Bad-Faith Insurance Cases

# The Ramifications of a Less-Than-Thorough Investigation

By Tyler Gerking and Alex Potente

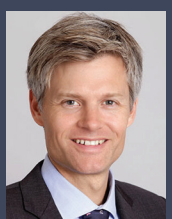
**Can an insurer defend itself against a bad-faith claim with information that it did not know? And when should the insurer have known the information?**

An insurance carrier has declined to defend a claim asserted against its insured, arguably without meeting its obligation to investigate the claim. For whatever reason—a change in personnel, loss of a file, or some other motivation—the carrier has done little, if anything, to investigate the claim tendered to it: no Google search, no phone calls, and very little factual investigation other than the information tendered by the insured. The carrier has, however, relied on the plain language of the policy, and the few facts of which it was aware supported its denial.

But when a court later finds that the carrier's coverage position was wrong—the facts in existence created a potential for coverage and hence triggered the carrier's duty to defend—the insured may argue that its carrier's failure to investigate supports a finding that it breached the implied warranty of good faith and fair dealing; that is, the insurer acted in bad faith. This leads to two questions:

- In defending itself against its insured's bad-faith claim, can the carrier rely on facts that it would have discovered—had it conducted a more complete investigation—that tend to show the coverage question was a close one and thus the denial was reasonable?
- Could the existence of a genuine dispute over the potential for coverage insulate the carrier from bad-faith liability, even if the carrier had failed to investigate thoroughly, particularly when the dispute involves a third-party insurance policy?

In this article, we review possible answers to these questions from the perspective of both insurance carriers and policyholders in both first- and third-party



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contexts. Not surprisingly, with the law unsettled, carriers and their policyholders may reach different conclusions. As the departure point for our analysis, we briefly review what the covenant of good faith and fair dealing that is implied in every insurance policy requires.

### Bad Faith Requires Proof that a Carrier Acted "Unreasonably"

Implied into every insurance contract is a covenant of good faith and fair dealing, which requires the carrier to act reasonably and "give at least as much consideration" to the insured's interests as it does to its own. *Egan v. Mutual of Omaha Ins. Co.*, 24 Cal. 3d 809, 818–19, 620 P.2d 141, 145 (1979). Among other duties, the covenant imposes on the carrier a duty to investigate its policyholder's insurance claim thoroughly, including all possible bases that might support coverage—even those facts and theories that the insured has not advanced. *Id.* at 818–19, 620 P.2d at 145; *Jordan v. Allstate Ins. Co.*, 148 Cal. App. 4th 1062, 1072, 56 Cal. Rptr. 3d 312, 318 (2007), *as modified on denial of reh'g* (Apr. 20, 2007).

An insurer's duty to investigate a third-party claim against its insured must be viewed in light of the law governing the insurer's duty to defend. An insurer must defend its policyholder against any claim that creates a potential for indemnity under the policy. *Scottsdale Ins. Co. v. MV Transp.*, 36 Cal. 4th 643, 654, 115 P.3d 460, 466 (2005). The duty to defend is determined in the first instance by a comparison of the allegations in the complaint against the insured and the terms of the policy. *Id.* at 654, 115 P.3d at 466. Extrinsic facts known to the insurer may also present a duty to defend, if they would give rise to potentially covered liability. *Id.* at 654, 115 P.3d at 466. Facts extrinsic to the complaint may also negate a duty to defend. *Montrose Chem. Corp. v. Superior Court*, 6 Cal. 4th 287, 288–89, 295, 861 P.2d 1153, 1157 (1993).

An insured has a duty to cooperate and to provide information to its insurance carrier, *Truck Ins. Exch. v. Unigard Ins. Co.*, 79 Cal. App. 4th 966, 975–76, 94 Cal. Rptr. 2d 516, 523 (2000), and the carrier has a duty to investigate the insured's claim. *Travelers Cas. & Sur. Co. v. Employers Ins. of Wausau*, 130 Cal. App. 4th 99, 110, 29 Cal. Rptr. 3d 609, 616 (2005). Some jurisdictions do not recognize an independent tort claim for bad faith. For example, proof of unreasonable conduct under Virginia law merely allows the policyholder to recover its attorney's fees incurred in obtaining coverage as part of its breach of contract claim. *See Douros v. State Farm Fire & Cas. Co.,* 508 F. Supp. 2d 479, 483 (E.D. Va. 2007) ("it is well-settled in Virginia law that there exists no independent tort for bad-faith refusal to honor an insurance claim."). Similarly, there presently exists no independent bad-faith tort action in the state of Hawaii for breach of insurance contract. *Cuson v. Maryland Cas. Co.*, 735 F. Supp. 966, 968 (D. Haw. 1990) (holding that a bad-faith tort cause of action does not exist in the insurance context according to Hawaii law). Additionally, some jurisdictions, including the District of Columbia, Massachusetts, and the Virgin Islands, have not addressed the issue of whether the bad-faith action extends to first-party cases. *See* Stephen S. Ashley, *Bad Faith Actions* §2.15, 2-57 (2d. ed. 1997). Illinois does not recognize an independent and separate bad faith tort action. *See Cramer v. Ins. Exch. Agency*, 174 Ill. 2d 513, 519, 675 N.E.2d 897, 901 (1996).

