RECENT DECISIONS IMPACTING "BAD FAITH" LAW IN NEW JERSEY

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Introduction

New Jersey has long been recognized as an insured friendly jurisdiction on the majority of insurance coverage issues. As a result, insureds large and small have flocked to New Jersey in an effort to gain a favorable forum in which to litigate large exposure insurance coverage issues. One need look no further than the flood of environmental coverage suits filed in New Jersey in recent years for evidence that New Jersey remains a favorite jurisdiction for policyholders.

Given its reputation for insured friendly rulings on coverage issues, insurance practitioners have been closely watching the evolution of New Jersey law in the area of bad faith litigation. In a number of instances, insureds have sought to persuade New Jersey judges to adopt a liberal philosophy toward bad faith claims -- one which would permit the assertion of bad faith claims based upon the slimmest of allegations of improper claims handling or incorrect decisions in denying coverage. The New Jersey courts have consistently rejected these overtures, commencing with the landmark 1993 Supreme Court decision in *Pickett v. Lloyd's*.[1] In *Pickett*, the New Jersey Supreme Court embraced the "fairly debatable" standard for adjudicating bad faith claims, following the Supreme Court of Rhode Island decision in *Bibeault v. Hanover Insurance Co*.[2] *Bibeault* adopted the reasoning of the 1978 Wisconsin Supreme Court decision in *Anderson v. Continental Insurance Co*.,[3] the first court to articulate the "fairly debatable" standard. Under the "fairly debatable" standard, "[i]f a claim is 'fairly debatable,' no liability in tort will arise."[4]

This article will explore the evolution of bad faith litigation in New Jersey beginning with *Pickett* and include a discussion of two 1999 appellate court rulings which have addressed the applicability of the "fairly debatable" bad faith standard in a variety of other coverage contexts.

Pickett v. Lloyd's

Pickett presented an issue of first impression to the New Jersey Supreme Court, i.e., whether New Jersey would recognize a cause of action based upon alleged bad faith refusal to pay benefits under a "first-party" property insurance policy. The Supreme Court explained at the outset the distinction between "first-party" and "third-party" claims, noting that first-party claims are those asserted against one's own insurer whereas a third-party claim involves coverage for claims filed against the insured by a third party.[5] In its 1974 decision in *Rova Farms Resort Inc. v. Investors Insurance Co*., the Supreme Court had recognized an insured's right to pursue a bad faith claim where an insurer controlling the defense of a "third-party" suit, after agreeing to provide coverage, acted unreasonably in failing to settle the suit within the policy limits.[6] Prior to *Pickett*, however, the Supreme Court had not considered an insured's ability to pursue a bad faith cause of action based upon an insurer's *processing* of a coverage claim in either the first-party or third-party context.

Pickett stemmed from an over-the-road trucker's claim for collision benefits payable under a physical-damage policy issued by defendant Lloyd's of London. On January 13, 1987, Mr. Pickett was involved in an accident which resulted in substantial damage to his insured tractor-trailer. The policy provided $30,000 in benefits for physical damage to the vehicle, which was payable within 60-days after submission of a proper proof of loss or any required appraisal of damages. Pickett promptly reported the accident to his insurance agent. Approximately one week later, his agent reported the claim to defendant Peerless Insurance Agency Inc. ("Peerless"), an agent of Lloyd's.[7] The initial notice to Peerless stated that the insured will be "out of work until his vehicle is repaired. Please expedite."[8] Pickett had 37 years of experience with his employer and was therefore entitled to a 90-day grace period to repair or replace his damaged vehicle without loss of his seniority status.[9]

The handling of the Pickett claim was a combination of delays, mistakes, inattention, and almost total unresponsiveness

to the insured, which lasted several months and caused him to lose his seniority status and incur a substantial loss of income. Notwithstanding Mr. Pickett's prompt reporting of the claim, and his clear entitlement to benefits, the claim was not processed and concluded until September 1987, some nine months after the accident and six months after he lost his seniority status. Commenting on the claim handling debacle, the Supreme Court observed that "were it not for the economic consequences to all parties, this case would be thought to arise from an almost comic mixup" in handling a routine covered claim.[10]

Pickett sued Lloyd's and the agents involved for negligent handling of the claim, breach of contract, and unfair and deceptive practices. A jury awarded $70,000 in damages, finding Lloyd's agent Peerless 60% negligent and Lloyd's 40% negligent. The jury specifically found that Peerless "had been directly responsible to Pickett for a lack of good faith and fair dealing outside of its agency relationship with Lloyd's."[11] The Appellate Division affirmed and the Supreme Court granted certification.

