes of a loss, the predominating efficient one must be regarded as the proximate, when the damage done by each cannot be distinguished.").

2 *Sabella*, 377 P.2d at 895, quoting 6 Couch, Insurance (1930), section 1466.

3 *Id.* at 895.

4 656 P.2d 1077, 1080-81 (Wash. 1983).

5 702 P.2d 869 (Idaho Ct. App. 1985).

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TORT TRIAL INSURANCE

 

ECHOES *MYRON*: The Importance of New Jersey Supreme Court's Ruling on Fee-Shifting

By: Copernicus T. Gaza and Brian Margolies

The decision by the New Jersey Supreme Court in last year's *Myron Corporation v. Atlantic Mutual Ins. Corp.*, 4 A.3d 999 (N.J. 2010) represents a significant development in that jurisdiction concerning the collection of attorneys' fees in coverage litigation where the insured prevails. While New Jersey's fee-shifting rule, set forth in Rule 4:42-9(a)(6), historically has been a powerful tool for New Jersey insureds, the ruling in *Myron* is likely to further liberalize the application of the rule. In a six to one decision, the New Jersey Supreme Court affirmed an appellate court decision holding that the insured was entitled to recover attorneys' fees incurred in defending a declaratory judgment action litigated in an out-of-state court in a matter that was not even decided on the merits. This article will explore New Jersey's fee-shifting rule and the importance of the *Myron* decision.

The American Rule and New Jersey Rule 4:42-9(a)(6)

Fee-shifting, whether in the context of insurance coverage litigation or otherwise, is an exception to the longstanding rule in civil litigation that a successful litigant is not entitled to recovery of attorneys' fees and expenses. This is known as the American Rule. While the American Rule is the majority rule in traditional civil litigation, it is a decided minority rule in the context of insurance coverage litigation.

The decline of the American Rule, at least in the context of insurance-related litigation, was examined in great detail by the Connecticut Supreme Court in *Acmat Corp. v. Greater New York Mutual Ins. Co.*, 923 A. 2d 697 (Conn. 2007). The court noted that as of 2007, only seven states – Alabama, California, Kentucky, Louisiana, Michigan, New Mexico and Tennessee – strictly adhered to the American Rule, *i.e.*, those states do not have some statutory or common law rule allowing insureds to recovery attorneys' fees in insurance-related litigation. *Id.* at 702-03. By contrast, Arkansas, Kansas, Maryland, Montana, South Carolina, Washington and West Virginia, and New York have common law exceptions to the American Rule for insurance coverage disputes. *Id.* at 703-05. The courts of Arizona, Missouri, North Dakota and Texas allow for recovery of attorneys' fees in coverage-related litigation "pursuant to broad interpretations of their states' general attorney's fee or declaratory judgment statutes." *Id.* at 704. The courts of Indiana, Iowa, Maine, Mississippi, North Carolina, Pennsylvania, Utah, Vermont and Wisconsin allow for recovery of attorneys' fees only when the coverage litigation is the result of bad faith conduct on the part of the insurer. *Id.* at 705-06. Finally, New Jersey, along with Delaware, Florida, Georgia, Hawaii, Nebraska and New Hampshire have statutes or court rules allowing an insured to recovery attorneys' fees in a successful insurance coverage litigation. *Id.* at 704.

New Jersey's Rule of Court 4:42-9 sets forth various circumstances under which a litigant is entitled to recovery for attorneys' fees. Rule 4:42-9(a)(6) specifically addresses fee-shifting in the context of insurance litigation:

> (a) Actions in Which Fee Is Allowable. No fee for legal services shall be allowed in the taxed costs or otherwise, except:
>
> . . .
>
> (6) In an action upon a liability or indemnity policy of insurance, in favor of a successful claimant.

An award of attorneys' fees under the Rule is discretionary and only will be awarded to a "successful claimant." *Felicetta v. Commercial Union Ins. Co.*, 285 A.2d 242 (N.J. App. Div. 1971), *certif. den.* 286 A.2d 514 (N.J. 1972). While the fee-shifting rule is contained within the Rules of the Courts of the State of New Jersey, and thus on its face a procedural rule applicable to state court litigation, New Jersey federal courts also have applied the rule to coverage litigation. *See, e.g.*, *Foodtown Inc. v. Nat'l Union Fire Ins. Co.*, 2011 WL 37816 (3d Cir. Jan. 6, 2011); *Baughman v. United States Liab. Ins. Co.*, 723 F. Supp. 2d 741, 747 n.4 (D.N.J. 2010).

The *Myron* Decision

Rule 4:42-9(a)(6) has generated a significant body of case law in New Jersey's state and federal courts. The decision in *Myron Corporation v. Atlantic Mutual* nevertheless represents a significant expansion of the Rule, both in terms of when the Rule will be applied and when a policyholder will be considered a "successful claimant." To appreciate the scope of the *Myron* decision, it is first necessary to understand the procedural history of the multidistrict coverage litigation involved.

The coverage dispute between Myron and Atlantic Mutual pertained to coverage under general liability policies for "blast fax" or "junk fax" cases. *Myron*, 970 A.2d 1083, 1085 (N.J. App. Div. 2009). Myron, a New Jersey-based company, among other things, was a "direct seller of business promotional products" through the use of telefaxes, or faxes, to various businesses throughout the United States. *Id.* These unsolicited faxes resulted in Myron being named as a defendant in a putative class action brought by Stonecrafters, Inc. in an Illinois state court. *Id.* Stonecrafters' suit alleged violations of the Telephone Consumer Protection Act ("TCPA"), Illinois' Consumer Fraud and Deceptive Business Practices Act, and common law conversion. *Id.* Myron tendered the Stonecrafters' suit to Atlantic Mutual, and at the same time, gave Atlantic Mutual notice of various TCPA claims that had been asserted in Colorado, Arizona and Missouri. *Id.* Atlantic Mutual thereafter agreed to defend Myron in the Stonecrafters' suit under a reservation of rights. *Id.* at 1086.

After defending Myron for over a year, Atlantic Mutual commenced a declaratory judgment action against Myron in the United States District Court for the Northern District of Illinois. *Id.* Atlantic Mutual sought a declaration that its policy did not provide coverage for the TCPA claims. *Id.* It was implied that Atlantic Mutual chose to file suit in Illinois federal court based in order to take advantage of a 2004 ruling by the United States Court of Appeals for the Seventh Circuit which held that TCPA claims are not covered under general liability policies. *Id.* The Northern District of Illinois later dismissed Atlantic Mutual's suit, but not on substantive grounds. *Id.* Rather, the court held that it lacked jurisdiction over the dispute as the amount in controversy did not exceed $75,000. *Id.* Two days after the dismissal, Atlantic Mutual filed a second suit in the same Illinois federal court, this time alleging a sufficient amount in controversy to exceed the jurisdictional threshold. *Id.* Five days later, Myron filed its own competing declaratory judgment action against Atlantic Mutual in New Jersey state court. *Id.* Myron's state court action, however, was later dismissed, without prejudice, based on the "first-filed" rule. *Id.* The New Jersey court ruled, however, that it would allow the case to be re-filed in the event that the Illinois suit was dismissed. *Id.*

Shortly after its competing action was dismissed, Myron filed an abstention motion in the Illinois federal court. *Id.* Notwithstanding the fact that there no longer was an actual competing action in New Jersey, Myron argued that the Illinois court should abstain from exercising jurisdiction over the coverage dispute on the basis that the competing declaratory judgments actions (i.e., those in Illinois federal court and New Jersey state court) were virtually identical and concerned issues of state law that were of no federal interest. *Id.* In support of its motion, Myron pointed to the fact that New Jersey had the most substantial interest in the coverage dispute since Myron was a New Jersey company and the Atlantic Mutual policies were issued in New Jersey. *Id.* Given these factors, argued Myron, there was no logical reason for an Illinois court to decide the parties' respective rights under the policies. *Id.* The Illinois court agreed, finding that the litigation did not involve issues of federal law, but rather issues of state law concerning insurance coverage for which New Jersey, rather than Illinois, had a greater interest. *Id.* at 1086-87. It is important to note that just as was the case in Atlantic Mutual's initial federal suit, no substantive coverage issues actually were litigated, and the Illinois federal court did not rule on whether Myron actually was entitled to coverage under the Atlantic Mutual policies.

