Bad Faith Is Fairly Debatable

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I. Introduction to the Genuine Dispute Doctrine and Fairly Debatable Doctrine

Implied in every contract, including insurance contracts, is the covenant of good faith and fair dealing. How that obligation affects an insurer's liability to its policyholder is dependent on the particular state's laws applicable to the coverage dispute at issue. Some states afford the policyholder a separate tort cause of action for breach of the implied covenant, opening up recovery for consequential damages. Other states confine it to breach of contract claims. Moreover, the level of conduct necessary to establish bad faith varies. This article does not attempt to provide a survey of bad faith law generally. Rather, we focus on the issue of whether an insurer may avoid a finding of bad faith when its coverage decision, although ultimately found to be incorrect, was reasonable or fairly debatable in light of the facts or law known at the time. This defense is often referenced as the genuine dispute or fairly debatable doctrine.

In California, courts hold that the genuine dispute doctrine is an affirmative defense offering an insurer protection from bad faith when there is a genuine dispute as to the existence or amount of coverage. *Wilson v. 21st Century Ins. Co.*, 42 Cal.4th 713, 723 (2007). Other states hold that an insurer may not be liable for bad faith if the insured's claim is fairly debatable, that is if there is a reasonable basis for denying the claim. *See e.g. National Sec. Fire & Cas. Co. v. Bowen*, 417 So.2d 179 (Ala. 1982); *Noble v. National Am. Life Ins. Co.*, 624 P.2d 866 (Ariz. 1981); *Sanderson v. Am. Fam. Mut. Ins. Co.*, 251 P.3d 1213 (Colo.App.2010); *Empire Fire & Marine Insurance Company v. Simpsonville Wrecker Service, Inc.*, 880 S.W.2d 886 (Ky.App. 1994); *Windmon v. Marshall*, 926 So.2d 867, 872 (Miss. 2006); *Safeco Ins. Co. v. Ellinghouse*, 223 Mont. 239, 248, 725 P.2d 217 (Mont. 1986); *Niver v. Travelers Indem. Co. of Illinois*, 412 F. Supp. 2d 966, 977 (N.D. Iowa 2006); *Fetch v. Quam*, 623 N.W.2d 357, 366 (N.D. 2001); *Badiali v. New Jersey Mfrs. Ins. Grp.*, 220 N.J. 544 (2015); *Fetch v. Quam*, 623 N.W.2d 357 (N.D. 2001);; *Skaling v. Aetna Ins. Co.*, 799 A.2d 997 (R.I. 2002); State *Farm Fire & Cas. Co. v. Barton*, 897 F.2d 729, 731 (4th Cir. 1990) (South Carolina); *Dakota, Minnesota & Eastern R.R. Corp. v. Acuity*, 771 N.W.2d 623 (S.D. 2009); *Jones v. Farmers Ins. Exch.*, 286 P.3d 301 (Utah 2012); *Cuna Mutual Ins. Society v. Norman*, 375 S.E.2d 724, 726-27 (Va. 1989); *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368 (Wis. 1978); *First Wyoming Bank, N.A., Jackson Hole v. Continental Ins. Co.*, 860 P.2d 1094 (Wyo. 1993).

While Ohio and Oklahoma do not use the term "fairly debatable," the standard is similar: a decision to withhold or delay payment, if based on a legitimate dispute or reasonable justification (legal or factual) cannot form the basis of bad faith tort liability. *Barnes v. Oklahoma Farm Bureau Mut. Ins. Co.*, 11 P.3d 162, 171 (Okla. 2000); *Zoppo v. Homestead Ins. Co.*, 71 Ohio St. 3d 552(1994) ("reasonable justification" standard)

A. Which Party has the Burden?

In some states, the burden is placed on the insured to show that the claim was not fairly debatable. *See e.g., Weinstein v. Prudential Prop. and Cas. Ins. Co.*, 233 P.3d 1221, 1237 (Idaho 2010) ("In order for a first-party insured to recover on a bad faith claim, the insured must show . . . 2) the claim was not fairly debatable . . . ."); *Kmart Corp. v. Footstar, Inc.*, No. 09 CV 3607, 2013 WL 6670746, *2 (N.D. Ill. Dec. 18, 2013) (applying New Jersey law the court held the insured must show that "no debatable reason existed for the denial of benefits.");

In contrast, California law provides the genuine dispute doctrine is an affirmative defense for which the insurer carries the burden. *See Gaylord v. Nationwide Mutual Insurance Co.*, 776 F. Supp. 2d 1101, 1124-1127 (E.D. Cal. 2011) (applying California law, the Eastern District of California found that the genuine dispute doctrine can act as an affirmative defense when an insured contends the insurer breached its duty to indemnify and defend).