If a carrier decides not to defend its insured without conducting what the policyholder might later characterize as a thorough investigation, to prove a claim for breach of the implied covenant of good faith and fair dealing (bad faith), the policyholder must establish (1) a potential for covered damages, which triggered the duty to defend; and (2) that the insurer acted unreasonably. The reasonableness determination requires the use of an objective standard. *Morris v. Paul Revere Life Ins. Co.*, 109 Cal. App. 4th 966, 973, 135 Cal. Rptr. 2d 718, 723 (2003) ("[I]f the conduct of [the insurer] in defending this case was objectively reasonable, its subjective intent is irrelevant."). A carrier's conduct will likely be found unreasonable in the bad-faith context if it (1) "unfairly frustrates the agreed common purposes and disappoints" the insured's "reasonable expectations," *Wilson v. 21st Century Ins. Co.*, 42 Cal. 4th 713, 726, 171 P.3d 1082, 1091(2007), *as modified* (Dec. 19, 2007); and (2) involves a conscious and deliberate act rather than an honest mistake or negligence. *Careau & Co. v. Security Pacific Business Credit, Inc.*, 222 Cal. App. 3d 1371, 1395, 272 Cal. Rptr. 387, 399–400, *as modified on denial of reh'g* (Oct. 31, 2001) (1990). In other words, as stated above, a carrier must "give at least as much consideration" to the insured's interests as it does to its own. *Egan*, 24 Cal. 3d at 818–19, 620 P.2d at 145.

Whether an insurance carrier's conduct meets these criteria requires a case-by-case analysis. *Chateau Chamberay Homeowners Ass'n v. Associated Int'l Ins. Co.*, 90 Cal. App. 4th 335, 347, 108 Cal. Rptr. 2d 776, 784 (2001). The "totality of the circumstances" surrounding the insurer's conduct—the context in which the carrier denied coverage—is relevant. *Walbrook Ins. Co. v. Liberty Mut. Ins. Co.*, 5 Cal. App. 4th 1445, 1455, 7 Cal. Rptr. 2d 513, 518 (1992); *Wilson*, 42 Cal. 4th at 723, 171 P.3d at 1091 (citing *Walbrook*). For example, the scope of the parties' interactions is relevant to whether the offending carrier acted unreasonably in refusing to defend the insured. *Griffin Dewatering Corp. v. N. Ins. Co. of New York*, 176 Cal. App. 4th 172, 181, 97 Cal. Rptr. 3d 568, 574 (2009), *as modified on denial of reh'g* (Aug. 28, 2009) ("Also, because this is a bad faith case, we quote the precise and full language of a number of important documents, so read-

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ers can easily see the 'source materials' which reveal *how the parties were dealing with each other.*") (emphasis added) (internal quotations omitted). Stated simply, whether a carrier acted unreasonably, and therefore in bad faith, in handling a claim turns on the circumstances of the case. *See Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 537, 647 P.2d 1127, 1135 (1982); *Condio v. Erie Ins. Exchange*, 899 A.2d 1136 (Pa. Super. 2006). We now examine how courts have applied this rubric to a carrier's duty to investigate.

**A failure to investigate** does not constitute bad faith in the duty to defend context if the coverage issues were so clear that the carrier need only look to the policy to determine whether the possibility of coverage existed.

### The Carrier's Perspective: Reasonable Investigation

*What the carrier would have found had it conducted additional investigative work is the touchstone of whether its investigation was reasonable.*

A failure to investigate does not constitute bad faith in the duty to defend context if the coverage issues were so clear that the carrier need only look to the policy to determine whether the possibility of coverage existed. On the other hand, when a carrier fails to conduct an investigation that would have found facts supporting the possibility of coverage triggering the duty to defend, the carrier is imputed with this knowledge. *Safeco Ins. Co. of Am. v. Parks*, 170 Cal. App. 4th 992, 1008, 88 Cal. Rptr. 3d 730, 743 (2009); *West Beach Development Co., L.L.C. v. Royal Indem. Co.*, 2000 WL 1367994, at *7 (S.D. Ala., Sep 19, 2000). The issue becomes a little murkier—and more interesting—when a carrier fails to investigate thoroughly, but the investigation would have revealed facts tending to *support* its decision to deny coverage.