The Court commenced its analysis by noting that every contract imposes on each party the duty of good faith and fair dealing in its performance and enforcement. It held that such a duty is an "implied term of every contract" entered in New Jersey.[12] The Court further noted that New Jersey insurance regulations impose on insurers the duty to act "in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear."[13] N.J.A.C. 11:3-10.5, the Court observed, mandates that physical damage claims under auto policies are to "be settled within '30 calendar days' assuming no clear justification for a delay exists."[14]

The Court next surveyed case law nationwide and noted a split among jurisdictions concerning recognition of bad faith causes of action for failure to honor first-party claims. Some states have totally refused to recognize such claims, limiting an insured's recovery to the limits payable under the policy.[15] The *Pickett* Court noted, however, that at least 25 states have recognized such a cause of action -- some finding it tort based and others characterizing it as a contractual remedy.[16] In recognizing the cause of action under New Jersey law, the Supreme Court saw no reason to debate its roots, noting only that it is "best understood as one that sounds in contract."[17] The Court observed that "[t]he demands of formalism do not require that we make a tort out of what is really an unfulfilled [contractual] promise."[18]
Proceeding to a discussion of the appropriate legal standard to apply in adjudging the viability of bad faith refusal to pay benefits, the Court again examined and weighed the law in other jurisdictions. It noted that some states have limited bad faith claims to situations where the insurer has engaged in conduct involving a "dishonest purpose."[19] California and Idaho, it noted, are at "[t]he other end of the spectrum," adopting "a definition of bad faith that would equate with simple negligence."[20] *Pickett* rejected both of these "end-of-spectrum" definitions as contrary to the "public interest" in New Jersey.[21] Instead, the Supreme Court embraced the "fairly debatable" standard, describing it as "the most balanced approach," adopted in Rhode Island and a number of other jurisdictions.[22] Under the "fairly debatable" standard, an insured must establish (1) the lack of a reasonable basis for denying coverage benefits and (2) the insurer's "knowledge or reckless disregard of the lack of a reasonable basis for denying the claim."[23]

In an effort to give trial courts clear direction on how to apply the "fairly debatable" standard, the Supreme Court articulated a summary judgment litmus test. Discussing the hypothetical denial of benefits for experimental surgery under a medical insurance policy, the Court explained that:

> [u]nder the "fairly debatable" standard, a claimant who could not have established as a matter of law a right to summary judgment on the substantive claim would not be entitled to assert a claim for an insurer's bad faith refusal to pay the claim.[24]

The rationale underlying the summary judgment test is easily understood -- if an insured could not establish entitlement to summary judgment on its substantive coverage claim due to disputed issues of law or fact, then a "fair debate" on a question of law or fact necessarily existed at the time the insurer declined to provide coverage.

Application of the standard, the Court acknowledged, is slightly more difficult in situations such as Mr. Pickett's, involving "inattention in the handling of a valid, uncontested claim."[25] It nonetheless concluded that the test essentially

is identical -- an insured must establish unreasonable conduct by the insurer *and* the insured's knowledge of the conduct or reckless disregard of its unreasonableness. The Supreme Court expressly noted that "[n]either negligence nor mistake is sufficient to show bad faith."[26]

