

# **CAN AN INSURED BY HELD LIABLE FOR A TORTIOUS BREACH OF THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING?**

By Richard Huver

The a covenant of good faith and fair dealing is implied in every contract, including insurance contracts. Each party to the contract is bound by the covenant and can be held liable in contract for a breach of the covenant. However, can an insured be held liable for the tortious breach of the implied covenant of good faith and fair dealing (i.e., bad faith)? That question was recently answered by the Second District Court of Appeal in Agricultural Insurance Company v. Superior Court (1999) 70 Cal.App,4th 385, 82 Cal.Rptr.2d 594.

## 1. Implied Covenant of Good Faith & Fair Dealing

Every contract contains an implied covenant of good faith and fair dealing. “[E]very contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement.” Foley v. Interactive Data Corp. (1988) 47 Cal.3d 654, 683. The implied covenant, in the context of an insurance contract, imposes a responsibility on the insurer to act fairly and in good faith when handling an insured’s claim. This obligation is separate and apart from the contractual obligations created by the terms of the insurance policy. Thus, the insurer “. . . must act fairly and in good faith in discharging its contractual responsibilities.” California Shoppers, Inc. v. Royal Globe Ins. Co. (1985) 175 Cal.App.3d 1, 54 (emphasis in original).

While generally a breach of the implied covenant only gives rise to a contractual cause of action, “[a]n exception to this general rule has developed in the context of insurance contracts, where for a variety of policy reasons, courts have held that breach of the implied covenant provides the basis for an action in tort. California has a well developed judicial history addressing this exception.” Foley, supra, 47 Cal.3d at 684. Thus, for example, where an insurer’s conduct is objectively unreasonable in the handling of a claim, it can be subject to tort liability. Carma Developers, Inc. v. Marathon Develop. California, Inc. (1992) 2 Cal.4th 342, 372. This is often referred to as “bad faith” liability.

The concept of a tortious breach of the implied covenant has been extended only to an insurer’s conduct in handling a claim, and not the insured’s conduct in submitting the claim. The Second District Court of Appeal dealt with an allegation of “reverse bad faith” by an insurer against its insured in Agricultural Insurance Company v. Superior Court (1999) 70 Cal.App,4th 385, 82 Cal.Rptr.2d 594.

## 2. Factual Background

Agricultural was one of two excess carriers who insured a sports health club in Los Angeles. The owner of the club, MKDG/Rhodes SC Partnership (MKDG), purchased \$20 million in coverage from four carriers - two primary policies and two excess policies, each for \$5 million. The coverage extended to the replacement cost of damaged property, including code upgrades, business income interruption and extra expenses incurred to continue operations, expedite rebuilding and mitigate losses. 82 Cal.Rptr.2d at 596, fn. 2.

In 1994, the health club sustained damage as a result of the Northridge earthquake. MKDG submitted claims to its primary and excess carriers, contending that the total cost to repair the structure exceeded the combined coverage of \$20 million. Three of the carriers paid their policy limits. Agricultural initially paid claims totaling about half its policy but then refused to pay additional claims pending an investigation. *Id.* at 598-99.

MKDG filed suit for bad faith, alleging, *inter alia*, breach of contract and breach of the implied covenant of good faith and fair dealing. The bad faith suit was stayed to permit Agricultural to complete its investigation. As a result of its investigation, Agricultural concluded that MKDG had deliberately misrepresented and concealed information both in its application for insurance and in the claims submitted following the earthquake. Agricultural denied the remaining claims, voided the insurance policy and demanded refund of the funds already paid. *Id.* at 596.

## 3. Agricultural's cross-complaint

Thereafter, Agricultural filed a cross-complaint against MKDG which included two tort claims; intentional misrepresentation (fraud) and breach of the implied covenant of good faith and fair dealing (termed "reverse bad faith"). *Id.* at 597. The trial court sustained MKDG's demurrer to the two tort causes of action without leave to amend, and struck the prayer for punitive damages and attorney's fees. Agricultural filed a writ petition directly in the Supreme Court, which declined to accept direct review and instead referred the petition to the Appellate Court. *Id.* at 595.

## 4. No "Reverse Bad Faith" Cause of Action

The Second District upheld the trial court's demurrer as to the tort cause of action for breach of the implied covenant of good faith and fair dealing. Although detailing factual allegations that clearly supported a fraud cause of action, the Court distinguished between an insured's contractual breach and tortious breach of the implied covenant of good faith and fair dealing.

