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FORC QUARTERLY JOURNAL OF INSURANCE LAW AND REGULATION
Fall 1998 September 12, 1998 Vol. X, Edition III

ARIZONA BAD FAITH LAW: GOOD NEWS AND BAD NEWS,

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Good news and bad news. From an insurance industry perspective, the Arizona law of bad faith is a mixed bag. There are several Arizona decisions which are helpful both from the standpoint of defending a bad faith claim, as well as containing the amount of damages that can result therefrom. On the other hand, Arizona courts have expanded the duty owed by an insurer to a policyholder beyond the denial or mishandling of a claim. Indeed, recent case law suggests that bad faith can be found even when it is clear that no coverage exists under the policy.

Overview of Arizona Bad Faith Decisions

Arizona, like most states, recognizes the tort of bad faith. The tort arises when an insurer breaches the implied covenant of good faith and fair dealing which is part of the insurance contract itself.¹ Essentially, bad faith is an intentional tort where the policyholder must show that the insurance company acted intentionally, as opposed to inadvertently or mistakenly.² The insurer must be shown to have treated the policyholder unfairly or dishonestly in connection with his claim or that the insurer failed to give fair and equal consideration to the policyholder's interest.³

Arizona follows a two part analysis for purposes of determining bad faith. The first is whether the insurer, in fact, acted unreasonably towards its insured.⁴ In other words, is the insurer's action consistent with what a reasonable insurer under similar circumstances would have done in connection with processing the payment of a claim.⁵

The second part of the two part test requires an analysis of the insurer's intent. If the insurer is found to have acted unreasonably, it must then be shown that the insurer knew it was acting unreasonably or it acted with such reckless disregard of its policyholder's interest, one could impute knowledge of consciously unreasonable conduct to it.⁶ Again, both parts of the analysis must be satisfied before a determination that an insurer acted in bad faith can take place.

The Good News

Insurance companies have the right to challenge claims that are "fairly debatable," even if it is later determined that the claim should be paid.⁷ Indeed, because of the requirement of intentional conduct or actions reflecting reckless disregard of the policyholder's interest, simple mistakes or errors on the part of insurers in processing claims will not give rise to bad faith.⁸ Clearly, this is important and provides a basis to defend in a bad faith action. However, the corollary is also true that once the mistake is discovered, it is incumbent upon the insurer to take prompt and appropriate steps to remedy the situation.⁹

Arizona has also uncoupled a punitive damage award from a finding of bad faith. In *Linthicum v. Nationwide Life Ins. Co.*,¹⁰ the Arizona Supreme Court required that punitive damages would only be available in "those cases of consciously malicious or outrageous acts of misconduct in which punishment and deterrence is both paramount and likely to be achieved." Indeed, according to the *Linthicum* Court, there must be evidence of both "an evil mind" and "aggravated and outrageous conduct."¹¹ Thus, the bar to be awarded punitive damages in a bad faith action has been set at a far higher level than the simple finding of acting in bad faith. Clearly, the recognition by the Court that ordinary mistakes do not breach the implied covenant of good faith and fair dealing, together with the double standard of requiring an evil mind and outrageous misconduct before a punitive damages award can be upheld, provides a meaningful basis for insurers to contest bad faith claims where

punitive damages award can be upheld, provides a meaningful basis for insurers to contest bad faith claims where appropriate.

The Bad News

Beginning with *Rawlings v. Apodaca*,¹² the Arizona Supreme Court has determined that bad faith can exist even though there is no breach of the express terms of the insurance contract. There, the Court concluded that the insurer acted in bad faith when it attempted to prevent its insureds from filing a law suit against a tortfeasor who had also purchased a policy from the same company, notwithstanding the fact that the company settled and fully paid on the insured's claim. In *Rawlings*, the insurer failed to make a fire investigation report available to its insureds, which report could have assisted the insureds in pursuit of a claim against a next door neighbor also insured by the same company. The Court concluded that the implied covenant of good faith and fair dealing is breached, whether an insurer pays a claim or not, when its conduct damages the very protection or security which the insured sought to gain by buying the policy.¹³