Having found that the cause of action sounded more in contract than in tort, the *Pickett* Court held that basic principles of contract law would provide a sufficient measure of damages. A breaching party, it noted, is normally responsible for all natural, probable and foreseeable consequential damages flowing from a breach.[27] The Supreme Court concluded that the proofs before it satisfied the newly articulated bad faith test, noting that there was ample evidence that the processing of Mr. Pickett's claim was more than mere mishandling. The Court noted that the jury could have concluded, based on the evidence, that the defendants knew and were indifferent to the reality that there was no valid reason to deny prompt payment of Mr. Pickett's claim. The Court was also influenced by the defendant's knowledge that Mr. Pickett would be unable to work until his truck was repaired and of the potential economic consequences attendant thereto. Consequently, it affirmed the jury's damages award in its entirety.[28]

Pickett expressly held that the newly recognized cause of action would not support a claim for negligent infliction of emotional distress under New Jersey law. The Court noted, however, that insurers would not be insulated from liability for independent torts conducted in the course of business. It cited as examples of "[d]eliberate, overt and dishonest dealings," insult and personal abuse claims and outrageously intolerable conduct "such as threats by the insurer's agents to kill the insured and the insured's children."[29]

Lastly, the Supreme Court noted that punitive damages would not be available for the bad faith cause of action recognized in its decision. In order to support an award of punitive damages, an insured would have to establish much more than intentional or reckless misconduct -- it would have to establish "wantonly reckless or malicious" misconduct with "egregious circumstances."[30]

Bad Faith Decisions Post-Pickett

In the six years since it was decided, insureds in a number of instances have sought to limit *Pickett* to its narrow facts and the first-party context. These attempts have been largely rejected by courts at both the state and federal level. Indeed, every published decision in New Jersey since *Pickett* has applied the "fairly debatable" standard and held that its reasoning applies with equal force to both first- and third-party coverage disputes.

The first published decision to address the *Pickett* "fairly debatable" standard was *Polizzi Meats, Inc. v. Aetna Life & Casualty Company*.[31] *Polizzi* involved a first-party coverage claim arising out of a fire loss at the insured's place of business. Defendant Aetna's lengthy investigation of the fire revealed it to be of suspicious origin, and as a result, disclaimed coverage. After discovery was completed, Aetna moved for summary judgment seeking dismissal of the bad faith claim while Polizzi cross-moved for summary judgment seeking coverage for the fire loss.[32]

Polizzi's motion for summary judgment on the substantive coverage issues was denied based upon the existence of disputed issues of material fact. Polizzi attempted to distinguish *Pickett* and circumvent the summary judgment litmus test by arguing that the reasonableness of Aetna's conduct in denying coverage constituted a fact issue for the jury and could not be disposed of on summary judgment.[33] Aetna countered by relying upon the summary judgment test articulated in *Pickett*, arguing:

> [I]f there are genuine issues of material fact regarding coverage which would preclude summary judgment in favor of the insured, then the insurer cannot be held liable in bad faith for consequential damages.[34]

Relying upon *Pickett*, *Bibeault*, and the Wisconsin Supreme Court decision in *Anderson*, the federal district court accepted Aetna's argument. Quoting *Anderson*, the Court observed that "when a claim is 'fairly debatable,' the insurer is entitled to debate it, whether the debate concerns a matter of fact or law."[35] The *Polizzi* Court explained that the rationale behind its holding was to insulate the insurer from the "*in terrorem* effect of 'bad faith' litigation."[36] An insurer,

it reasoned, should be entitled to litigate a claim when it believes "there is a question of law or fact which needs to be decided before it in good faith is required to pay the claimant."[37]

In support of its finding that Aetna had a right to "fairly debate" the coverage issue, the district court noted that Aetna's investigation, as well as one conducted by the Trenton, New Jersey, Police Department, had "raised serious questions about the nature and origin of the fire, and Polizzi's possible involvement."[38] The Court concluded that *Pickett's* articulation of the "fairly debatable" standard, along with the district court's denial of Polizzi's own cross-motion for partial summary judgment seeking coverage, "lead inexorably to the conclusion" that the insurer was entitled to summary judgment on the bad faith claim.[39]

*Polizz*i subsequently filed a motion for reconsideration challenging the district court's interpretation of *Pickett*. The Court summarily rejected the motion holding as follows:

> PMI's [Polizzi Meats, Inc.] failure to demonstrate its entitlement to summary judgment on the issue of Aetna's liability for coverage, a summary judgment which PMI affirmatively sought and had every incentive to pursue aggressively, led necessarily to the conclusion that "bad faith" damages could not be recovered from Aetna.[40]

The federal district court in 1997 revisited the applicability of the *Pickett* standard in a claim arising under a third-party liability policy in *Hudson Universal Ltd. v. Aetna Casualty & Surety Co*.[41] *Hudson* involved a bad faith claim arising out of defendant Aetna's coverage denial with respect to a third party "advertising injury" claim. Judge Politan applied the "fairly debatable" standard of *Pickett v. Lloyd's* and granted summary judgment to Aetna dismissing Hudson's bad faith claim with prejudice.[42]

The insured Hudson had been sued by Bausch & Lomb for "patent infringement, trademark infringement, unfair competition and false designation" in connection with the marketing and selling of sunglasses which allegedly were "substantially similar" to sunglasses marketed by Bausch & Lomb.[43] The underlying litigation ultimately settled in November 1995. When Hudson tendered a claim for coverage under the advertising injury provisions of its liability policy, Aetna denied coverage based upon its conclusion that the underlying allegations did not fall within the advertising injury coverage. Hudson thereafter filed a declaratory judgment action seeking coverage and a determination that Aetna was guilty of bad faith in denying its coverage claim.[44]

Hudson prevailed on its claim for coverage in September 1995, apparently on a motion for summary judgment heard by a different judge. Aetna subsequently moved to dismiss the bad faith claim pointing to the unsettled state of the law on "advertising injury" claims and arguing that the coverage issues were "fairly debatable" at the time it disclaimed coverage in December 1991. In arguing that it was entitled to summary judgment on the bad faith claim, Aetna contended (1) that bad faith claims are not recognized in the third party context and (2) "even if they were, they would be limited by the 'fairly debatable' standard."[45]

The District Court recognized the issue before it as one of first impression:

> [I]t is imperative for this Court to look to the circumstances of this case quite carefully, as it brings forth a novel issue to this jurisdiction. More particularly, the Court is faced with determining the appropriate standard for a bad faith refusal of coverage by an insurance carrier in the context of a third party insurance contract.[46]

The Court proceeded to discuss the history of bad faith claims in New Jersey, focusing upon *Rova Farms Resort, Inc. v. Investors Ins. Co*., 65 N.J. 474, 323 A.2d 495 (1974) (recognizing cause of action for bad faith refusal to settle third party claim within policy limits after coverage is acknowledged), and *Pickett v. Lloyd's*, 131 N.J. 457, 621 A.2d 445 (recognizing bad faith claim for denial of first-party insurance benefits where no reasonable basis exists for denying benefits and coverage obligation is clear and not "fairly debatable").[47] It thereafter stated that *Rova Farms* was inapplicable because (1) Aetna denied coverage outright, never tendering a defense and (2) Hudson settled with Bausch & Lomb for a sum well within the policy limits, i.e., there was no excess verdict.[48]

Notwithstanding the inapplicability of *Rova Farms*, the Court upheld the insured's right to bring a cause of action for bad faith denial of a third party claim where coverage is "incontestable." It held:

> Though this is a case of first impression, the Court finds that New Jersey would extend the "fairly debatable" standard to the third-party context where an insurer denies coverage outright on a claim. Even though most of the jurisprudence on denial of coverage in New Jersey has been in the first-party context, the principles associated with the application of the "fairly debatable" standard are still applicable in this case.[49]

Commenting on the *Pickett* standard, the District Court stated:

> This "fairly debatable" standard is premised on the idea that when an insurer denies coverage with a reasonable basis to believe that no coverage exists, it is not guilty of bad faith even if the insurer is later held to have been wrong. "The rationale for this legal principle is based upon the potential in terrorem effect of bad faith litigation upon the insurer." (Quoting *Polizzi Meats, Inc. v. Aetna Life & Cas. Co.*, 931 F.Supp. 328, 334 (D.N.J. 1996).[50]