An insurer has no claim against its insured in tort for breach of the covenant of good faith and fair dealing. A breach of this covenant is, at base, a breach of contract. A relationship including specialized circumstances of reliance and dependence is necessary to transmute such a contractual breach into a tort. Such

circumstances do not exist in the context of an insured's responsibilities toward its insurer, or in the reciprocal context of an insurer's legitimate expectations from its insured.

Id. at 595-96.

The Court detailed extensive factual allegations by Agricultural that it claimed supported its cause of action for breach of the implied covenant, including an alleged conspiracy to inflate the claims, submitting repair bills for structures not covered by the insurance policy, completing a "state of the art" remodel of the sports club that was unrelated to earthquake damage, etc. However, these allegations still did not give rise to the tort cause of action.

Although a false claim by an insured might trigger adverse contractual or penal consequences, the obligations undertaken by an insured in entering into an insurance contract are simply not of the same character as the obligations undertaken by an insurer. Hence, an insured does not bear a risk of affirmative tort liability for failing to perform the panoply of indefinite but fiduciary-like obligations contained within the concept of "insurance bad faith."

Id. at 596.<sup>1</sup>

#### 5. Policy Reasons for Implied Covenant

The Second District cited to Foley v. Interactive Data Corp., *supra*, in support of its decision, which had rejected extending the concept of tortious breach of the implied covenant to the employment law arena. The Foley court outlined the reasons supporting the tortious breach of the implied covenant in the insurance context, including the peace of mind an insured seeks in purchasing insurance and the dependency on the insurance company to supply that peace of mind. On the other hand, an insurer does not depend on the insured in the same manner. Most importantly, a breach of the covenant by an insurer places an insured in a "type of dilemma not experienced by an insurance company if an insured should breach a term of the policy." Foley v. Interactive Data, 47 Cal.3d at 685.

An insurer's breach can therefore frustrate the core purpose of insurance (protecting the insured from calamity) and leave the insured exposed to a disaster it has paid to avoid. The insurance company, by contrast, faces no comparable dilemma. The insurer's exposure to potential tort liability thus flows from special factors that do not apply to the insured.

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<sup>1</sup> The plaintiff contended that a Agricultural was limited to asserting "reverse bad faith" only as an affirmative defense. This issue is currently pending before the California Supreme Court in Kransco v. American Empire Surplus Lines Ins. Co. (SO62139). The Supreme Court declined direct review of the Agricultural case, even though the Kransco case was pending on a somewhat related issue.

Agricultural, 82 Cal.Rptr.2d at 600.

The Court also cited to California Fair Plan Assn. v. Politi (1990) 220 Cal.App.3d 1612, wherein it was held that “[a]n action by an insurer against its insured for breach of the covenant of good faith and fair dealing only sounds in contract, and, thus, any recovery must be limited to contract damages.” Id. at 1618. See also, Liberty Mutual Ins. Co. v. Altfillisch Constr. Co. (1977) 70 Cal.App.3d 789.

#### 6. A Wealthy Sophisticated Client

Agricultural contended that the insured in this case should be held to a different standard than typical insureds, given his enormous wealth. The controlling partner of MKDG, Marvin Davis, was valued by Forbes magazine as one of the 400 Richest People in America, with an estimated wealth of \$2.2 billion. By contrast, Agricultural has surplus of only \$1.3 billion, making the insured wealthier than the insurer. Agricultural, 82 Cal.Rptr.2d at 602. Agricultural contended that a wealthy insured, such as Mr. Davis, had equal bargaining strength with the insurer, and should therefore be exposed to tort liability for breach of the implied covenant.

The Court, however, held that bargaining strength was but one reason for extending the tortious breach of the implied covenant to the insurer but not the insured. “. . . there are other reasons why insurers, but not insureds, are exposed to potential tort liability for breaching the covenant, key among them that an insured cannot buy protection after a loss has already occurred.” Id. at 601.

#### 7. Fraud Cause of Action Reinstated

While refusing to permit Agricultural to sue its insured for breach of the implied covenant of good faith and fair dealing, the Second District did reinstate Agricultural’s fraud cause of action, which had also been struck by the trial court. In addition, the Court granted the petition and reinstated the prayer for punitive damages, which the Court held could be awarded on the fraud cause of action. Id. at 602-05.