In the first-party context, an example of this occurs when a life insurer that refuses to pay benefits to the spouse-beneficiary suspected of killing the insured. In this example, the spouse is the only policy suspect, but the carrier arguably did not learn this from its investigation. Can the carrier use the wife's status as a policy suspect in its defense against the bad-faith action after it has interpleaded the funds to the court?

In another example, a carrier denies that a third-party claim triggered its duty to defend based on its reading of a manuscript exclusion for online activities, but it fails to investigate thoroughly the product at issue. A better investigation would have supported the carrier's decision to deny coverage. If a court found that the carrier had been wrong and that the third-party claim triggered the carrier's duty to defend, can the carrier and the carrier's counsel argue that there was nothing to be found, and therefore no investigation was warranted in the context of defending against a bad-faith suit?

As mentioned above, the penalty for failing to investigate is to impute the carrier with knowledge that it would have discovered had it conducted a more thorough investigation. The arguable logical converse is that if there was nothing to discover because the policy did not cover the claim on its face, there could not have been bad faith. As such, the only relevant question for the jury is whether the carrier's "failure to investigate" would have revealed facts triggering its duty to defend, and only "[w]here an insurer denies coverage[,] but a *reasonable investigation* would have disclosed facts showing [that] the claim was covered, [would] the insurer's failure to investigate breach[] its implied covenant." *Parks*, 170 Cal. App. 4th at 1008, 88 Cal. Rptr. 3d at 743 (emphasis in original). *Accord Jordan*, 148 Cal. App. 4th at 1074, 56 Cal. Rptr. 3d at 319 (same); *Worth Bargain Outlet v. AMCO Ins. Co.*, 2010 WL 2898264, at *9 (S.D. Cal. July 21, 2010) (finding that the plaintiff had failed to raise a triable issue of fact as to the reasonableness of the carrier's investigation on summary judgment for bad faith because "Plaintiff ha[d] not put forth any evidence which Defendant could or should have obtained, but which Defendant failed to request."); *Am. Int'l Bank v. Fid. & Deposit Co.*, 49 Cal. App. 4th 1558, 1571–73, 57 Cal. Rptr. 2d 567, 573–75 (1996) (finding that the insurer's denial of defense based on review of complaint and policy was reasonable where there was no suggestion of other facts that might trigger coverage); *Benavides v. State Farm Gen. Ins. Co.*, 136 Cal. App. 4th 1241, 1250, 39 Cal. Rptr. 3d 650, 656 (2006) (holding that failure to investigate the insured's claim for mold damage in a first-party case was not actionable because the policy excluded coverage for mold).

This line of reasoning holds that if the carrier would not have learned any additional facts had it conducted a more thorough investigation (or had it conducted any investigation at all), then there are no facts to be imputed to it, and its decision to deny coverage did not breach the covenant of good faith and fair dealing—regardless of the scope of investigation that the insurer actually undertook. Under this logic, as long as the initial determination to deny coverage was reasonable, the carrier has no further duty to investigate. *Brinderson-Newberg Joint Venture v. Pac. Erectors, Inc.*, 971 F.2d 272, 282 (9th Cir. 1992) (holding that the carrier's position that there was "no duty to investigate if the insurer already has a good faith reason to dispute liability" was "the better interpretation of the law"); *Gunderson v. Fire Ins. Exch.*, 37 Cal. App. 4th 1106, 1117, 44 Cal. Rptr. 2d 272, 279 (1995) ("Once it determine[s] on the basis of the lawsuit itself and the facts known to it at that time that there was no potential for coverage, [the insurer] [does] not have a continuing duty to investigate or monitor the lawsuit to see if the third party later made some new claim, not found in the original lawsuit.").

This makes sense from a policy perspective. What constitutes a thorough investigation is inherently a subjective enterprise. It is often difficult for a carrier to determine when to stop its investigation. It is a better rule to require the insured to bring information to the carrier to prove that its claim is covered under the insured's duty to cooperate. The rigors of litigating a bad-faith

case will inevitably lead to the discovery of new facts, and these facts (or lack of facts) should be admitted to show that the carrier's original denial was reasonable, particularly when the facts later discovered are consistent with the position taken by the insurance carrier in denying the claim.

