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A DOZEN YEARS AFTER *BIRTH CENTER*, THE THIRD PARTY BAD FAITH CLAIM CONTINUES TO EXPAND

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INTRODUCTION

Over a half century ago, Pennsylvania recognized the right of an insured to sue a liability insurer for its bad faith refusal to settle a lawsuit against the insured within the policy limits, thus exposing the insured to a verdict in excess of the limits. For much of that period, the fact pattern in such "third party bad faith" actions—so called because the underlying lawsuit against the insured is initiated by a third party—was fairly typical: (1) plaintiff's demand for settlement within policy limits; (2) the failure of the liability insurer to settle on behalf of the defendant insured; and (3) a subsequent trial and excess verdict against the insured. Damages awarded in such cases were likewise typical: the amount of the excess verdict. With the 1990 enactment of Pennsylvania's bad faith statute, 42 Pa.C.S.A. §8371, and more particularly with the Pennsylvania Supreme Court decision in *Birth Center v. St. Paul Companies, Inc*., 787 A.2d 376 (Pa. 2001), the third party bad faith claim has, whether rightly or wrongly, been the subject of expansion by the courts.

THE COMMON LAW ORIGIN OF THIRD PARTY BAD FAITH IN PENNSYLVANIA

The third party bad faith cause of action was first judicially recognized by the Pennsylvania Supreme Court in *Cowden v. Aetna Casualty Insurance Company*, 134 A.2d 223 (Pa. 1957). In that case, Pennsylvania joined the majority of other jurisdictions in recognizing that a liability insurer's conduct in handling the defense of a third party claim could give rise to a bad faith claim against the insurer. The court held that the insurer was obligated under the contract to act in good faith in the defense of the underlying claim, stating:

It is established by the greatly preponderant weight of authority in this country that an insurer against public liability for personal injury may be liable for the entire amount of a judgment secured by a third party against the insured, regardless of any limitation in the policy, if the insurer's handling of the claim, including a failure to accept a proffered settlement, was done in such a manner as to evidence bad faith on the part of the insurer in the discharge of its contractual duty. (*Id*. at 227.)

In *Cowden* and later cases, the courts recognized that the transfer of rights—investigation, defense, and settlement of claims—from the policyholder to the insurer transferred a corollary obligation to act in good faith. An insurer's failure to act in good faith exposed it to extra-contractual damages. The damage award recoverable for a liability insurer's bad faith failure to settle a claim or suit against its insured was typically "the entire amount of a judgment secured by a third party against the insured, regardless of any limitation in the policy … ." *Id.*

***BIRTH CENTER'S* ALLOWANCE FOR CONSEQUENTIAL DAMAGES IN ADDITION TO PAYMENT OF POLICY LIMITS AND EXCESS VERDICT AMOUNT**

The bad faith statute, enacted in 1990, provided that "[i]n an action arising under an insurance policy, if the court finds that the insurer has acted in bad faith toward the insured," the court is empowered to award punitive damages, attorneys' fees, interest, and court costs against the insurer. *See* 42 Pa.C.S.A. §8371. This statute had an immediate impact on first party claims, i.e., policies where the insured brings his or her claim directly with the insurer (such as homeowners' property coverage or auto comprehensive/collision coverage) because, before 1990, Pennsylvania had not recognized the first party bad faith claim. *See D'Ambrosio v. Pennsylvania National Mutual Casualty Insurance Company*, 431 A.2d 966 (Pa. 1981). The bad faith statute's impact upon the traditional common law third party claim was to come later, and was, at least initially, more subtle.

The bellwether decision came in 2001 with the Supreme Court's opinion in *Birth Center v. St. Paul Companies, Inc*. St. Paul insured Birth Center under a medical professional liability policy with a $1 million policy limit. St. Paul refused to settle a medical malpractice suit against Birth Center. The case proceeded to trial, resulting in a verdict (after the inclusion of delay damages and interest) against Birth Center of $4,317,743. St. Paul agreed to indemnify Birth Center for the entire verdict and the parties settled the case for $5,000,000.