Myron thereafter filed a second lawsuit in New Jersey state court and successfully litigated the issue of whether Atlantic Mutual had a duty to defend the underlying TPCA claims. *Id.* at 1087. Atlantic Mutual paid all defense costs associated with the direct defense of the *Stonecrafters'* suit, and, pursuant to 4:42-9(a)(6), Atlantic Mutual paid Myron's attorneys' fees associated with Myron's successful declaratory judgment action in New Jersey. *Id.* A dispute remained between the parties as to whether Myron was entitled to reimbursement of approximately $160,000 in attorneys' fees and costs associated with defending the two suits commenced by Atlantic Mutual in Illinois federal court. *Id.* The trial court denied Myron's application for recovery of such amounts under the Rule, holding in pertinent part that the litigation in Illinois was "separate and independent" from the coverage litigation in New Jersey. *Id.* The trial court conceded that the Illinois court could have awarded fees under New Jersey's rule had the Illinois court decided that New Jersey, rather than Illinois law, governed the coverage dispute. *Id.* As to whether a New Jersey court could award fees for extraterritorial litigation, the trial court held that:

> … the application is not supported by Rule 4:42-9a(6) because the fees that are sought were not created, generated or incurred or earned in an action upon a liability or indemnity policy of insurance in favor of a successful claimant. They were earned in a different action …
>
> *Id.*

The New Jersey Appellate Division, however, reversed the trial court's ruling. In doing so, the Appellate Division found no express prohibition in the Rule which precluded recovery of attorneys' fees associated with extraterritorial litigation, and to the contrary, found case law support in other jurisdictions such as Colorado and Washington. *Id.* at 1088-92. The court further held that while the Illinois court did not address the merits of the coverage dispute, Myron could still be considered a "successful claimant" because it later prevailed on the coverage issue in the New Jersey litigation. *Id.* at 1092.

The Appellate Division's ruling was affirmed *per curiam* by the New Jersey Supreme Court for the reasons set forth in the Appellate Divisions' ruling. *Myron*, 4 A.3d 999 (N.J. 2010). The Supreme Court's decision, however, contains an impassioned thirteen-page dissent by Justice Roberto Rivera-Soto in which he concluded that "[c]ommon sense, long-standing precedent, and basic principles of comity" dictated that the Rule could not apply to coverage litigation brought in a non-New Jersey court. *Id.* at 1002. Justice Rivera-Soto further concluded that Myron could not be considered a "successful claimant" in the Illinois litigations since neither matter resulted in an adjudicated on the merits. *Id.* at 1002.

Both the Appellate Division and Justice Rivera-Soto devoted significant attention to the issue of whether Rule 4:42-9(a)(6) should apply to litigation conducted outside of New Jersey. The Appellate Division stated two reasons for allowing such broad application of the Rule. The court first explained that Myron's right to an award of attorneys' fees arose from its successful litigation of the New Jersey coverage action. *Myron*, 970 A.2d 1083, 1089. In other words, this was "not a case in which Myron litigated the merits of the coverage issue in Illinois and then filed suit in New Jersey solely to collect counsel fees." *Id.* The Appellate Division further explained that applying the rule to fees incurred in out-of-state coverage litigation would serve the important purpose of leveling the playing field between an insurer and insured by minimizing the potential that "an insurer could wear down the insured financially through forum-shopping." *Id.* Justice Rivera-Soto, in his dissent, argued that allowing for fee-shifting under such circumstances would result in too great an advantage for the insured, asking the question that if "a plaintiff in New Jersey can seek counsel fees on a properly brought action in another state, what will keep a plaintiff, any plaintiff, from litigating its insurance coverage questions elsewhere, and once successful, then coming to New Jersey to take advantage of this fee-shifting rule?" *Id.* at 1003. Justice Rivera-Soto further argued that extending the Rule to out-of-state coverage litigation "does needless violence to the vital concept of comity among states." *Id.* at 1003Overlooked in both the Appellate Division's opinion, and Justice Rivera-Soto's dissent, is the fact that, like in the New Jersey federal courts, the Rule has been applied, or at least considered on its merits, by courts in other states where New Jersey law was found to govern the policies at issue. *See, e.g., Royal Ins. Co. of America v. Laurelton Welding Service, Inc.*, 2004 WL 1969684 (E.D.Pa. Sept. 3, 2004); *Wiener v. Unumprovident Corp.*, 2002 WL 31108182 (S.D.N.Y. Sept. 20, 2002). It was entirely possible that the Illinois federal court could have applied the Rule had it adjudicated either litigation on the merits, and determined that New Jersey law governed the policies. As such, the holding by in *Myron* that the Rule applies to out-of-state coverage litigation, while undoubtedly expanding the application of the Rule, may not be the most significant aspect of the decision.

Rather, it can be argued that the more important aspect of the decisions by the Appellate Division and the Supreme Court pertains to the issue of whether Myron should be considered a "successful claimant." New Jersey courts historically have established a low threshold for whether a policyholder constitutes a "successful claimant." For example, in *Transamerica Ins. Co. v. Keown*, 472 F. Supp. 306 (D.N.J. 1979), the court held that a policyholder was a successful claimant for the purpose of the Rule even though he recovered only a quarter of the total amount alleged in the complaint. Some courts, however, have held that where a policyholder is only partially successful in prosecuting its declaratory judgment action, then a court should consider a proportionate reduction of a fee award under the Rule. *See, e.g., Singer v. State*, 472 A.2d 138, 144-45; *Foodtown, Inc. v. National Union Fire Ins. Co. of Pittsburgh, Pa.*, 2008 WL 3887617 (D.N.J. Aug. 20, 2008). The *Myron* decision, however, goes farther than these cases in holding that a party can be considered a "successful claimant" even when the insured is not successful on the merits.

The *Myron* decision has not yet been cited by any subsequent court on the issue of what constitutes a "successful claimant" for the purpose of the Rule. As such, the impact of this decision, and what it means to be a "successful claimant" under the Rule in the wake *Myron*, remains to be seen. It is likely, however, that *Myron* signals a broadened application of New Jersey's fee-shifting rule which is likely to be seized upon by New Jersey insureds.