### The Policyholder's Perspective: Faulty Investigation

*A carrier that fails to investigate should be imputed to know only facts that support coverage, not facts that defeat coverage.*

An insurer that has been found to have breached its duty to defend might attempt to avoid bad-faith liability by arguing that facts in existence, of which it was unaware when it made its coverage decision, show that its decision, while incorrect, was reasonable and therefore not in bad faith. But allowing a non-defending insurer to do so would give it the benefit of the investigation that it wrongfully failed to conduct. Knowing that they could use the fruits of an after-the-fact investigation to defend bad-faith claims, insurers would have less incentive to conduct prompt and thorough investigations, as the law requires them to do, and encourage scorched earth litigation tactics to uncover every stone previously left unturned in attempts to justify retrospectively their prior wrongful conduct.

Such a rule also would conflate two separate and independent obligations imposed on the insurer by the implied covenant of good faith and fair dealing, one procedural and one substantive. First, the covenant requires the insurer to investigate its insured's claim promptly and thoroughly. Second, the covenant requires the insurer to make a reasonable coverage decision in light of the facts that it knows. If an insurer failed to investigate a claim promptly and thoroughly that turns out to be covered, such a failure constitutes bad faith in and of itself. The fact that the insurer might have discovered information during that investigation that would have tended to show that the insurer's substantive coverage decision was reasonable does not eliminate the insurer's initial breach—the failure to investigate.

For this reason, when courts focus on the carrier's substantive coverage decision, they determine the reasonableness of the carrier's decision as of the time that it was made, rather than on the basis of later developments. *See Mullen v. Glen Falls Ins. Co.*, 73 Cal. App. 3d 163, 173–74, 140 Cal. Rptr. 605, 611 (1977); *Filippo Industries, Inc. v. Sun Ins. Co of New York,* 74 Cal. App. 4th 1429, 1441–42 (1999); *Century Sur. Co. v. Polisso*, 139 Cal. App. 4th 922, 949, 43 Cal. Rptr. 3d 468, 487 (2006), *as modified on denial of reh'g* (June 16, 2006) ("We evaluate the reasonableness of the insurer's actions and decision to deny benefits as of the time they were made rather than with the benefit of hindsight."). *See also Austero v. Nat'l Cas. Co.*, 84 Cal. App. 3d 1, 32, 148 Cal. Rptr. 653 (1978) ("In evaluating the evidence to see if there was any unreasonable conduct by the Company, it is essential that no hindsight test be applied.") (*disapproved of on other grounds by Egan*, 24 Cal. 3d at 824, 620 P.2d at 149); *CNA Cas. of California v. Seaboard Sur. Co.*, 176 Cal. App. 3d 598, 610, 222 Cal. Rptr. 276, 282 (1986) ("The duty to defend cannot be adjudged on the basis of hindsight. It must be determined from the facts and inferences known to an insurer from the pleadings, available information and its own investigations at the time of the tender of the defense.") (*disapproved of by Montrose*, 6 Cal. 4th 287, at 296–98, 861 P.2d at 1157–59).

A carrier may not base its defense against a bad-faith action for denying a claim on information acquired from a subsequent investigation. *See Skaling v. Aetna Ins. Co.*, 799 A.2d 997, 1010 (R.I. 2002) (holding that an insurer may not use later acquired information because it has a duty to conduct a fair and comprehensive investigation before refusing to pay a claim, and must therefore justify its denial only with information obtained from this initial investigation. An insurer may not gather information it should have had in the first instance of deciding coverage to defend its decision to deny coverage); *See, e.g., Gaylord v. Nationwide Mut. Ins. Co.*, 776 F. Supp. 2d 1101, 1124 (E.D. Cal. 2011); *North Georgia Lumber & Hardware v. Home Ins. Co.*, 82 F.R.D. 678 (N.D. Ga. 1979).

Imputing insurers with knowledge of facts that support coverage, but not facts that would tend to show that an insurer's coverage decision was reasonable, does not unfairly favor insureds over insurers. Because a carrier must give at least as much consideration to its insured's interests as it does to its own, it cannot stick its head in the sand and ignore facts that support coverage. This would frustrate the purposes of the insurance policy and defeat the policyholder's reasonable expectations. *KPFF, Inc. v. California Union Ins. Co.*, 56 Cal. App. 4th 963, 973, 66 Cal. Rptr. 2d 36, 42 (1997); *Eigner v. Worthington*, 57 Cal. App. 4th 188, 195–200, 66 Cal. Rptr. 2d 808, 813 (1997). Allowing the insurer to reap the benefits of an investigation it did not perform would be equally wrong.

### The Carrier Perspective: Genuine Dispute Doctrine Insulation

*Bad faith is precluded if a genuine dispute existed pertaining to whether coverage applied.*

Many jurisdictions recognize the genuine dispute doctrine, which insulates a carrier from bad-faith liability if there was a genuine dispute regarding the existence of coverage:

> As a close corollary of [the reasonableness] principle, it has been said that "an insurer denying or delaying the payment of benefits *due to the existence of a genuine dispute with its insured as to the existence of coverage liability…* is not liable in bad faith even though it might be liable for breach of contract."