Birth Center thereafter filed a §8371 and common law bad faith actions. In the bad faith trial, a jury found that (1) St. Paul acted in bad faith when it refused

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to settle the suit against Birth Center and (2) the insurer's bad faith conduct was a substantial factor in causing Birth Center to incur compensatory damages (loss of business and reputation) in the amount of $700,000. In affirming the bad faith verdict, the Supreme Court held, "Where an insurer refuses to settle a claim that could have been resolved within policy limits without 'a *bona fide* belief . . . that it has a good possibility of winning,' it breaches its contractual duty to act in good faith and its fiduciary duty to its insured. *Birth Center*, 787 A.2d at 379 (citing *Cowden*, 134 A.2d at 229).

Significantly, the Supreme Court held that the payment by St. Paul of the excess verdict did not insulate it from bad faith liability, stating:

> The fact that the insurer's intransigent failure to engage in settlement negotiations forced it to pay damages far in excess of the policy limits … does not insulate the insurer from liability for its insured's compensatory damages where the insured can prove that the insurer's bad faith conduct caused damages. (*Id.*)
>
> The Court allowed the insured, Birth Center, to recover its lost profits and compensatory damages under a contractual bad faith theory as well as under §8371. While stating that "the insured's liability for an excess verdict is a type of compensatory damage for which this Court has allowed recovery," *id.* at 389, the Court added, "[W]hen an insurer breaches its insurance contract by a bad faith refusal to settle a case, it is appropriate to require it to pay other damages that it knew or should have known the insured would incur because of the bad faith conduct." *Id.* at 389. According to the court, apart from §8371 damages, "the insurer is liable for the known and/or foreseeable compensatory damages of its insured that reasonably flow from the insurer's bad faith conduct." *Id.*

Although the Supreme Court majority in *Birth Center* suggested that its decision did not represent a departure from existing law for breach of contract, for all practical purposes the law regarding bad faith damages took a dramatic turn with that decision. The Supreme Court allowed the imposition of consequential damages over and above the amount of the excess verdict. No reported cases had ever upheld such a claim before. Following *Birth Center*'s rationale, subsequent courts have rendered large consequential damages awards in the context of an insurer's denial of coverage under a liability policy. *See, e.g., Upright Material Handling, Inc. v. Ohio Cas. Grp*., 74 Pa. D.&C.4th 305 (Lackawanna 2005), *aff'd sub nom., Bombar v. West Am. Ins. Co*., 932 A.2d 78 (Pa. Super 2007); *Pa. Nat. Mut. Cas. Ins. Co. v. Johnson*, 82 Pa.D.&C. 4th 23 (Del. 2007).

APPLICATION OF RELAXED NEGLIGENCE STANDARD IN THIRD PARTY BAD FAITH FAILURE TO SETTLE CASES

In acknowledgment that it was creating a new cause of action with significant extra-contractual repercussions, the *Cowden* court required that "bad faith must be proven by clear and convincing evidence and not merely insinuated." *Cowden*, 134 A.2d at 229. Further, *Cowden* expressly acknowledged that negligence or bad judgment by the insurer did not equate to bad faith, holding that "bad faith and bad faith alone was the requisite to render the [insurer] liable," and "of course, bad judgment, if alleged, would not have been actionable." *Id*.

The recognition that mere negligence does not establish bad faith, and that bad faith must be proven by clear and convincing evidence, has long underpinned the jurisprudence regarding insurer bad faith, and, indeed, these principles have been incorporated into decisions applying the bad faith statute. *See e.g., Terletsky v. Prudential Property & Cas. Ins. Co*., 649 A.2d 680, 688 (Pa. Super. 1994), appeal denied, 659 A.2d 560 (Pa. 1995); *Condio v. Erie Insurance Exch*., 899 A. 2d. 1136, 1142 (Pa. Super. 2006).