CAN AN INSURER DEFEND…

Continued from page 1

Bad Faith Requires Proof That an Insurer Acted "Unreasonably."

Implied into every insurance contract is a covenant of good faith and fair dealing, which requires the insurer to act reasonably and "give at least as much consideration" to the insured's interests as it does to its own. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 818-19 (1979). Among other duties, the covenant imposes on the insurer a duty to investigate its policyholder's insurance claim thoroughly, including all possible bases that might support coverage — even those facts and theories that the insured has not advanced. *Id.*; *Jordan v. Allstate Ins. Co.*, 148 Cal. App. 4th 1062, 1072 (2007).

An insurer's duty to investigate a third-party claim against its insured must be viewed in light of the law governing the insurer's duty to defend. An insurer must defend its policyholder against any claim that creates a potential for indemnity under the policy. *Scottsdale Ins. Co. v. MV Transportation*, 36 Cal. 4th 643, 654 (2005). The duty to defend is determined in the first instance by a comparison of the allegations in the complaint against the insured and the terms of the policy. *Id.* Extrinsic facts known to the insurer may also present a duty to defend, if they would give rise to potentially covered liability. *Id.* Facts extrinsic to the complaint may also negate a duty to defend. *Montrose Chemical Corp. v. Superior Court*, 6 Cal. 4th 287, 288-89 (1993). An insured has a duty to cooperate and provide information to its insurer, *Truck Ins. Exchange v. Unigard Ins. Co.*, 79 Cal. App. 4th 966, 976 (2000), and the insurer has a duty to investigate the insured's claim. *Travelers Cas. and Sur. Co. v. Employers Ins. of Wausau*, 130 Cal. App. 4th 99, 110 (2005).

If an insurer decides not to defend its insured without conducting what the policyholder might later characterize as a thorough investigation, to prove a claim for breach of the implied covenant of good faith and fair dealing (bad faith), the policyholder must establish: (1) a potential for covered damages, which triggered the duty to defend; and (2) that the insurer acted unreasonably.[2] The reasonableness determination generally requires the use of an objective standard. *Morris v. Paul Revere Life Ins. Co.*, 109 Cal.App.4th 966, 974 (2003) ("if the conduct of [the insurer] in defending this case was objectively reasonable, its subjective intent is irrelevant").

An insurer's conduct will likely be found unreasonable in the bad faith context if it: (1) "unfairly frustrates the agreed common purposes and disappoints" the insured's "reasonable expectations," *Wilson v. 21st Century Ins. Co.*, 42 Cal. 4th 713, 726 (2007); and (2) involves something more than an honest mistake or mere negligence. *Careau & Co. v. Security Pacific Business Credit, Inc.*, 222 Cal. App. 3d 1371, 1395 (1990). In other words, as stated above, an insurer must "give at least as much consideration" to the insured's interests as it does to its own. *Egan*, 24 Cal. 3d at 818-19.

2 Many jurisdictions do not recognize an independent tort claim for bad faith, while others do. Under Virginia law, proof of unreasonable conduct merely allows the policyholder to recover its attorneys' fees incurred in obtaining coverage as part of its breach of contract claim. *See Douros v. State Farm Fire & Cas. Co.*, 508 F. Supp. 2d 479, 483 (E.D. Va. 2007) ("it is well-settled in Virginia law that there exists no independent tort for bad-faith refusal to honor an insurance claim."). Similarly under Hawaii law, courts "hold that there is a legal duty, implied in a first- and third-party insurance contract, that the insurer must act in good faith in dealing with its insured, and a breach of that duty of good faith gives rise to an independent tort cause of action." *Best Place, Inc. v. Penn America Ins. Co.*, 82 Haw. 120, 132 (1996). Massachusetts has not addressed the issue of whether the bad faith action extends to first-party cases. *See* Ashley, *Bad Faith Actions* § 2:15, 2-57 (2d. ed. 1997 & Supp. 2010-2011) (stating that "Massachusetts courts are unlikely to reach the issue, because the Massachusetts unfair claim settlement practices statute includes an express statutory cause of action." Mass. Gen. L. Ch. 93A, § 9, and Ch. 176D, § 3(9)) "The District of Columbia has refused to recognize a cause of action for bad faith in first-party cases." Ashley, *Bad Faith Actions*, § 2:15, n. 60 (2d ed. Supp. 2010-2011) (citing *Choharis v. State Farm Fire and Cas. Co.*, 961 A.2d 1080 (D.C. 2008). "Only traditional contract remedies are available [in Maine] for breach of the implied covenant of good faith and fair dealing." Ashley, *Bad Faith Actions*, § 2:15, n. 53 (2d ed. Supp. 2010-2011) (citing *Greenvall v. Maine Mut. Fire Ins. Co.*, 715 A.2d 949 (Me. 1998). Under Illinois law, a breach of the covenant of good faith is not an independent cause of action and is remediable only through a breach of contract action. *APS Sports Collectibles, Inc. v. Sports Time, Inc.*, 299 F.3d 624, 628 (7th Cir. 2002).

Whether an insurer's conduct meets these criteria requires a case-by-case analysis. *Chateau Chamberay Homeowners Ass'n v. Associated Intern. Ins. Co.*, 90 Cal.App.4th 335, 347 (2001). The "totality of the circumstances" surrounding the insurer's conduct — the context in which the insurer denied coverage — is relevant. *Walbrook Ins. Co. v. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1445, 1455 (1992); *Wilson*, 42 Cal. 4th at 723 (citing *Walbrook)*. For example, the scope of the parties' interactions is relevant to whether the insurer acted unreasonably in declining to defend the insured. *Griffin Dewatering Corp. v. Northern Ins. Co. of New York*, 176 Cal. App. 4th 172, 181 (2009) ("Also, because this is a bad faith case, we quote the precise and full language of a number of important documents, so readers can easily see the source materials which reveal ***how the parties were dealing with each other.***") (emphasis added) (internal quotations omitted).

Stated simplistically, whether an insurer acted unreasonably, and therefore in bad faith, in handling a claim turns on the circumstances of the case. *See Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 537 (1982); *Condio v. Erie Ins. Exchange*, 899 A.2d 1136 (Pa. Super. 2006). We now examine how courts have applied this rubric to an insurer's duty to investigate.

The Insurer's Perspective: What The Insurer Would Have Found Had It Conducted Additional Investigative Work Is the Touchstone of Whether Its Investigation Was Reasonable

A claimed inadequate investigation does not constitute bad faith in the duty to defend context if the coverage issues were so clear that the insurer need only look to the policy and the underlying complaint to determine whether the possibility of coverage existed. On the other hand, when an insurer fails to conduct an investigation that would have uncovered facts supporting the possibility of coverage triggering the duty to defend, the insurer may be imputed with this knowledge. *Safeco Ins. Co. of America v. Parks*, 170 Cal. App. 4th 992, 1008 (2009); *West Beach Development Co., L.L.C. v. Royal Indem. Co.*, 2000 WL 1367994, at *7 (S.D. Ala., Sep 19, 2000).

The issue becomes a little murkier — and more interesting — when an insurer, during the course of litigating a bad faith claim, discovers facts tending to <u>support</u> its decision to deny coverage consistent with its original determination. For example, an insurer denies that a third-party claim triggered its duty to defend. After losing on the coverage issue and in litigating the bad faith claim, the insurer learns of facts that support its initial denial.

