Mealey's California Insurance Conference
June 01, 2001
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Recent Developments in Insurance Bad-Faith Litigation

1. No "Comparative Bad Faith."

In Kransco v. American Empire Surplus Lines Ins. Co. (2000) 23 Cal.4th 390, 97 Cal.Rptr.2d 151, the California Supreme Court soundly rejected the idea that an insurer could assert its insured's "comparative bad faith" as an affirmative defense in a bad-faith lawsuit by the insured. In so doing, the court endorsed the view of the Supreme Courts of Montana and Oklahoma, which had earlier rejected the defense of "comparative bad-faith." (Stephens v. Safeco Ins. Co. of America (1993) 258 Mont. 142, 852 P.2d 565; First Bank v. Fidelity and Deposit Ins. (Okla. 1996) 928 P.2d 298, 306.)

In Kransco, the insured (Kransco) manufactured a backyard water slide toy called a "slip and slide." A Wisconsin consumer broke his neck while using the toy, resulting in partial quadriplegia. He sued Kransco for product liability in Wisconsin. The insurer, AES, turned down a settlement offer of $750,000, which was below policy-limits. The case went to trial and resulted in an excess verdict of $2.3 million in compensatory damages, plus $10 million in punitive damages.

Kransco sued AES in California for bad-faith. One of AES's affirmative defenses was the "comparative bad faith" of Kransco, particularly with respect to its conduct of the Wisconsin litigation. During that lawsuit, Kransco had originally responded to an interrogatory from the plaintiff asking about its knowledge of prior cervical injuries associated with its product by denying any knowledge. The company later amended its response to explain it was aware of two prior injuries, one resulting in death, and a second in quadriplegia. AES argued that by providing an incorrect interrogatory response, Kransco allowed the plaintiff's trial lawyer to argue to the jury that there may have been other undisclosed accidents concerning the slip and slide.
The California Supreme Court held that an insurer could not assert its insured's "comparative bad-faith" as an affirmative defense in a bad-faith action. The Court explained that although the implied covenant of good faith and fair dealing is a "two-way street," the duties the law imposes on the insurer and the insured differ, as do the remedies available to each for breach of the implied covenant of good faith. (23 Cal.4th at 402,) The insurer's duty of good faith is independent of the insured's performance of its obligations under the policy. (23 Cal.4th at 402.) And the insurer's breach of the implied covenant is a tort, whereas the insured's breach is not. (23 Cal.4th at 402.)

The Court explained:

A fundamental disparity exists between the insured, which performs its basic duty of paying the policy premium at the outset, and the insurer, which, depending on a number of factors, may or may not have to perform its basic duties of defense and indemnification under the policy. (See, Foley, supra, 47 Cal.3d at p. 693 . . . [noting the "insurer's and insured's interest are financially at odds"].) An insured is thus not on equal footing with its insurer - the relationship between insured and insurer is inherently unequal, the inequality resting on contractual asymmetry. An insurer's tort liability for breach of the covenant is thus predicated upon special policy factors inapplicable to the insured." (23 Cal.4th at 404-405.)

The Court concluded by observing that an insured's misconduct, whether intentional or negligent, could support a variety of contract defenses to a bad-faith action, by voiding coverage or factually disproving the

insurer acted unreasonably. (23 Cal.4th at 410.) But, "[a]n insurer may not . . . assert an insured's comparative bad faith as an affirmative defense to partially absolve itself of its own tort liability for breach of the covenant of good faith and fair dealing." (23 Cal.4th at 411.)

2. Erosion of ERISA Preemption

In UNUM Life Ins. Co. of America v. Ward (1999) 526 U.S. 358, 119 S.Ct. 1380, the Supreme Court held that California's common-law "notice prejudice rule" was within the scope of ERISA's saving clause, and therefore not preempted. Ward is significant for two reasons: First, it clarified and thereby broadened the scope of the saving clause, rejecting the crabbed reading that had crept into the lower courts' application of that clause. Second, Ward has spawned a debate about the preemptive scope of the civil remedies provision in ERISA, and the Court's analysis of that issue in Pilot Life Ins. Co. v. Dedeaux. (1987) 481 U.S. 41, 45-46. In Pilot Life, the Court held that Mississippi's cause of action for "bad-faith" arising out of claims handling by an ERISA plan was outside of the scope of ERISA's saving clause, and was preempted.
Ward's analysis of the saving clause made it clear that Pilot Life's analysis of whether Mississippi's bad faith cause of action was saved would not necessarily extend to the bad-faith remedy in every state. If the remedy was applicable only to the insurance industry, then a strong argument could be made that the bad-faith tort was a regulatory tool, used by a state to regulate insurance. (The Supreme Court's decision in Humana Inc. v. Forsyth, 525 U.S. 299 (1999), holding that civil RICO did not invalidate, impair, or supersede Nevada's unfair claims practices act including its bad-faith tort against insurers, assumed that the Nevada law was a law that regulated insurance under the McCarran-Ferguson Act.)

To date, several district courts have held that, under Ward, a plaintiff is entitled to assert a bad-faith tort against an ERISA insurer, because a state's bad-faith tort meets the criteria for a state law that regulates insurance, and is therefore saved.