*Wilson*, 42 Cal. 4th at 723, 171 P.3d at 1088–89 (emphasis added); *Chateau Chamberay*, 90 Cal. App. 4th at 347, 108 Cal. Rptr. 2d at 784. *See also Opsal v. United Servs. Auto Assn.*, 2 Cal. App. 4th 1197, 1205–06, 10 Cal. Rptr. 2d 352, 357 (1991) ("[B]ad faith liability cannot be imposed where there 'exist[s] a genuine issue as to [the insurer's] liability under California law.'") (citation omitted); *Murphy v. Patriot Ins. Co.,* 197 Vt. 438, 446, 106 A. 3d 911, 918 (Vt. 2014) ("Where a claim is 'fairly debatable,' the insurer is not guilty of bad faith even if it is ultimately determined to have been mistaken."); *Bellville v. Farm Bureau Mut. Ins. Co.,* 2005 Iowa Sup. Lexis 104, at **8–10, 702 N.W. 2d 468, 473–74 (Iowa 2005) ("The fact that the insurer's position is ultimately found to lack merit is not sufficient by itself to establish the first element of a bad faith claim.… The focus is on the existence of a debatable issue, not on which party was correct.") (internal citations omitted); *Sanderson v. Am. Family Mut. Ins. Co.*, 2010 Colo. App. Lexis 1665, at * 9, 251 P. 3d 1213, 1217 (Colo. 2010) ("if a rea-

sonable person would find that the insurer's justification for denying or delaying payment of a claim was 'fairly debatable' (*i.e.*, if reasonable minds could disagree as to the coverage-determining facts or law), then this weighs against a finding that the insurer acted unreasonably" for the purpose of finding bad faith).

Erroneous denial of a claim may breach the insured's contract, but it does not by itself support tort liability: "The mistaken [or erroneous] withholding of policy benefits, if reasonable or if based on a legitimate dispute as to the insured's liability under California law, does not expose the insurer to bad faith liability." *Chateau Chamberay*, 90 Cal. App. 4th at 346, 108 Cal. Rptr. 2d 776, 784 (citation omitted). To clarify, "[m]istaken judgment is not… the equivalent of bad faith." *Walbrook*, 5 Cal. App. 4th at 1460, 7 Cal. Rptr. 2d at 521 (quoting *Neel v. Barnard*, 24 Cal.2d 406, 419, 150 P.2d 177 (1944)). Because law does not exist independent of facts, the genuine dispute doctrine frequently offers an important defense to a claim of bad faith based on a failure to investigate.

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Under the genuine dispute doctrine, when the law is unsettled concerning whether there is coverage for a claim, an insurer that denies coverage is not liable for bad faith *even if it ultimately loses on the coverage issue*. *See, e.g.*, *Opsal*, 2 Cal. App. 4th at 1205–06, 10 Cal. Rptr. 2d at 357; *Bosetti v. U.S. Life Ins. Co. in City of New York*, 175 Cal. App. 4th 1208, 1239, 96 Cal. Rptr. 3d 744, 771 (2009) (finding that the insurer's reliance on sole California case dealing with issue was not unreasonable even though that holding was subsequently rejected); *Karen Kane Inc. v. Reliance Ins. Co.*, 202 F.3d 1180, 1190 (9th Cir. 2000); *Lunsford v. American Guarantee & Liability Ins. Co.*, 18 F.3d 653, 656 (9th Cir. 1994). If the coverage case law is unsettled, the insurer may apply *any* reasonable interpretation—even one *that favors its own interests*. It need not adopt an interpretation favorable to the insured. *Dalrymple v. United Services Auto. Ass'n*, 40 Cal. App. 4th 497, 522–23, 46 Cal. Rptr. 2d 845, 859 (1995), *as modified* (Dec. 13, 1995) (finding a genuine issue where the law interpreting policy terminology "was still developing"). For a jury to decide whether to apply the genuine dispute rule, the jury must consider "all the circumstances." *Wilson*, 42 Cal. 4th at 729 n.7, 171 P.3d at 1092 n.7.