As mentioned above, the penalty for failing to investigate is to impute the insurer with knowledge of information supporting coverage that it would have discovered had it conducted a more thorough investigation. The arguable logical converse of this is that facts consistent with the insurer's investigation, but undiscovered until litigation on a bad faith claim, should be allowed to support the reasonableness of the insurer's declination. In determining bad faith, the only relevant question for the jury is whether the insurer's "failure to investigate" would have revealed facts triggering its duty to defend: only "[w]here an insurer denies coverage but a <u>reasonable investigation</u> would have disclosed facts showing the claim was covered, the insurer's failure to investigate breaches its implied covenant." *Parks*, 170 Cal. App. 4th at 1008 (emphasis in original); *Jordan*, 148 Cal. App. 4th at 1074 (same); *Worth Bargain Outlet v. AMCO Ins. Co.*, 2010 WL 2898264, at *9 (S.D. Cal. July 21, 2010) (finding that plaintiff had failed to raise a triable issue of fact as to the reasonableness of the insurer's investigation on summary judgment for bad faith because "Plaintiff ha[d] not put forth any evidence which Defendant could or should have obtained, but which Defendant failed to request"); *American Int'l Bank v. Fidelity & Deposit Co.*, 49 Cal. App. 4th 1558, 1570-71 (1996) (insurer's denial of defense based on review of complaint and policy was reasonable where there was no suggestion of other facts that might trigger coverage); *Benavides v. State Farm Gen. Ins. Co.*, 136 Cal. App. 4th 1241, 1250 (2006) (holding that failure to investigate insured's claim for mold damage in first party case was not actionable because policy excluded coverage for mold).

This line of reasoning holds that, if the insurer would not have learned any additional facts had it conducted a more thorough investigation, then there are no facts to be imputed to it and its decision to deny coverage did not breach the covenant of good faith and fair dealing — regardless of the scope of investigation the insurer actually undertook. Under this logic, as long as the initial determination to deny coverage was reasonable, the insurer has no further duty to investigate. *Brinderson-Newberg Joint Venture v. Pacific Erectors, Inc.*, 971 F.2d 272, 282 (9th Cir. 1992) (holding that the insurer's position that there was "no duty to investigate if the insurer already has a good faith reason to dispute liability" was "the better interpretation of the law"); *Gunderson v. Fire Ins. Exchange*, 37 Cal. App. 4th 1106, 1117 (1995) ("Once it determine[s] on the basis of the lawsuit itself and the facts known to it at that time that there was no potential for coverage, [the insurer] [does] not have a continuing duty to investigate or monitor the lawsuit to see if the third party later made some new claim, not found in the original lawsuit.").

This reasoning can also be extended to allow insurers to admit later-discovered evidence consistent with the insurer's original denial. What constitutes a thorough investigation is inherently a subjective enterprise. It is often difficult for an insurer to determine when to stop its investigation. It is a better rule to require the insured to bring information to the insurer to prove that its claim is covered under the insured's duty to cooperate. The rigors of litigating a bad faith case will inevitably lead to the discovery of new facts, and these facts (or lack of facts) should be admitted to show that the insurer's original denial was adequate, particularly when the facts later discovered are consistent with the position taken by the insurer in denying the claim. Any other conclusion would simply be punitive to the insurer – and would lack the necessary element of causation.

The Policyholder's Perspective: An Insurer That Fails to Discover Facts During Its Initial Investigation Should Be Imputed to Know Only Facts That Support Coverage, Not Facts That The Insurer Might Argue Support The Reasonableness Of Its Decision.

An insurer that has been found to have breached its duty to defend or provide indemnity coverage might attempt to avoid bad faith liability by arguing that facts, of which it was unaware – but could have discovered – when it made its coverage decision show that its erroneous coverage decision was reasonable and therefore not in bad faith. Allowing an insurer that has wrongfully denied a defense and/or coverage to use such information to attempt to prove that its denial was reasonable would give it the benefit of information that it deliberately ignored when it made its coverage decision. Such a rule would encourage insurers to conduct less than thorough investigations, as they would know that any evidence – whether actually known to them or not – would be at their disposal in defense of a later bad faith claim.

For this reason, the reasonableness of the insurer's decision is determined as of the time it was made, rather than on the basis of information the insurer later learns. *See* *Mullen v. Glen Falls Ins. Co.*, 73 Cal. App. 3d 163, 173-74 (1977); *Filippo Industries, Inc. v. Sun Ins. Co of New York,* 74 Cal. App. 4th 1429, 1441-42 (1999); *Century Sur. Co. v. Polisso*, 139 Cal. App. 4th 922, 949 (2006) ("We evaluate the reasonableness of the insurer's actions and decisions to deny benefits as of the time when they were made rather than with the benefit of hindsight."); *see also* *Austero v. National Casualty Co.*, 84 Cal. App. 3d 1, 32 (1978) (*disapproved on other grounds* in *Egan v. Mutual of Omaha Ins. Co., supra,* 24 Cal. 3d at 824) ("In evaluating the evidence to see if there was any unreasonable conduct by the Company, it is essential that no hindsight test be applied."); *CNA Casualty of California v. Seaboard Surety Co.*, 176 Cal. App. 3d 598, 610 (1986) ("The duty to defend cannot be adjudged on the basis of hindsight. It must be determined from the facts and inferences known to the insurer from pleadings, available information and its own investigations at the time of the tender.").

An insurer may not base its defense of a bad faith action on information acquired from a subsequent investigation. *See* *Skaling v. Aetna Ins. Co.*, 799 A.2d 997 (R.I. 2002) (an insurer may not use later acquired information because it has a duty to conduct a fair and comprehensive investigation before refusing to pay a claim, and must therefore justify its denial only with information obtained from this initial investigation. An insurer may not gather information it should have had in the first instance when deciding coverage to defend its decision to deny coverage); *Gaylord v. Nationwide Mut. Ins. Co.*, 776 F.Supp.2d 1101 (E.D. Cal. Mar. 4, 2011); *North Georgia Lumber & Hardware v. Home Ins. Co.*, 82 F.R.D. 678 (N.D. Ga. 1979).

The rule imputing insurers with knowledge of facts that support coverage, but not facts that would tend to show the insurer's coverage decision was reasonable, does not unfairly favor insureds over insurers or penalize insurers. It simply judges the reasonableness of an insurer's decision to deny coverage based on the information that the insurer itself determined was sufficient to support its coverage denial. *KPFF, Inc. v. California Union Ins.* Co., 56 Cal. App. 4th 963, 973 (1997); *Eigner v. Worthington*, 57 Cal. App. 4th 188, 195-200 (1997). Allowing the insurer to reap the benefits of an investigation it did not conduct would be wrong and encourage it to conduct less than thorough investigations.