Following *Rawlings*, the Arizona Supreme Court in *Deese v. State Farm*,¹⁴ determined that notwithstanding the payment by the insurer of all contractual benefits due under a policy, bad faith could be found based upon the procedures an insurer follows in making a coverage decision. In *Deese*, the insurance company was accused of deliberately using certain chiropractors for the purpose of reducing the plaintiff's claim. The Plaintiff argued that the claims procedures followed by State Farm were really designed to lower claim costs without regard to the insured's interest in making sure the claim was processed fairly and in good faith. Clearly, this case casts a pall over efforts to contain claims costs by an insurer aggressively reducing the amount of provider bills related to same. Indeed, in *Deese*, the Plaintiff received an indemnity commitment from the insurer in the event the provider sought to recover for the unreimbursed portion of the services billed. The *Deese* Court held that notwithstanding the indemnity, the net effect of the insurer's claim processing procedures undermine the security and protection desired by the policyholder and violated the covenant of good faith and fair dealing.¹⁵

Recently, the Arizona Court of Appeals in *Lloyd v. State Farm Mut. Auto Ins. Co.*¹⁶ concluded that bad faith could arise even when it is ultimately determined that there is no coverage under the policy. In that case, an individual was struck by the policyholder's midget race car which was not covered under the insured's personal automobile liability policy. In this case, the insureds did not attempt to obtain insurance coverage on the midget race car, they knew they had no insurance on the vehicle and they understood they could not get coverage for it through the personal auto policy because it was a race car. Regardless, when they were sued because of the accident, they contacted the insurance company's Claim Department and were told that someone from the insurer would "take care of it." A Default was later entered against the insureds; although, the insurance company did retain an attorney to try to set aside same. At the same time, the insurer continued to investigate the claim and concluded there was no coverage. The insurer notified its policyholder of the denial of the claim because there was no coverage and advised the policyholders to obtain their own counsel. Notwithstanding the foregoing, the Court concluded that the assumption of the gratuitous defense by the insurer brought the matter within the ambit of the *Rawlings* and *Deese* cases because the insurer failed to act reasonably towards its insureds and neglected to adequately protect its insureds under the circumstances of this case.¹⁷

Obviously, the troubling aspect of the *Lloyd* decision for insurers is that even where the ultimate decision that no coverage exists under a policy is indisputable, any actions of the insurer during the period of time such coverage review is taking place can trigger the implied covenant of fair dealing and good faith that arises under other policies with the insured and, accordingly, the insurer can be held in bad faith for attempting to disengage from a claim under a contract where no coverage exists. While *Lloyd* may be distinguishable in part because of affirmative actions undertaken by the insurer during the period of time that the coverage determination is being analyzed, the import of *Lloyd*, if taken to an extreme, could give rise to a bad faith claim under circumstances far removed from traditional bad faith considerations. Is *Lloyd* the precursor of cases where bad faith arises based upon an insurer's relationship with a former policyholder? Does a *Lloyd* analysis mean that any determination that coverage does not exist potentially give rise to a bad faith claim as the insurer tries to withdraw from the defense of a pending law suit? Obviously, these are important issues which will doubtless emerge in the future.

Conclusion

This review of Arizona bad faith law is merely a brief summary which has endeavored to focus upon key aspects that are both favorable and unfavorable to insurers' interests in the context of a bad faith action in Arizona. The ability to defend bad faith cases based upon ordinary mistakes and clerical errors is an important one and favorable to the insurance industry. Similarly, the high standard for punitive damages in the state uncouples such damages from a finding of bad faith and

Similarly, the high standard for punitive damages in the state uncouples such damages from a finding of bad faith and requires the presence of an evil mind and outrageous conduct before a large award can take place. Notwithstanding the foregoing, Arizona courts have expansively recognized the implied covenant of good faith and fair dealing even when no coverage exists under the policy. The watchword to the insurance industry in Arizona is that in examining claims, as well as other conduct between an insurer and its policyholders, technical arguments relating to coverage, even when concluded to be legally correct, do not avoid a potential bad faith action based upon the insurer's overall conduct. The best approach is to view every point of contact with one's policyholder from the perspective that the policyholder, at all times, must be treated fairly and given every reasonable consideration under the circumstances, even when the case for no coverage is clear.

Endnotes

1. *See Noble v. National American Life Ins. Co.*, 624 P.2d 866 (Ariz. 1981).
2. *Hawkins v. State Farm Ins. Co.*, 733 P.2d 1073 (Ariz. 1987).
3. *Id.*