Judge Politan ultimately concluded that "[a]n insurer should not be required to undertake the defense of a case where it makes an informed determination based on legal authority that it need not respond under a policy."[51] Applying this newly recognized principle, he noted that before the decision on Hudson's claim, no New Jersey court had addressed coverage issues relating to advertising injury. He observed that the law on coverage was "fairly debatable" at the time of Aetna's disclaimer and "is still 'fairly debatable'."[52] Since coverage was "fairly debatable" at the time Aetna's coverage disclaimer was issued, Judge Politan determined that Hudson had no factual basis to support its bad faith claim.[53]

New Jersey's Appellate Division recently had the opportunity to consider the applicability of the "fairly debatable" standard in the context of a third-party claim in *Universal Rundle v. Commercial Union Ins.*,[54] a declaratory judgment action arising out of an environmental coverage claim. Universal-Rundle asserted a bad faith claim against Commercial Union after the carrier declined to provide third-party coverage to its insured for an underlying claim arising out of the insured's dumping of "by-products and waste from its manufacturing process in an area between the manufacturing facility and the Delaware River."[55] The insured contended that Commercial acted in bad faith when it "failed 'to conduct a thorough, objective, and good-faith investigation prior to determining coverage and [ ] den[ied] the claim without any proper basis in the facts or applicable New Jersey law.'"[56] The trial court granted summary judgment to Commercial and the insured appealed.[57]

In an opinion issued in March 1999, the Appellate Division unanimously held that *Pickett v. Lloyd's* established the "fairly debatable" standard for determining the viability of a bad faith claim.[58] Moreover, it expressly rejected the argument that *Pickett* was limited to first-party coverage claims and did not control because *Universal-Rundle's* claim involved third-party liability policies. The Court held that the first-party/third-party "distinction is not dispositive or even of substantive effect."[59] The Appellate Division concluded that there is "no particular policy reason why, for purposes of evaluating bad faith claims against an insurer, it should matter whether the coverage at issue is first- or third-party."[60] Finding that "Commercial undertook some investigation, including contacting Universal on numerous occasions to request information," the Appellate Division ruled that the coverage claim was "'fairly debatable' as a matter of law."[61] The Court therefore affirmed the grant of summary judgment to Commercial "[b]ased on the *Pickett* standard."[62]

Just two months after *Universal Rundle*, the Third Circuit weighed in on the application of the *Pickett* standard to third-party coverage claims in *Robeson Industries Corp. v. Hartford Accident & Indemnity Co.*[63] *Robeson* was another environmental coverage case involving third-party coverage claims brought under general liability policies. The Third Circuit first observed that the insured's bad faith cause of action was grounded in the law of contracts and stemmed from the covenant of good faith and fair dealing implied in every contract. In following the "fairly debatable" standard, the Third Circuit saw no reason why the Supreme Court's *Pickett* rationale "should not likewise apply in the third-party context."[64] Commenting on the "fairly debatable" standard and quoting *Pickett*, the Court noted that "the insured must

'show the absence of a reasonable basis for denying benefits of the policy and the defendant's knowledge or reckless disregard of the lack of a reasonable basis for denying the claim.'"[65]

The *Robeson* Court quoted the summary judgment litmus test from *Pickett* and noted that Robeson was unable to establish a right to summary judgment on the substantive coverage issues.[66] Consequently, *Robeson's* bad faith claim was subject to dismissal as a matter of law.

Conclusion

The *Picket*t Court characterized the fairly debatable standard as "the most balanced approach" to determining when a bad faith cause of action may be permitted against an insurer. While recognizing an insured's right to sue for extra-contractual compensatory damages where there is no "fair debate" as to coverage and an insurer is guilty of intentional delays and/or reckless misconduct, the standard provides necessary protections to insurers. As the *Polizzi* and *Hudson Universal* Courts properly recognized, the "fairly debatable" standard protects insurers from the "*in terrorem*" effect of bad faith claims and allows an insurer to contest coverage wherever there is a question of fact and/or law that may impact upon the insured's entitlement to coverage.[67]

The summary judgment litmus test articulated in *Pickett* provides trial courts with a practical mechanism for pre-screening bad faith claims. While an insured who wins summary judgment on the substantive coverage claim is not guaranteed to prevail on a bad faith cause of action -- coverage still could be found to be "fairly debatable" as in *Hudson Universal* -- an insured who cannot satisfy the summary judgment threshold is precluded from pursuing a bad faith cause of action as a matter of law.