Incongruously, therefore, one of the more remarkable developments in the last decade has been the emergence of case law suggesting that the standard to prove the third party common law bad faith claim is that of negligence. In *Schubert v. American Independent Ins. Co*., 2003 U.S. Dist. LEXIS 10769 (E.D. Pa. June 24, 2003), the late Judge Newcomer held that negligence was the standard to be applied in such cases, stating:

> [A]n insurer must act with due care when handling an insured's litigation. Included within this duty is the obligation to act reasonably when deciding whether or not to accept a settlement offer. Reasonableness has traditionally been the standard governing an insurer's decision whether to settle. . . . An insurer has been deemed to act reasonably when its decision whether or not to settle is "honest, intelligent, and objective." (*Id*. at *6-7.)

This analysis was echoed more recently in Judge McLaughlin's opinion in *DeWalt v. Ohio Cas. Ins. Co*., 513 F. Supp. 2d 287 (E.D. Pa. 2007). Citing Third Circuit and Pennsylvania Supreme Court cases, the court concluded that under Pennsylvania decisions (or at least *dicta* in those decisions), "negligence or unreasonableness in investigating a claim or refusing an offer of settlement can constitute bad faith." *Id*. at 297. Although applying this relaxed standard, the *DeWalt* court ultimately concluded that the insurer there did not act in bad faith in refusing to pay its policy limits to one claimant when there had been two other claimants also suing the insured.

ALLOWANCE OF THIRD PARTY BAD FAITH CLAIM EVEN WHEN INSURER SETTLES THIRD PARTY SUIT BEFORE TRIAL WITHIN POLICY LIMITS

The classic third party bad faith claim involved the failure of an insurer to settle a suit within the liability policy limits, followed by trial and a resulting excess verdict against the insured. In exchange for an agreement not to execute upon the excess verdict, the insured would assign his or her rights to the successful plaintiff in the underlying case, who, as assignee of the insured, would prosecute the bad faith action. *See, e,g., Gray v. Nationwide Mut. Ins. Co*., 223 A.2d 8 (Pa. 1966) (holding that common law bad faith claims were assignable).

With the conceptual expansion of the third party bad faith claim after *Birth Center*, it was only a matter of time until a court would be asked to determine whether a §8371 or common law third party bad faith claim might be allowed to proceed even where the insurer agreed to settle a suit against its insured before trial—in other words, where there was *no trial*, and thus *no excess verdict*.

Judge Schiller of the Eastern District first answered this question in the negative in *Daniel P. Fuss Builders-Contractors, Inc. v. Assurance Company of America*, 2006 U.S. Dist. LEXIS 56742 (E.D. Pa., Aug.11, 2006). There, the court concluded that where the third party litigation was ultimately settled within policy limits and without the entry of an excess verdict, there could be no bad faith claim, even where it was alleged that the insurer acted unreasonably and in bad faith in delaying the settlement of the litigation. According to the court, it did not "uncover a single federal or state court in Pennsylvania that has recognized a cause of action for an insurer's delay of payment in the context of a third party claim brought under § 8371 or a contractual bad faith claim." *Id*. at *12. The court stated that it was unwilling to "create a cause of action not yet recognized by Pennsylvania law." *Id*. at *14.

Notwithstanding Judge Schiller's discretion on the issue, subsequent district court judges have answered the question differently. Judge Cohill of the Western District refused to dismiss a bad faith case where it was alleged that a liability insurer acted in bad faith in the way it handled a third party claim which was ultimately settled by the insurer in *Gideon v. Nationwide Mut. Fire Ins. Co.*, 2008 U.S. Dist. LEXIS 26729 (W.D. Pa. Mar. 20, 2008). Acknowledging that its decision differed from that in *Fuss Builders*, the court stated, with little discussion on the point, "We simply disagree with the analysis of the issue by our sister court." *Id* at *23. In *Standard Steel, LLC. v. Nautilus Ins. Co*., 2008 U.S. Dist. LEXIS 71487 (W.D. Pa. Sept. 17, 2008), Magistrate Judge Mitchell of the Western District weighed in on the subject. Relying upon *Gideon*, and declining to follow *Fuss Builders*, the court concluded, "[A]bsent Pennsylvania caselaw or statutory text which supports [the insurer's] position that an excess verdict is a condition precedent to a statutory bad faith claim for failure to settle a third party claim, we do not impose such a requirement here." *Id.* at *12.