The Insurer's Perspective: Reliance on the Genuine Dispute Doctrine to Preclude a Finding of Bad Faith If a Genuine Dispute Existed as to Whether Coverage Applied

Many jurisdictions recognize the genuine dispute doctrine, which insulates an insurer from bad faith liability if there was a genuine dispute regarding the existence of coverage: "As a close corollary of [the reasonableness] principle, it has been said that 'an insurer denying or delaying the payment of benefits ***due to the existence of a genuine dispute with its insured as to the existence of coverage liability*** . . . is not liable in bad faith even though it might be liable for breach of contract.'" *Wilson*, 42 Cal. 4th at 723 (emphasis added); *Chateau Chamberay*, 90 Cal. App. 4th at 347; *see also Opsal v. United Services Auto Ass*n*, 2 Cal. App. 4th 1197, 1205-06 (1991) ("bad faith liability cannot be imposed where there 'exist[s] a genuine issue as to [the insurer's] liability under California law.'") (citation omitted). Erroneous denial of a claim may breach the insured's contract, but does not by itself support tort liability: "[t]he mistaken [or erroneous] withholding of policy benefits, if reasonable or if based on a legitimate dispute as to the insured's liability under California law, does not expose the insurer to bad faith liability." *Chateau Chamberay*, 90 Cal. App. 4th at 346 (citation omitted). "Mistaken judgment is not the equivalent of bad faith." *See Walbrook Ins. Co. v. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1445 (1992) (citing *Neel v. Barnard*, 24 Cal.2d 406, 419, 150 P.2d 177 (1944)). Because law does not exist independent of facts, the genuine dispute doctrine frequently offers an important defense to a claim of bad faith, failure to investigate.

Under the genuine dispute doctrine, when the law is unsettled concerning whether there is coverage for a claim, an insurer that denies coverage is not liable for bad faith ***even if it ultimately loses on the coverage issue***. *See, e.g., Opsal*, 2 Cal. App. 4th at 1205-06; *Bosetti v. U.S. Life Ins. Co. in City of New York*, 175 Cal. App. 4th 1208, 1239 (2009) (insurer's reliance on sole California case dealing with issue not unreasonable even though that holding was subsequently rejected); *Karen Kane Inc. v. Reliance Ins. Co.*, 202 F.3d 1180, 1190 (9th Cir. 2000); *Lunsford v. American Guarantee & Liability Ins. Co.*, 18 F.3d 653, 656 (9th Cir. 1994). Where coverage case law is unsettled, the insurer may apply ***any*** reasonable interpretation — even one ***that favors its own interests***. It need not adopt an interpretation favorable to the insured. *Dalrymple v. United Services Auto. Ass'n*, 40 Cal. App. 4th 497, 522-23 (1995) (finding genuine issue where law interpreting policy terminology "was still developing"). For a jury to decide whether to apply the genuine dispute rule, the jury must consider "all the circumstances." *Wilson*, 42 Cal. 4th at 724. This determination can be made on summary judgment in some cases.

The Ninth Circuit, in *Safeco Ins. Co. of America v. Guyton*, 692 F.2d 551 (9th Cir. 1982) ("*Guyton*"), applied California law and developed the genuine dispute doctrine. In *Guyton*¸ the district court granted summary judgment to the insurer on the policyholder's causes of action for breach of contract and bad faith, upholding the insurer's coverage decision. The district court concluded that it should find coverage only if the covered risk was the "sole or efficient proximate cause" of the loss and the covered risk preceded in time the operation of the excluded risk and found that the policies did not cover the policyholder's loss. The Ninth Circuit determined that the district court had misinterpreted California law and reversed on the coverage issue, but affirmed the dismissal of the bad faith cause of action. It held that a "genuine issue concerning legal liability" precluded an insurer's bad faith as a matter of law, even if coverage was later established:

> Although the district court did not specify the grounds on which it entered judgment for Safeco on this cause of action, it may have concluded that since the policy in dispute involved a genuine issue concerning legal liability, Safeco could not, as a matter of law, have been acting in bad faith by refusing to pay on the Policyholders' claims. Although we conclude that Policyholders' losses are covered by the policy if third-party negligence is established, we agree that there existed a genuine issue as to Safeco's liability under California law. We therefore affirm the dismissal of Policyholders' claims of bad faith.

Id. at 557.

Cases decided subsequent to *Guyton* have expanded the application of the "genuine issue" doctrine, applying it to both legal and factual disputes. *Feldman v. Allstate Ins. Co.*, 322 F.3d 660, 669 (9th Cir. 2003) ("under the Ninth Circuit's interpretation of California law, a genuine dispute may concern either a reasonable factual dispute or an unsettled area of insurance law"); *Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 994 (9th Cir. 2001) (the court "decline[d] to limit the genuine dispute doctrine to purely legal or contractual disputes," and "[r]ather than establish a bright-line rule, [held] that the genuine dispute doctrine should be applied on a case-by-case basis"); *Chateau Chamberay*, 90 Cal. App. 4th at 347 ("[i]t is now settled law in California that an insurer denying or delaying the payment of policy benefits due to the existence of a genuine dispute with its insured as to the existence of coverage liability or the amount of the insured's coverage claim is not liable in bad faith even though it might be liable for breach of contract") (citations omitted).

Similarly, the Supreme Court of Alabama supports the use of the genuine dispute doctrine in protecting insurers' denial of claims from bad faith actions when factual issues create a legitimate question of coverage. *Jones v. State Farm Bureau Mut. Cas. Co.*, 507 So. 2d 396, 400 (Ala. 1986). A court must evaluate an insurer's liability in a bad faith action according to the information available to the insurer at the time of denial. *National Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1362 (Ala. 1982). If the evidence produced by either side legitimizes the insurer's denial of a claim through the establishment of a genuine factual issue affecting the validity of a claim, the tort claim for bad faith against the insurer must fail. *Jones*, 507 So. 2d at 400.

Under Iowa law, when coverage is fairly debatable in a first-party claim, the insurer's denial of coverage cannot be in bad faith. *See* *Reid v. Pekin Ins. Co.*, 436 F. Supp. 2d 1002 (N.D. Iowa 2006); *Reuter v. State Farm Mut. Auto Ins. Co., Inc.*, 469 N.W.2d 250, 254-55 (Iowa 1991). As long as the insurer has an "objectively reasonable basis for denying the claim," the insurer can avoid any liability in a bad faith action in the first-party context. *Id.* An imperfect or incomplete investigation alone is not a basis for recovery in a bad faith action when the insurer has an objectively reasonable basis for denying the claim. *See* *Seastrom v. Farm Bureau Life Ins. Co.*, 601 N.W.2d 339, 347 (Iowa 1999). Additionally, when an insurer has an objectively reasonable basis to deny coverage, it has no obligation to investigate further before reaching the conclusion to deny coverage. *See* *Hollingsworth v. Schminkey*, 553 N.W.2d 591 (Iowa 1996). Under Wyoming law, the genuine dispute doctrine protects insurers from bad faith liability as long as the denied claim is fairly debatable. *See* *Hutchinson Oil Co. v. Federated Service Ins. Co.*, 851 F. Supp. 1546, 1557 (D. Wyo. 1994).

