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US tort system: insurance bad faith and extra-contractual damages can level the playing field with your insurance company

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Non-United States corporations with operations in the US face an unpredictable tort liability system. Moreover, the liability insurance system does not always immediately protect a company as expected, which leads to uncertainty in company finances. Non-US policyholders face the reality of difficult insurance company claims practices and should be prepared to respond, when necessary, by using extra-contractual liability and insurance bad faith concepts.

The insurance industry functions analogously the world over. In the US, however, uncertainties and unfamiliarity with the tort liability system accentuate problems in proper loss transfer to insurance companies. To obtain value for insurance premiums, non-US policyholders should understand insurance bad faith liability rules. Policyholders can protect their rights to the insurance they paid for and protect their US business operations.

Your insurance company may wrongfully deny a claim by: suggesting that coverage is not triggered; misrepresenting the scope of policy exclusions; or failing to affirm or deny coverage within a reasonable time (as mandated by some state laws). Therefore, insurance companies often act on the undeniable truth that it may be profitable for them to breach their duties under the insurance policy. Nevertheless, policyholders can uncover another truth by activating the potential consequences of unfair claims handling practices. Bad faith liability and extra-contractual liability change the calculus and opportunistic breach may no longer appear profitable.

Insurance company liability for bad faith and related above-policy limits liabilities provides crucial remedies for policyholders seeking to receive the benefit of the insurance policy that their insurance company sold. US law tells policyholders that every insurance policy contains a duty of good faith and fair dealing. Enforcing that duty of good faith makes the insurance transaction fairer to policyholders and can potentially save a company's US business operations from suffering a substantial loss due to a wrongful denial of insurance coverage.

Some examples of above-policy limits exposure for insurance companies

By showing the insurance company its possible exposure to: (1) policyholder attorney's fees; (2) interest on the unpaid claim; (3) damages for bad faith behaviour; and (4) punitive or exemplary damages on account of wrongful behaviour, policyholders can exert immense leverage and wield invaluable tools to deter their insurance company from refusing to comply with its obligations under the policy.

Policyholder lawyer's fees

Most states in the US treat insurance claims differently from other disputes by permitting a policyholder's recovery of lawyer's fees. A majority of states may force the insurance company to pay the policyholder's legal fees to force them to honour the policy they sold.

By engaging in an 'opportunistic breach', the insurance company may wrongfully deny coverage, and continue to collect and invest premiums during its well-financed coverage litigation. Lacking the threat of bad faith or other extra-contractual damages, the only penalty it risks is paying the policyholder the same coverage it owed all along. This may not constitute a sufficient deterrent.

award of the attorney's fees to policyholders in insurance coverage disputes is generally founded on one or more of these rationales:

the nature of the insurance promise (eg, the nature of an insurance company's duty to defend its policyholder);

the theory of consequential damages;

the language of particular insurance policy provisions;

public policy considerations; or

specific statutory provisions.

New York courts have recognised that fees may be recoverable as consequential damages when the policyholder brings a breach of contract action against the insurance company.

Other courts have found that attorney's fees constitute an element of the policyholder's damages for the insurance company's bad-faith refusal to pay a claim. Courts in a number of jurisdictions look to statutes to award attorney's fees. Moreover, where the policyholder establishes the duty to defend in a declaratory judgment action, the insurance company that has failed to fulfil that duty should bear the consequences of its wrongful action and reimburse the policyholder for its attorney's fees and costs in the declaratory judgment action, a principle that has been vindicated in the courts.

The potential award of policyholder attorney's fees can act as a safeguard against an insurance company from breaking its contractual promise to perform and wrongfully denying a claim.

Interest on the unpaid claim

Requiring that insurance companies pay interest – one measure of damages – for their delay in payment helps reduce the profit from the insurance company's breach, therefore providing a remedy that could help ensure that the policyholder's rights under the insurance policy are protected. State statutes vary as to the specified annual rate of interest to be assessed, but these often fall within the six to nine per cent range.