Whoever has the burden, the determination of whether the genuine dispute/fairly debatable doctrines applies is typically measured by an objective standard. *See Wilson*, 42 Cal.4th at 724, fn. 7; Iowa: *Dolan v. Aid Ins. Co.*, 431 N.W.2d 790, 794 (Iowa 1988) (finding that the test for bad faith "creates an objective standard and makes clear the intentional nature of the tort"); Wisconsin: *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 376 (Wis. 1978) (finding that the tort of bad faith is intentional and relies on an objective standard); South Carolina *State Farm Fire & Cas. Co. v. Barton*, 897 F.2d 729, 731 (4th Cir. 1990) (applying South Carolina law which provides that there must be an objectively reasonable basis for denying an insured's claim); Utah: *Campell v. State Farm Mut. Auto. Ins. Co.*, 840 P.2d 130, 139-40 n.16 (Utah App. 1992) (using an objective standard to determine if the insurer's decisions were "reasonable or unreasonable under all the circumstances"); *but see* Arizona: *Bronick v. State Farm Mut. Auto. Ins. Co.*, No. CV-11-01442-PHX-JAT, 2013 WL 3716600, *4-*5 (D. Ariz. July 15,

2013) (using both an objective standard to determine if the insurer's actions were objectively reasonable and a subjective standard to determine if the insurer's conduct was "consciously unreasonable").

B. Requirement of an Adequate Investigation

The genuine dispute/fairly debatable doctrines do not relieve insurance companies of their obligations to conduct reasonable and thorough investigations. Generally, even if a claim is fairly debatable or if there exists a genuine dispute, the insurer must still exercise reasonable care in its investigation of the claim. *See Skaling v. Aetna Ins. Co.*, 799 A.2d 997, 1010 (R.I. 2002) ("An insurer has a responsibility to assemble all the facts necessary for a fair and comprehensive investigation *before* it refuses to pay a claim . . . ."); *Zilisch v. State Farm*, 196 P.2d 276, 280 (2000) ("The carrier has an obligation to immediately conduct an adequate investigation . . . ."); *Anderson v. Western Nat'l Mut. Ins. Co.*, 857 F. Supp. 2d 896, 904 (D.S.D. 2012) ("if an insurer conducted an inadequate investigation of a claim, and, by doing so, failed to locate information indicating that the plaintiff was entitled to benefits, then the claim may not be fairly debatable . . . ."); *Fetch v. Quam*, 623 N.W.2d 357, 365 (N.D. 2001) ("An insurer does not act in bad faith by a reasonable investigation of a claim which is fairly debatable.").

As a thorough investigation is required in order to establish the applicability of the genuine dispute doctrine. Examples of evidence that could show a biased investigation, which would make the genuine dispute doctrine inapplicable, include: (1) the insurer was guilty of misrepresenting the nature of the investigatory proceedings; (2) the insurer's employees lied during the depositions or to the insured; (3) the insurer dishonestly selected its experts; (4) the insurer's experts were unreasonable; and (5) the insurer failed to conduct a thorough investigation. While a thorough report from an insurer's independent expert to support the genuine dispute doctrine, this is not automatic insulation from bad faith claims. *Keshish v. Allstate Ins. Co.*, 959 F. Supp. 2d 1226 (C.D. Cal. 2013).

II. Application of the Genuine Dispute/Fairly Debatable Doctrines to Issues of Law or Fact

For the states that follow the genuine dispute/fairly debatable doctrine, they appear to uniformly apply the defense to disputed questions of law. Recently, some states have also applied the defense to questions of fact.