Little law exists applying the genuine dispute doctrine in third-party duty to defend cases. The California Court of Appeal has observed, "In the case of a *legal* dispute over the insurer's duty to defend, the genuine dispute doctrine probably would apply. If the insurer had raised a legitimate, arguable question as to its liability, but turned out to have been wrong, it would be liable for breach of contract, but it would not be liable for a breach of the implied covenant or 'bad faith.'…The same cannot be said, however, for a *factual* dispute as to coverage." *Delgado v. Interinsurance Exch. of the Automobile Club*, 151 Cal.App.4th 227, 249 (Ct. App. 2007). In *Delgado*, which was reversed other grounds, the Court of Appeal stated, *in dicta*, that if the case involved a legal dispute over the insurer's duty to defend, the genuine dispute doctrine would probably apply, but if the case involved only a factual dispute, the mere existence of that dispute would create the potential for coverage and therefore activate the insurer's duty to defend. *Id.*

Application of the genuine dispute doctrine in the third-party, duty-to-defend context makes sense as it speaks to the reasonableness of the insurer's denial of coverage. While the duty to defend is interpreted broadly in the coverage context, this breadth of application does not apply to disputed questions of law. *Elliott v. Donahue*, 169 Wis.2d 310, 316 (1992); *John Deere Ins. Co. v. Sanders Oldsmobile-Cadillac, Inc.*, 2009 WL 1530164 (E.D. Cal. May 28, 2009); *Marquez Knolls Property Owners Ass'n., Inc. v. Executive Risk Indem., Inc.*, 153 Cal. App. 4th 228, 233-34 (2007). As such, there is no policy reason to limit an insurer's ability to claim a genuine dispute to first-party cases. *Gaylord v. Nationwide Mut. Ins. Co.*, 776 F.Supp.2d 1101, at 1125 (E.D. Cal. Mar. 4, 2011) ("while factual disputes preclude application of the genuine dispute doctrine in duty to defend cases, legal disputes do not preclude application of the genuine dispute doctrine.").

The Policyholder's Perspective: The Genuine Dispute Doctrine Does Not Apply in Third-Party Cases, Particularly With Respect to the Duty to Defend, Or In Any Case In Which The Insurer Has Failed To Thoroughly Investigate.

The genuine dispute doctrine was developed in the first-party insurance context and has almost never been applied outside of it, at least in a published opinion. *See* *Century Surety Co. v. Pollisso*, 139 Cal. App. 4th 922, 951 (2006) ("Century has failed to cite any cases that apply the genuine dispute doctrine to the duty to defend and our research has not disclosed any. The doctrine has been applied primarily in first-party coverage cases, usually involving disputes over policy language or its application."); *see also* Hon. H. Walter Croskey, et al., California Practice Guide: Insurance Litigation, at Ch. 12, § 12:618.5 (2009) ("There is no known case applying the 'genuine dispute' doctrine to a bad faith claim based on the insurer's refusal to defend its insured.").

The genuine dispute doctrine should not apply in the third-party context because establishing the existence of a genuine dispute as to the existence of a potential for indemnity coverage effectively proves that the insurer had a duty to defend. This is because the existence of such a dispute gives rise to the potential for such coverage, which triggers the insurer's duty to defend. *See* Montrose, 6 Cal. 4th at 288-89.

Several courts have arguably reached this conclusion. *See* *Carrillo v. Nationwide Mut. Fire Ins. Co.*, 2009 WL 1949123 , at *8 n.3 (N.D. Cal. July 2, 2009) ("At least one court has pointed out that the doctrine is not applicable in the duty to defend context because the existence of a genuine dispute as to coverage necessarily means that there was a duty to defend."); *Harbison v. American Motorists Ins. Co.*, 636 F. Supp. 2d 1030, 1040 (E.D. Cal. 2009) ("Because the existence of a genuine dispute as to the insurer's liability indicates that there is at least a potential for coverage, the existence of a genuine dispute is itself enough to trigger the insurer's duty to defend . . . the genuine dispute doctrine appears wholly incompatible with duty to defend cases.")

Finally, if the genuine dispute doctrine were to apply in the third-party liability context, an insurer that has breached its duty to investigate should not be able to rely on it. *Jordan*, 148 Cal. App. 4th at 1074 ("The insurer cannot claim a 'genuine dispute' regarding coverage in such cases because, by failing to investigate, it has deprived itself of the ability to make a fair evaluation of the claim."); *Wilson*, 42 Cal. 4th at 723 ("The genuine dispute rule does not relieve an insurer from its obligation to thoroughly and fairly investigate, process and evaluate the insured's claim. A genuine dispute exists only where the insurer's position is maintained in good faith and on reasonable grounds.") This makes sense because, as discussed above, an insurer cannot reasonably deny a claim without fully considering all the possible bases for coverage. *See* *Egan*, 24 Cal. 3d at 819. Thus, an insurer that has failed to fully consider all possible bases for coverage cannot have "genuinely" disputed the existence of coverage.

Additionally, a finding by the jury that the insurer's investigation was biased may prevent the court's recognition of the genuine dispute. *See* *Hangarter v. Provident Life and Acc. Ins. Co.*, 373 F.3d 998 (9th Cir. 2004). The jury's acknowledgement of the insurer's bias in its investigation allows for a finding of bad faith despite the alleged existence of a genuine dispute over coverage. *See* *Bernstein v. Travelers Ins. Co.*, 447 F. Supp. 2d 1100 (N.D. Cal. 2006).

Outside of California, some jurisdictions have held that an insurer may be liable for damages in a bad faith action in the first-party context despite the existence of a genuine dispute over coverage from a fairly debatable claim. *See* *Zilisch v. State Farm Mutual Auto. Ins. Co.*, 196 Ariz. 234 (2000). The Arizona Supreme Court held that an insurer will be liable in a bad faith action if it acts unreasonably in processing the claim, regardless of the ultimate merits of the insurer's decision. *Id.* at 238.

Conclusion

A bad faith claim for failure to recognize coverage in first- or third-party contexts requires an examination of the totality of the circumstances of an insurer's denial of an insured's claim. From the insurer's perspective, a case can be made that this analysis allows a court or jury to consider facts that support the insurer's decision to deny coverage, even facts the insurer did not know at the time the decision was made. These facts form part of the circumstances and are relevant in determining whether an investigation was reasonable and whether a genuine dispute existed as to how the law applied to the coverage question at hand.

Policyholders, in contrast, can argue that after-acquired evidence should not be admitted in a bad faith, failure-to-investigate context because the only relevant question is whether the insurer's conduct at the time the decision was made was objectively reasonable. While undiscovered bad facts may be admitted to an insurer's detriment, insureds are free to argue that undiscovered facts tending to support the insurer's coverage position should not be admitted to prove that an insurer's investigation was reasonable or the existence of a genuine dispute in either a first- or third-party context. Policyholders may also argue that the genuine dispute doctrine is limited to first-party cases.

We expect these issues to become more sharply addressed as courts continue to wrestle with the required scope of investigations and application of the genuine dispute doctrine in third-party cases.

ANTI-CONCURRENT CAUSE...

Continued from page 6

is "the efficient or predominant cause which sets into motion the chain of events producing the loss . . . [and is] not necessarily the last act in a chain of events."[6]

III. Development of the Anti-Concurrent Cause Clause

In 1982, the United States Ninth Circuit Court of Appeals greatly extended the reach of the efficient proximate cause doctrine.[7] In *Safeco Insurance Company of America v. Guyton*, extensive rains accompanying Hurricane Kathleen caused flooding which broke through flood control structures and inundated a home in Palm Desert, California. The homeowners filed a claim with their insurer, Safeco, but Safeco denied the claim asserting that flood was an excluded peril. In a declaratory judgment action brought by Safeco, the federal district court found in Safeco's favor, reasoning that the flood was the efficient proximate cause of the loss rather than negligent construction and maintenance of the flood control structures as the homeowners urged.