The Ninth Circuit, in *Safeco Ins. Co. of Am. v. Guyton*, applied California law and developed the genuine dispute doctrine. 692 F.2d 551, 557 (9th Cir. 1982) (*Guyton*) (*disapproved of by Garvey v. State Farm Fire & Cas. Co.*, 48 Cal. 3d 395, 397, 410, 770 P.2d 704, 713 (Cal. 1989)). In *Guyton*, the district court granted a summary judgment to the carrier on the policyholder's causes of action for breach of contract and bad faith, upholding the carrier's coverage decision. The district court concluded that it should find coverage only if the covered risk was the "sole or efficient proximate cause" of the loss and the covered risk preceded in time the operation of the excluded risk. The district court found that the policies did not cover the policyholder's loss. The Ninth Circuit determined that the district court had misinterpreted California law and reversed on the coverage issue, but the court affirmed the dismissal of the bad-faith cause of action. It held that a "genuine issue concerning legal liability" precluded a carrier's bad faith as a matter of law, even if coverage was later established:

> Although the district court did not specify the grounds on which it entered judgment for Safeco on this cause of action, it may have concluded that since the policy in dispute involved a genuine issue concerning legal liability, Safeco could not, as a matter of law, have been acting in bad faith by refusing to pay on the Policyholders' claims. Although we conclude that Policyholders' losses are covered by the policy if third-party negligence is established, we agree that there existed a genuine issue as to Safeco's liability under California law. We therefore affirm the dismissal of Policyholders' claims of bad faith.

*Id*. at 557.

Cases decided subsequent to *Guyton* have expanded the application of the "genuine issue" doctrine, applying it to both legal and factual disputes. *Feldman v. Allstate Ins. Co.*, 322 F.3d 660, 669 (9th Cir. 2003) ("[U]nder the Ninth Circuit's interpretation of California law, a genuine dispute may concern either a reasonable factual dispute or an unsettled area of insurance law."); *Guebara v. Allstate Ins. Co.*, 237 F.3d 987, 994 (9th Cir. 2001) ("[W]e decline to limit the genuine dispute doctrine to purely legal or contractual disputes. Rather than establish a bright-line rule, we hold that the genuine dispute doctrine should be applied on a case-by-case basis."); *Chateau Chamberay*, 90 Cal. App. 4th at 347, 108 Cal. Rptr. 2d at 784 ("It is now settled law in California that an insurer denying or delaying the payment of policy benefits due to the existence of a genuine dispute with its insured as to the existence of coverage liability or the amount of the insured's coverage claim is not liable in bad faith even though it might be liable for breach of contract.") (citations omitted).

Similarly, the Supreme Court of Alabama supports the use of the genuine dispute doctrine in protecting carriers' denial of claims from bad-faith actions when factual issues create a legitimate question of coverage. *Jones v. State Farm Bureau Mut. Cas. Co.*, 507 So. 2d 396, 400 (Ala. 1986). A court must evaluate a carrier's liability in a bad-faith action according to the information available to the carrier at the time of denial. *Nat'l Sav. Life Ins. Co. v. Dutton*, 419 So. 2d 1357, 1362 (Ala. 1982). If the evidence produced by either side legitimizes the carrier's denial of a claim through the establishment of a genuine factual issue affecting the validity of a claim, the tort claim for bad faith against the carrier must fail. *Jones,* 507 So. 2d at 400.

Under Iowa law, when coverage is fairly debatable in a first-party claim, the car-

rier's denial of coverage cannot be in bad faith. *See Reid v. Pekin Ins. Co.*, 436 F. Supp. 2d 1002, 1011 (N.D. Iowa 2006), *aff'd,* 245 Fed. Appx. 567 (8th Cir. 2007); *Reuter v. State Farm Mut. Auto Ins. Co., Inc.*, 469 N.W.2d 250, 254–55 (Iowa 1991). As long as the carrier has an "objectively reasonable basis for denying the claim," the carrier can avoid any liability in a bad-faith action in the first-party context. *See id.* An imperfect or incomplete investigation alone is not a basis for recovery in a bad-faith action when the carrier has an objectively reasonable basis for denying the claim. *See Seastrom v. Farm Bureau Life Ins. Co.*, 601 N.W.2d 339, 347 (Iowa 1999). Additionally, when an insurer has an objectively reasonable basis to deny coverage, it has no obligation to investigate further before reaching the conclusion to deny coverage. *See Hollingsworth v. Schminkey*, 553 N.W.2d 591 (Iowa 1996). Under Wyoming law, the genuine dispute doctrine protects carriers from bad-faith liability as long as the denied claim is fairly debatable. *See Hutchinson Oil Co. v. Federated Service Ins. Co.*, 851 F. Supp. 1546, 1557 (D. Wyo. 1994).