In New York the prevailing party in a breach of contract – including insurance cases – receives pre-judgment interest, to 'be computed from the earliest ascertainable date the cause of action existed.' The statute, according to one case, 'grants courts wide discretion in determining a reasonable date from which to award pre-judgment interest.'

Policyholders should invoke statutory and common law entitlement to pre-judgment and post-judgments interest to level the claims paying field.

Damages for bad faith claims behaviour

US courts have awarded lost profits from the breach of the insurance promise. More broadly a breach of the duty of good faith and fair dealing may lead to liability for compensatory damages. The liability for improper failure to settle is not constrained by the policy limits, and an insurance company can face liability far in excess for such a breach.

Furthermore, insurance companies that refuse a settlement offer in bad faith may be held liable in damages to the insured based on the principle that it has pursued its own interests by compromising those of the insured. For such a breach of the implied conditions of good faith and fair dealing, the damages to the insurance company may exceed policy limits.

In such an event, the insurance company's fiduciary obligation includes, in a typical formulation, 'a duty to use the same degree of care and diligence as a person of ordinary care and prudence should exercise in the management of his own business'. Therefore, an insurance company must 'make such decisions in good faith and with due regard' for the policyholder's interests. An insurance company has a duty to investigate and evaluate claims and fairly consider reasonable settlement offers.

Some states have statutory rules permitting a policyholder to bring a bad faith action against an insurance company if the insurance company does not attempt, in the words of Florida's law, 'in good faith to settle claims when, under all the circumstances, it could and should have done so, had it acted fairly and honestly toward its insured and with due regard for her or his interests[.]'

If an insurance company fails to authorise a favourable settlement within its policy limits, or if further delay causes this settlement opportunity to be lost, it can be held liable for any eventual judgment and other damages, even uninsured losses.

Although an insurance company may challenge the allegation that it has breached a promise, it does face liability for potential damages quite apart from what might be called insurance 'bad faith'. Policyholders may recover consequential damages in insurance cases involving a breach.

An award of damages for bad faith claims behaviour also can protect the policyholders by enhancing the symmetry of bargaining power between policyholder and insurance company.

Punitive or exemplary damages against the insurance company

A number of states in the US permit the recovery of punitive damages against insurance companies for their breach of the duty of good faith and fair dealing. New York, California, Louisiana and New Mexico are among those which permit this.

Even without the 'punitive' label, other courts will permit the recovery of tort damages for a breach of the duty of good faith and fair dealing. For example, in Colorado a policyholder may recover damages in tort for breach of the duty of good faith and fair dealing for emotional distress.

The financial realities of insurance coverage and the need for the availability of punitive damages for bad faith claims handling were explained by a standard textbook of the insurance industry as follows:

When an insurance company fails to pay claims it owes or engages in other wrongful practices, contractual damages are inadequate. It is hardly a novelty to require an insurer to pay the insured what it owed all along.'

An award of punitive or exemplary damages against the insurance company for the breach of the duty of good faith and fair dealing is another factor in helping policyholders enhance the balance of the relationship with their insurance companies.

Conclusion: the availability of remedies for an insurance company's bad faith claims behaviour makes the insurance transaction fairer to the policyholder

Insurance policies are a unique product, in that they first require the policyholder to perform, by paying insurance premiums; while the insurance company’s performance – the payment of the claim amount – is delayed until the insurance company decides. When making a claim, the policyholder is forced to rely on the good faith and fiduciary nature of the insurance company in meeting its promise. This disjointed performance of the parties to the insurance policy can lead, particularly in difficult matters, to wrongful and abusive claims practices aimed at protecting the insurance company’s financial self-interest rather than the interests of the policyholder in protecting itself from liability and minimising losses.

The high stakes presented in bad faith insurance litigation can help balance the battle between insurance companies and their policyholders. Introducing the realities of the insurance relationship by showing the exposure to liability for bad faith and related above-policy limits liabilities can act as a counterbalance. Such truths may help avoid the profitable breach of the insurance promise. Leveraging insurance companies’ well-established duty of good faith and fair dealing in the US can help policyholders from around the world level the playing field, protecting their interests and the interests of their US-based operations.

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