The first case was Hall v. UNUM, Case No. 97-M-1828 (D. Colo. 1999). In an unpublished order, Judge Richard Matsch granted the plaintiff's motion to amend her complaint to add a cause of action for bad-faith under Colorado law. While UNUM did raise the issue in its opposition to plaintiff's motion to amend, it did so almost as an afterthought, and its discussion was cursory. The bulk of its argument was devoted to showing that the claim was not saved.

Next, Judge Holmes of the Northern District of Oklahoma, in Lewis v. Aetna U.S. Healthcare, 78 F.Supp. 1202 (N.D. Okl. 1999), reached the same conclusion as Judge Matsch in Hall, holding that Oklahoma's bad-faith remedy was saved.

In Hill v. Blue Cross Blue Shield of Alabama, 2000 WL 1522841 (N.D. Ala. 2000), Judge Acker concluded that Alabama's bad-faith insurance tort, which has been codified in the Alabama Insurance Trade Practices Act, was saved. He noted, "Although there have been some district courts which disagree with this court's reading of Ward, this court finds nothing fuzzy or ambiguous about what the Ward court was saying." In Gilbert v. Alta Health & Life Ins, Co,, 2000 WL 1770650 (N.D. Ala. 2000), Judge Johnson of the same district followed Hill, and held that ERISA did not preempt the Alabama bad-faith tort.

Selby v. Principal Mutual Life Ins. Co., 2000 WL 178191 (S.D.N.Y. 2000), also held that ERISA did not preempt plaintiff's state-law based claim for punitive damages under New York law against an ERISA insurer for wrongful denial of disability benefits. But this decision did not base the conclusion directly on Ward. The court rejected the argument that under Pilot Life, the punitive damage claim was barred by § 502(a), stating:
[D]efendant's reliance on Pilot Life is misplaced since that case did not address the distinct question presented here: whether ERISA § 502(a) preempts a claim based on a state law which regulates insurance within the meaning of ERISA's saving clause. The United States Supreme Court recently declined to address

this question in [Ward, citing fn. 7] and indicated the question remained unresolved, see Hoffman v. Empire Blue Cross and Blue Shield, 1999 WL 782518, n.5 (S.D.N.Y. 1999)(it remains an "open question" whether ERISA preempts state laws that are saved, citing Ward.)

ERISA's saving clause, § 514(b)(2)(A), states that, "nothing in this subchapter shall be construed to exempt or relieve any person from any law of any State which regulates insurance." ERISA's civil remedies provision, § 502, is within the same subchapter as the saving clause. Accordingly, the saving clause itself says that nothing in § 502, which concerns causes of actions and remedies under ERISA, shall be "construed" to relieve or exempt any person from "any law" of a State that regulates insurance. If a state law is saved from ERISA preemption under the savings clause, it makes little sense to find that it is somehow preempted anyway by the civil remedies provision. In California, "insurance bad-faith", that is, tort liability for an insurer's breach of the implied covenant of good faith and fair dealing, is a remedy available only against insurers. This was made clear in the Kransco decision, discussed above. Accordingly, the logic of Hall, Hill and Lewis apply in California. Just as the common-law notice prejudice rule was "saved" in Ward, California's common-law "bad-faith" remedy should also be saved.

3. Rejection of Medicare Preemption

In McCall v. Pacificare of California (2001) __ Cal.4th __, __ Cal.Rptr.2d __, 2001 WL 460692, the California Supreme Court rejected the claim by HMOs offering a Medicare plan that the Medicare Act effectively preempted claims against the HMO arising out of its failure to provide care. The HMOs essentially urged the court to construe the Medicare Act (42 U.S.C. § 1395 et seq.) the way courts have construed ERISA - as displacing any state-law based claim for damages caused by the breach of the plan's terms.

In McCall, the insured was George McCall. He had assigned his Medicare benefits to defendant PacifiCare, and in exchange, PacifiCare agreed to provide him with all of his health care. McCall suffered from progressive lung disease. He alleged that his primary care physician and PacifiCare had repeatedly refused to refer him to a specialist for a lung transplant, or to provide other needed care, and ultimately forced him to disenroll from the PacifiCare plan in order to get on the list for a transplant. During this time, his condition worsened. (Mr. McCall ultimately died while his appeals were pending.)
McCall's complaint alleged causes of action against PacifiCare for, inter alia, fraud, wilful misconduct, negligence, negligent infliction of emotional distress, and injunctive relief. The trial court dismissed McCall's complaint on demurrer, finding as a matter of law that his claims arose under the Medicare Act, and were therefore subject to judicial review only in federal court, after McCall had exhausted his administrative remedies under Medicare. Since those remedies do not include any compensatory damages, McCall would have effectively been denied any remedy for his damages if the HMO's position had been adopted.

The Court held that the Medicare Act did not evidence any Congressional intent to displace state-law based tort remedies, and that the administrative review process in the Act applied only to claims that, "at bottom," are seeking payment for medical services under the plan, or reimbursement for medical services that the insured paid for out-of-pocket, that the plan should have covered. A claim that does not seek payment of benefits, or reimbursement for benefits, "is not subject to the administrative review process and may be pursued in our courts." (__ Cal.4th at __.) This is true, even if the claim, as pleaded, incidentally refers to a denial of benefits under Medicare. (Ibid.)