Little law exists applying the genuine dispute doctrine in third-party duty to defend cases. In a recent and unpublished federal district court opinion, Judge Ware of the United States District Court, Northern District of California, ruled that the genuine dispute doctrine could apply in third-party coverage actions:

> Contrary to Plaintiffs' contention, the Court has found several decisions applying California's genuine dispute doctrine to third-party insurance disputes. For example, the California Court of Appeals applied the genuine dispute doctrine to a third-party indemnity action in *Dalrymple v. United Services Auto. Assn.* The Ninth Circuit and district courts have also repeatedly applied the doctrine to third-party indemnity and duty to defend cases. *See, e.g., Lunsford v. American Guar. & Liab. Ins. Co.*, 18 F.3d 653, 656 (9th Cir. 1994); *American Cas. Co. v. Krieger*, 181 F.3d 1113, 1123 (9th Cir. 1999); *Align Tech., Inc. v. Fed. Ins. Co.*, 673 F. Supp. 2d 957, 973 (N.D. Cal. 2009). In sum, Plaintiffs have cited no case holding that the genuine dispute doctrine is inapplicable to a bad faith claim in a third-party duty to defend case. *The Court rejects Plaintiffs' contention that the genuine dispute doctrine is only applicable to first-party disputes.* Accordingly, Plaintiffs are not entitled to summary judgment on this ground.

*Netscape Communications Corp., et al. v. Federal Ins. Co., et al.*, No. C 06-00198 JW, (N.D. Cal. Nov. 4, 2010) (order denying the parties' motion for summary judgment).

Application of the genuine dispute doctrine in the third-party, duty-to-defend context makes sense as it speaks to the reasonableness of the carrier's denial of coverage. While the duty to defend is interpreted broadly in the coverage context, this breadth of application does not apply to disputed questions of law. *See, e.g., Elliott v. Donahue,* 169 Wis. 2d 310, 316, 485 N.W.2d 403, 405 (1992); *John Deere Ins. Co. v. Sanders Oldsmobile-Cadillac, Inc.*, 2009 U.S. Dist. Lexis 49623 (E.D. Cal. May 28, 2009); *Marquez Knolls Prop. Owners Ass'n., Inc. v. Executive Risk Indem., Inc.*, 153 Cal. App. 4th 228, 233–34, 62 Cal. Rptr. 3d 510, 514–15 (Cal. App. 2 Dist. 2007). As such, there is no policy reason to limit a carrier's ability to claim a genuine dispute in first-party cases. *Gaylord v. Nationwide Mut. Ins. Co.*, 2011 U.S. Dist. Lexis 21736, at *63 (E.D. Cal. Mar. 4, 2011) ("[W]hile factual disputes preclude application of the genuine dispute doctrine in duty to defend cases, legal disputes do not preclude application of the genuine dispute doctrine.").

### The Policyholder's Perspective: Genuine Dispute Doctrine Limitations

*The genuine dispute doctrine does not apply in third-party cases, particularly with respect to the duty to defend.*

The genuine dispute doctrine was developed in the first-party insurance context and has almost never been applied outside of it, at least in a published opinion. *See Polisso*, 139 Cal. App. 4th at 951, 43 Cal. Rptr. 3d at 488 ("[Insurer] has failed to cite any cases that apply the genuine dispute doctrine to the duty to defend and our research has not disclosed any. The doctrine has been applied primarily in first-party coverage cases, usually involving disputes over policy language or its application."); *See also* Hon. H. Walter Croskey, *et al.*, California Practice Guide: Insurance Litigation, at Ch. 12, §12:618.5 (2009) ("There is no known case applying the 'genuine dispute' doctrine to a bad faith claim based on the insurer's refusal to defend its insured.").

In fact, the genuine dispute doctrine, as much as insurers might try to raise the defense in third-party insurance cases, simply does not fit there. In fact, establishing a genuine dispute that coverage potentially may exist under a third-party liability policy effectively proves that the insurer had a duty to defend. This is because the existence of a factual dispute bearing on whether indemnity coverage will be available gives rise to the potential for such coverage, which triggers the insurer's duty to defend. *See Montrose*, 6 Cal. 4th at 288–89, 861 P.2d at 1157.

**Little law exists** applying the genuine dispute doctrine in third-party duty to defend cases.

Several courts, applying California law, have reached this conclusion. *See Carrillo v. Nationwide Mut. Fire Ins. Co.*, 2009 U.S. Dist. Lexis 56916, at *26 n.3 (N.D. Cal. July 2, 2009) ("At least one court has pointed out that the doctrine is not applicable in the duty to defend context because the existence of a genuine dispute as to coverage necessarily means that there was a duty to defend."); *Harbison v. Am. Motorists Ins. Co.*, 636 F. Supp. 2d 1030, 1040 (E.D. Cal. 2009) ("Because the existence of a genuine dispute as to the insurer's liability indicates that there is at least a potential for coverage, the existence of a genuine dispute is itself enough to trigger the insurer's duty to defend… the genuine dispute doctrine appears wholly incompatible with duty to defend cases."). In sum, policyholders should be so lucky that insurers will continue to raise the genuine dispute doctrine defense in duty to defend cases because the insurers will be proving the policyholders' cases for them.