The Ninth Circuit reversed asserting that the district court misinterpreted California law by focusing solely on the fact that the flood preceded the failure of the flood control structures. The Ninth Circuit held that when determining the efficient proximate cause, if a covered cause was simply *a* concurrent proximate cause, and not necessarily *the* prime, moving, or efficient cause of the loss, the loss was covered. The court thus held that because *two concurrent causes* interacted together to cause the damage and one – the negligent construction of the flood control structures – was covered, the policy covered the claim.[8]

In reaction to *Guyton's* concurrent-cause variation on the efficient proximate cause rule, the Insurance Services Office introduced an amendment to the lead-in clause of exclusions contained in certain policies, which is now commonly referred to as the anti-concurrent cause clause (or ACC clause). The short form of the ACC lead-in clause provides:

> We will not pay for loss or damage caused directly or indirectly by any of the following. Such loss or damage is excluded regardless of any other cause or event that contributes concurrently or in any sequence to the loss.[9]

The long form of the ACC clause that is also often used typically provides:

> We do not insure under any coverage for any loss which would not have occurred in the absence of one or more of the following excluded events. We do not insure for such loss regardless of: (a) the cause of the excluded event; or (b) other causes of the loss; or (c) whether other causes acted concurrently or in any sequence with the excluded event to produce the loss; or (d) whether the event occurs suddenly or gradually, involves isolated or widespread damage, arises from natural or external forces, or occurs as a result of any combination of these.

Through the ACC clause, insurers attempt to contract out of the efficient proximate cause doctrine in any form and exclude coverage unless the sole cause of the loss was a covered peril. The majority of jurisdictions enforce the ACC clause and regularly exclude coverage for losses caused by a combination of covered and excluded perils. But other jurisdictions have determined that, at least in certain circumstances, the ACC clause is unenforceable.

IV. Majority View

The majority of jurisdictions enforce the anti-concurrent cause clause asserting that it is unambiguous, does not create illusory coverage, and does not contradict the reasonable expectations of the insured.

A 1993 Utah Supreme Court case, *Alf v. State Farm Fire and Casualty,*[10] was one of the earliest cases to apply the ACC clause. In *Alf*, the main water line to the plaintiffs' home froze and burst washing away soil beneath the tennis court, driveway, and fences causing damage to these structures. Plaintiffs' homeowners insurer, State Farm, agreed to cover the repair of the pipe but refused to cover the ensuing damage caused by the soil erosion due to the earth movement exclusion. In denying the claim, State Farm relied upon the long-form ACC clause in its policy.

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6 *Id.* at 872-73 (quoting *Graham v. Public Employees Mut. Ins. Co.*, 656 P.2d 1077, 1080-81 (Wash. 1983)).

7 692 F.2d 551 (9th Cir. 1982).

8 *Guyton*, 692 F.2d at 555. Interestingly, the California Supreme Court later reversed the concurrent causation analysis of *Partridge*, and reaffirmed *Sabella* in *Garvey v. State Farm Fire & Casualty Co.*, 770 P.2d 704 (Cal. 1989). The court held that the *Sabella* rule provided a workable rule to determine coverage when there was a "causal or dependent relationship between covered and excluded perils." *Id.* at 708.

9 Contractual Modifications of Common Law Rules, IRMI.com (March 2009).

10 850 P.2d 1272 (Utah 1993).

The Utah Supreme Court found that the anti-concurrent cause clause was unambiguous. The court noted that Utah did not recognize the reasonable expectations doctrine, but that even if it did, the ACC clause was no more inconsistent with the plaintiffs' reasonable expectations than any other policy exclusion. After discussing the efficient proximate cause doctrine as developed in California and elsewhere, the court concluded that, "We believe that the proper path to follow is to recognize the efficient proximate cause rule only when the parties have not chosen freely to contract out of it."[11] Accordingly the court affirmed judgment in favor of State Farm, enforcing the ACC clause.

Many other jurisdictions have enforced anti-concurrent cause clauses as unambiguous, and have upheld the parties' ability to contract out of the efficient proximate cause doctrine. For example:

- South Carolina. In *South Carolina Farm Bureau Mutual Insurance Company v. Durham*, [12] the insured's pool "floated" out of the ground due to a combination of the presence of underground water pressure, an excluded peril, and improper draining of the pool, a covered peril. The court held that because the excluded peril, the underground water pressure, was *a* cause of the loss, even though it was not the efficient proximate cause of the loss, the ACC clause worked to exclude coverage for the entire loss.
- North Carolina. In *Builders Mutual Insurance Company v. Glascarr Properties, Inc*,[13] vandals broke into the insured's house and left the water taps running causing extensive flooding in the house. Later, the insured discovered mold, and made a claim. Builders Mutual denied the mold claim citing the policy's mold exclusion. The court rejected the insured's argument that the cause of the mold, vandalism, was covered, and instead applied the anti-concurrent cause clause and held that coverage for the loss was properly denied.
- Alabama. In *State Farm Fire & Casualty Company v. Slade*[14] the plaintiffs' home was damaged when a retaining wall collapsed after being struck by lightning. After investigating the damage, State Farm, relying on the long form of the anti-concurrent cause clause, denied coverage because the loss was caused, at least in part, by soil settling and moving underneath the house, which was excluded under the earth movement exclusion. The Alabama Supreme Court ruled in favor State Farm holding that, due to the ACC clause lead-in, the loss was not covered. A "loss caused by earth movement is excluded regardless of the cause of the earth movement, 'whether other causes acted concurrently or in any sequence with [earth movement],' or whether the earth movement arose from 'natural or external forces.'" The court specifically rejected plaintiffs' argument that the anti-concurrent cause clause defeated the reasonable expectations of the parties.
- Colorado. In *Colorado Intergovernmental Risk Sharing Agency v. Northfield Insurance Company*, [15] a Colorado appellate court concluded that the anti-concurrent cause clause barred recovery for losses due to a roof collapse, when the cause of the collapse was ninety percent due to weight of snow (covered) and ten percent due to decay of wooden trusses (not covered). The court, relying upon the Colorado Supreme Court's 1989 decision in *Kane v. Royal Ins. Co.*,[16] held that the anti-concurrent cause clause was enforceable to exclude coverage where the insured's loss was in any way due to an excluded cause, even if there were other possible causes of the loss.[17] Significantly, the Colorado Supreme Court granted writs in May 2009 to considered the correctness of this decision, specifically referencing *Kane*. The case was settled and the appeal was dismissed before the Colorado Supreme Court could issue an opinion. The writ grant suggests that Colorado may be open to moving to the minority camp on ACC clauses.

V. Minority View

A minority of jurisdictions – California, North Dakota, Washington, West Virginia, and Mississippi at the time of this writing – prohibit insurers from relying on the anti-concurrent cause clause to deny coverage

11 *Id.* at 1277.

12 671 S.E.2d 610, 613 (S.C. 2009).

13 688 S.E.2d 508 (N.C. Ct. App. 2010).

14 747 So. 2d 293 (Ala. 1999).

15 207 P.3d 839, 842 (Colo. App. 2008), *cert. granted*, No. 08-907, 2009 WL 1485804 (Colo. May 26, 2009).