As a result of this year's recent appellate court decisions in *Universal-Rundle* and *Robeson*, the "fairly debatable" standard is firmly engrained in New Jersey law. Barring a complete reversal of the New Jersey Supreme Court's philosophy towards bad faith litigation as articulated in *Pickett v. Lloyd's*, this standard is likely to control the litigation of bad faith claims in New Jersey for the foreseeable future.

Endnotes

1. 621 A.2d 445 (N.J. 1993).

2. *Id.* at 453 (quoting *Bibeault*, 417 A.2d 313, 319 (R.I. 1980)).

3. 271 N.W. 2d 368, 376-378 (Wis. 1978).

4. *Bibeault*, 417 A.2d at 319.

5. 621 A.2d at 450.

6. 323 A.2d 495 (N.J. 1974).

7. 621 A.2d at 447-448.

8. *Id.* at 448.

9. *Id.* at 447.

10. *Id*.

11. *Id*. at 449.

12. *Id*. at 450.

13. *Id*. at 451 (quoting N.J.S.A. 17:29B-4(9)(f)).

14. *Id*. at 451 (quoting N.J.A.C. 11:3-10.5).

15. *Id*. at 451 (citations omitted).

16. *Id*.

17. *Id*. at 452.

18. *Id*.

19. *Id.* at 453 (quoting *Coyne v. Allstate Ins. Co*., 771 F.Supp. 673, 677 (E.D. Pa. 1991)).

20. 621 A.2d at 453.

21. *Id*.

22. *Id*.

23. *Id.* (quoting *Bibeault*, 417 A.2d at 319).

24. 621 A.2d at 454.

25. *Id*.

26. *Id.* (quoting *Blue Cross & Blue Shield v. Granger*, 461 So.2d 1320, 1327-28 (Ala. 1984)).

27. 621 A.2d at 454.

28. *Id*. at 456-457.

29. *Id*. at 455.

30. *Id*.

31. 931 F.Supp. 328, 334 (D.N.J. 1996).

32. *Id*. at 330.

33. *Id*. at 334.

34. *Id*.

35. *Id.* at 334 (quoting *Anderson v. Continental Ins. Co*., 271 N.W.2d at 376).

36. *Id*. at 334.

37. *Id.* at 334-335 (quoting *Anderson*, 271 N.W.2d at 377).

38. *Id*. at 335.

39. *Id*.

40. *Id*. at 339.

41. 987 F.Supp. 337 (D.N.J. 1997).

42. *Id*. at 343.

43. *Id*. at 338.

44. *Id*. at 338-339.

45. *Id*. at 339.

46. *Id*. at 340 (emphasis in original).

47. *Id*.

48. *Id*. at 341.

49. *Id*.

50. *Id*.

51. *Id*. at 342.

52. *Id*.

53. *Id*. at 343.

54. 725 A.2d 76 (N.J. App. Div. 1999).

55. *Id*. at 78.

56. *Id*. at 89.

57. *Id*.

58. *Id*. at 89-90.

59. *Id*. at 90.

60. *Id*.

61. *Id*. at 89.

62. *Id*. at 90.

63. ___ F. 3d ___ (3rd Cir. 1999) (Docket No. 98-5168, filed May 13, 1999).

64. Slip. op. at 14, n.11.

65. Slip. op. at 14-15 (quoting *Pickett*, 621 A.2d at 453).

66. *Id.* at 15. Indeed, the insurers were granted summary judgment on the coverage issues in *Robeson* based upon the Court's application of New York law. The Third Circuit affirmed. *Id.*

67. *Polizzi*, 931 F.Supp. at 334; *Hudson Universal*, 987 F.Supp. at 341.