The federal cases on which the insurers above have relied—*Netscape* (Northern District of California), *Lunsford* (Ninth Circuit), *Krieger* (Ninth Circuit), and *Align*

*Tech* (Northern District of California)—do not hold otherwise. Those courts simply determined whether there was a disputed fact that precluded summary judgment on the issue of whether the insurer had acted unreasonably in denying coverage. The California Court of Appeal case, *Dalyrmple,* referenced in *Netscape,* did not hold that the genuine dispute doctrine applies in the third-party liability context. Rather, *Dalrymple* was analogizing to the malicious prosecution standard in determining whether the insurer had "proper cause" to bring a declaratory relief action. *Dalrymple*, 40 Cal.App.4th at 522–23, 46 Cal. Rptr. 2d at 859.

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Finally, even if the genuine dispute doctrine applied in the third-party liability context, an insurer that has breached its duty to investigate should not be able to rely on it. *Jordan*, 148 Cal. App. 4th at 1074, 56 Cal. Rptr. 3d at 319 ("The insurer cannot claim a 'genuine dispute' regarding coverage in such cases because, by failing to investigate, it has deprived itself of the ability to make a fair evaluation of the claim."). As discussed above, an insurer cannot deny a claim without fully considering all the possible bases for coverage. *See Egan*, 24 Cal. 3d at 819, 620 P.2d at 145–46. An insurer that has failed to consider all possible bases for coverage fully cannot reasonably or "genuinely" dispute the existence of coverage.

However, the existence of a genuine dispute may not protect an insurer from a finding of bad faith if its investigation was biased. *See Hangarter v. Provident Life and Acc. Ins. Co.*, 373 F.3d 998, 1010 (9th Cir. 2004). A jury's determination that a carrier was unlawfully biased in its investigation permits a finding of bad faith despite the existence of a genuine dispute over coverage. *See Bernstein v. Travelers Ins. Co.*, 447 F. Supp. 2d 1100, 1114 (N.D. Cal. 2006). A carrier may be found to have engaged in a biased investigation if it put its own interests above those of its insured by failing to inquire into all possible bases that might support the insured's claim, *i.e.*, looking "*only in one self-serving direction* for evidence about the source, nature, or extent of the claimed losses." *Id*. at 1112 (emphasis in original).

In addition, some jurisdictions have held that a carrier may be liable for damages in a bad faith action in the first-party context despite the existence of a genuine dispute over coverage from a "fairly debatable" claim. *See Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234, 237, 995 P.2d 276, 279 (2000). The Arizona Supreme Court held that a carrier will be liable in a bad-faith action if it acts unreasonably in processing its insured's claim, regardless of the ultimate merits of the carrier's decision. *See Id.* at 238, 995 P.2d 276, 282. *See also Skaling v. Aetna Ins. Co.*, 799 A.2d 997, 1011 (R.I. 2002) ("The insurer's failure to conduct an appropriate and timely investigation may subject the insurer to bad faith liability notwithstanding the merits of the claim."); *Dakota, Minnesota & Eastern R.R. Corp. v. Acuity*, 771 N.W.2d 623, 630 (S.D. 2009) (citing *Skaling* and *Zilisch* with approval).

## Conclusion

A bad-faith claim for failure to investigate requires examination of all the circumstances surrounding a carrier's denial of an insured's claim. From the carrier's perspective, a case can be made that this analysis allows a court or a jury to consider facts that support the carrier's decision to deny coverage, even facts that the carrier did not know at the time that the decision was made. These facts form part of the circumstances and are relevant in determining whether an investigation was reasonable and whether a genuine dispute existed pertaining to how the law applied to the coverage question at hand.

Policyholders, in contrast, can legitimately argue that after-acquired evidence should not be admitted in a bad-faith, failure-to-investigate context because the touchstone is the objectively reasonable nature of the carrier's conduct at the time that the decision was made. While undiscovered bad facts may be admitted to a carrier's detriment, insureds are free to argue that undiscovered facts showing reasonable claims handing should not be admitted to prove that a carrier's investigation was reasonable or to prove the existence of a genuine dispute in either a first- or third-party context. Policyholders may also argue that the genuine dispute doctrine is limited to first-party cases.

We expect these issues to become more sharply resolved as courts continue to wrestle with the required scope of investigations and the application of the genuine dispute doctrine in third-party cases. FD