16 768 P.2d 678, 685 (Colo. 1989).

17 *See also Leonard v. Nationwide Mutual Insurance Co.*, 499 F.3d 419, 431 (5th Cir. 2007).

at least in certain circumstances. These states take different approaches, but the result is the same: damage for which the efficient proximate cause is a covered peril will be covered under the policy.

California Insurance Code § 530 provides that, "An insurer is liable for a loss of which a peril insured against was the proximate cause, although a peril not contemplated by the contract may have been a remote cause of the loss; but he is not liable for a loss of which the peril insured against was only a remote cause." California courts have concluded that this statute and California case law including *Sabella* and its progeny make the insurer liable whenever a covered peril is the "efficient proximate cause" of the loss, regardless of other contributing causes. For instance, in *Howell v. State Farm Fire and Casualty Company*,[18] the California appellate court stated, "[I]f we were to give full effect to the State Farm policy language excluding coverage whenever an excluded peril is a contributing or aggravating factor in the loss, we would be giving insurance companies *carte blanche* to deny coverage in nearly all cases."[19]

A limited bypass of California's stance on ACC clauses was successful in *Julian v. Hartford Underwriters Ins. Co.*,[20] a 2005 California Supreme Court case. There, the insured's home was damaged by a rain-induced landslide. The policy contained one set of exclusions preceded by the short form ACC clause. Earth movement was listed in this first set of exclusions. A second set of exclusions was introduced far more innocuously. This second list, however, contained the following excluded peril:

> "a. Weather conditions. However, this exclusion only applies if weather conditions contribute in any way with a cause or event excluded in [the first set of exclusions] above to produce the loss...."

The *Julian* court held that such an exclusion, which essentially targeted a specific combination of an otherwise covered peril (weather conditions) with an excluded peril (earth movement), did *not* violate California law. In essence the court reasoned that an insurer may provide coverage for some, but not all, manifestations of a peril, as long as the policy makes clear which perils are and are not covered. However, the court cautioned it was only addressing the application of this particular weather conditions exclusion to a loss occasioned by a rain-induced landslide. Subsequent to *Julian* several California cases have enforced exclusions that clearly describe specific combinations of covered and excluded perils.[21]

Like California, North Dakota statutorily codifies the efficient proximate doctrine in N.D. Cent. Code §§ 26.1-32-01 and 26.1-32-03. North Dakota prohibits an insurer from contractually excluding coverage when a covered peril is the efficient proximate cause of damage, even though an excluded peril may have contributed to the damage.[22]

The state of Washington developed its application of the efficient proximate cause doctrine through case law. If covered and excluded perils combine to cause a loss and the efficient proximate cause is covered, then the loss is covered, regardless of the contribution or sequence of other causes.[23] The Washington Supreme Court has, however, enforced a version of the limited weather conditions exclusion as in the *Julian* case from California.[24]

West Virginia has also developed its view of the anti-concurrent cause clause jurisprudentially. In *Murray v. State Farm Fire and Casualty Company*,[25] the West Virginia Supreme Court held that enforcement of the ACC clause violates the reasonable expectations of an insured. The court reasoned that where a covered peril is the proximate cause of the loss, an insured would expect coverage. "Only through a painstaking review of the lengthy 'Losses Not Included' section would a policyholder discover the language suggesting that, because the negligence occurred in conjunction with an excluded event, the loss would not be covered."[26] The court further noted that because the homeowner's policy was an "all-risk" policy, the insured would have a heightened expectation that a loss caused by a covered

18 267 Cal. Rptr. 708 (Cal. Ct. App. 1990).

19 *Id.* at 715, n. 6.

20 110 P.3d 903 (Cal. 2005).

21 *De Bruyn v. Superior Court*, 70 Cal. Rptr. 3d 652 (Cal. Ct. App. 2008) and *Freedman v. State Farm Ins. Co.*, 93 Cal. Rptr. 3d 296 (Cal. Ct. App. 2009).

22 *Western National Mutual Ins. Co. v. University of North Dakota*, 643 N.W.2d 4 (N.D. 2002).

23 *See e.g.*, *Safeco Insurance Company of America v. Hirshmann*, 773 P.2d 413 (Wash. 1989).

24 *Findlay v. United Pacific Ins. Co.*, 917 P.2d 116 (Wash. 1996).

25 509 S.E.2d 1, 4 (W. Va. 1998).

26 *Id.*

cause would be covered regardless of a contributing excluded cause.

Recently, the Mississippi Supreme Court held that the ACC clause was ambiguous, and refused to apply it when two perils do not occur "concurrently" or at the same time, thus severely limiting its efficacy. The plaintiffs in *Corban v. United Services Automobile Association*,[27] suffered losses resulting from Hurricane Katrina, and made a claim under their homeowner's policy with USAA. USAA invoked the ACC clause and denied coverage because the majority of the damage to the home was caused by storm surge, which was excluded under the water exclusion.

The Mississippi Supreme Court first noted that the term "loss," which was undefined in the policy, was not synonymous with the word "damage". Loss of property includes many losses of different property elements. The Corbans were entitled to recover for every loss not otherwise excluded under their all-risk policy. Only if losses occurred concurrently (at the same time) would they be excluded by the effect of the ACC clause. However, when perils are sequential, they result in different losses. The court concluded that the term "in any sequence" in the ACC clause could not be used to divest an insured of rights that accrued when a covered loss had already occurred. Thus, if the Corbans' property was first damaged by wind, the Corbans were entitled to recover for that loss, whether or not the property was later flooded.

The *Corban* case was the first from the Mississippi Supreme Court to definitively interpret the anti-concurrent cause clause under Mississippi law. The result in *Corban* conflicted with prior cases from the United States Fifth Circuit, *Leonard v. Nationwide Mutual Insurance Co.*,[28] and *Tuepker v. State Farm Fire & Casualty Co.*,[29] which had predicted that Mississippi would find the ACC clause to be unambiguous and would enforce it.

VI. Conclusion

Under the efficient proximate cause doctrine, when a covered peril and an excluded peril combine to cause a loss, the loss will be covered if the peril that set all others in motion was covered. Insurers developed anti-concurrent cause clauses to avoid the effect of this doctrine, hoping to bar coverage when an excluded peril contributed in any way and in any sequence to the loss. The majority of states find that ACC clauses are unambiguous and enforceable. However, a significant minority invalidate or limit such clauses either statutorily or jurisprudentially.

Not every state has spoken on the validity of the ACC clause. Difficult fact situations (as in the *Colorado Intergovernmental Risk Sharing Agency* case where the excluded cause was deemed to be only a ten percent cause) and mass disasters (as in the *Corban* case involving Hurricane Katrina) may persuade courts to take a second look at ACC clauses. On the other hand, insurers may successfully respond to challenges to the ACC clause by revising their policies to explicitly describe certain combinations of covered and excluded perils which are themselves excluded as was effectively done in the *Julian* case. Thus, when faced with an ACC issue, the practitioner must look carefully to the language of the exclusion in question and the law of the particular jurisdiction at issue to determine the effect of clause.

27 20 So. 3d 601 (Miss. 2009).
28 499 F.3d 419 (5th Cir. 2007).
29 507 F.3d 346 (5th Cir. 2007).

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