In May 2013, Judge Mariani of the Middle District sided with the judges of the Western District in *Bodnar v. Nationwide Mut. Ins. Co*., 2013 U.S. Dist. LEXIS 70144 (M.D. Pa. May 16, 2013). Stephen Bodnar was a masonry contractor insured under a $1 million commercial liability policy with Nationwide. Bodnar was sued by the Estate of James Berry in connection with a fatal accident involving Berry. Nationwide agreed to defend Bodnar subject to a reservation of rights. Coverage questions included whether Berry had been an employee of Bodnar's business at the time of the accident. Nationwide instituted a declaratory judgment action, which was dismissed.

Ultimately, Bodnar entered into an agreement with the Estate, which provided that Nationwide would pay the Estate $1,000,000 plus interest, and the Estate would hold Bodnar harmless from any further liability in connection with the fatality involving Berry. Bodnar then sued Nationwide for common law and statutory bad faith, based upon the insurer's alleged unjustified delay in resolving the Estate's litigation against Bodnar. The complaint alleged that the company acted in bad faith in its "callous, unjustified and unreasonable refusal to settle the action," and that even though Bodnar had allegedly "continuously told the Defendant that Berry was not his employee," the insurer "continued to drag out the litigation" between Bodnar and the Estate. *Id*. at *9-10.

Nationwide moved for summary judgment on the bad faith counts. The insurer argued that in the absence of the possibility of an excess verdict, there could be no viable common law or statutory bad faith claim against it. Because it paid its policy limits plus interest to the Estate on behalf of Bodnar in accordance with the settlement agreement, it said, there could be no further recovery against the insurer. Citing *Fuss Builders*, the company pointed out that there were no appellate court decisions recognizing a viable third party bad faith claim based solely on delay.

In a detailed and citation-filled opinion, Judge Mariani rejected the insurer's arguments. Although "express[ing] no opinion as to the merits of Plaintiffs' claims, any attempt at the determination of which must be deferred, at least until the conclusion of discovery," the court denied summary judgment. *Id*. at *43. The court ruled that the insurer "may not avoid further inquiry into its conduct in connection with its handling of the claims," explaining as follows:

> That is not to say that an insurer's delay in the settlement of a claim, standing alone, presents a cause of action for breach of contract or bad faith. But it is equally the case that an insurer's payment of the policy limits prior to a verdict cannot insulate an insurer from claims of breach of contract and bad faith in connection with its conduct prior to its payment. A delay in payment of a third party claim, if of inordinate and unreasonable length, effectively becomes a denial of the claim as assuredly as if the denial was swiftly and unequivocally communicated to the insured. This is particularly the case when the insurer's conduct over a substantial period of time is consistent with or suggests the absence of a good faith intent to resolve the claim for the benefit of its insured. (*Id*. at *41.)

CONCLUSION

In the dozen years since the decision in *Birth Center v. St. Paul Companies*, courts have wrought a significant expansion of the traditional third party common law bad faith action. This expansion is evident in at least three ways.

First, as demonstrated in *Birth Center*, the courts may choose to take an expansive view of the consequential damages a plaintiff is permitted to seek for alleged breach of the implied contractual duty of good faith and fair dealing. Second,

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as seen in the *Schubert* and *DeWalt* decisions, in reviewing the conduct of an insurer in deciding not to settle a case before trial, courts may apply a more relaxed negligence standard, rather than the bad faith standard originally articulated in *Cowden*. Third, as demonstrated most vividly in *Bodnar v. Nationwide*, in the face of allegations of delay or other misconduct, courts may be persuaded to allow a third party bad faith claim to proceed even where the insurer fully satisfies its contractual agreement to settle a suit against its insured before trial.

Query whether this expansion of the third party bad faith cause of action reflects sound public policy, a fair understanding of the real-world duties of the liability insurer, or even the correct interpretation of the cause of action as founded in *Cowden*. Certainly, this is an area requiring more input from our state appellate courts. In the meantime, however, insurance claims professionals and attorneys representing insurance companies must be mindful of the new reality exemplified by the cases cited above.