A. Question of Law

As applied to questions of law, insurers may refuse to defend in circumstances where there is a sufficient basis in the law for taking such a position. An insurer cannot be held in bad faith on a reasonable but incorrect interpretation of law. *See, e.g., New England Env't Techs. v. American Safety Risk Retention Grp., Inc.*, 738 F. Supp. 2d 249, 259 (D.Mass. 2010) (finding no bad faith where insurer's position was "based on a 'plausible interpretation of the policy's terms); *Brown v. Labor and Industry Review Comm'n*, 671 N.W.2d 279 (Wis. 2003) (concluding there was no bad faith when there was a reasonable conclusion based on a question of law was reached, even if different conclusions were more reasonable); *United States Fire Ins. Co. v. Williams*, 955 S.W.2d 267, 269 (Tex. Sup. Ct. 1997) (finding that the insurer's interpretation of a rule was "at least arguable" as three out of five Commission reviewing officers had the same interpretation); *Aetna Cas. & Sur. Co. v. Superior Court*, 788 P.2d 1333, 1336 (Az. App. Div. 1989) (concluding that the insurer's denial of coverage was reasonable because two courts agreed even though the outcome of the question on appeal was different); *but see Hayes v. Acuity*, No. CV 17-5015-JLV, 2020 WL 1322269, *9 (D.S.D. March 20, 2020) (denying insurer's motion for summary judgment regarding the insured's bad faith claim because the insurer's "legal duty was not fairly debatable" because its "obligation was clear from the statutory language alone").

B. Question of Fact

Wisconsin, Alabama and Iowa allow the fairly debatable doctrine for matters of fact and matters of law. "When a claim is 'fairly debatable,' the insurer is entitled to debate it, whether the debate concerns a matter of fact or law." *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 376–77 (Wis. 1978); *see also National Sec. Fire & Cas. Co. v. Bowen*, 417 So.1d 179, 183 (Ala. 1982); *M-Z Enters., Inc. v. Haweye-Security Ins. Co.*, 318 N.W.2d 408, 415 (Iowa 1982).

The Iowa Supreme Court more recently stated, "where an objectively reasonable basis for denial of a claim *actually exists*, the insurer cannot be held liable for bad faith as a matter of law." *Bellville v. Farm Bureau Mut. Ins. Co.*, 702 N.W.2d 468, 473 (Iowa 2005) (citations and quotations omitted) (emphasis in original).

In California, the genuine dispute doctrine was once limited to legal issues. For nearly twenty years, however, California has applied the doctrine to questions of fact, stating, "we see no reason why the genuine dispute doctrine should be limited to legal issues." *Chateau Chamberay Homeowners Ass'n v. Associated Int'l Ins. Co.*, 90 Cal.App.4th 335, 348 (2001).

Oklahoma courts have also applied this to questions of fact, stating, "a claim must be promptly paid unless the insurer has a reasonable belief the claim is either *legally* or *factually* insufficient." *Barnes*, 11 P.3d at 171 (emphasis added).

There appears to be an interplay between the applicability of these doctrines to legal vs. factual issues depending on whether the claim involves first party or liability coverage. Generally, these doctrines are applicable to both legal and factual issues for first party claims. First-party policies often allow for a broader investigation, including reviewing the insured's records and examining the insured under oath. Courts are more likely the permit an insurer to use these doctrines with first party claims for legal and factual issues because an insured is not being held liable and there is no risk of increasing the insured's exposure. For third party claims, the defense is typically limited to disputed questions of law. For example, California courts have stated that "[i]t is doubtful that the so-called 'genuine dispute doctrine' applies in third-party duty to defend cases." *Mt. Hawley Ins. Co. v. Lopez*, 215 Cal.App.4th 1385, 1425 (2013). This is understandable since the duty to defend is dependent on the existence of a potential for coverage. Further, "it has never been held that an insurer in a third party case may rely on a genuine dispute over coverage to refuse settlement." *Howard v. American Nat'l Fire Ins. Co.*, 187 Cal.App.4th 498 (2010). However, the Ninth Circuit has applied the genuine dispute doctrine to an issue of duty to defend. *See Lunsford v. American Guar. Liab. Ins. Co.*, 18 F.3d 653, 654 (9th Cir. 1994); *see also Vaid-Raizada v. Lexington Nat'l Ins. Co.*, 2009 U.S. Dist. LEXIS 76314, *4–*5 (C.D. Cal. Aug. 12, 2009) ("Courts have consistently applied the 'genuine dispute' rule in assessing bad faith tort claims on the duty to defend.").

Utah has also applied the fairly debatable standard to third-party insurance bad faith claims. *See Allegis Inv. Servs., LLC v. Arthur J. Gallagher & Co.*, 371 F. Supp. 3d 983 (D. Utah 2019.)

In contrast, a New Jersey court rejected application of the fairly debatable standard in the context of a third party claim. *See State Nat'l Ins. Co. v. County of Camden*, 10 F.Supp.3d 568, 584 (N.J. 2014) (holding the fairly debatable standard does not apply to claims involving a potential for an excess of limits verdict against the insured).

IV. How Are The Doctrines Utilized?

The genuine dispute/fairly debatable doctrines typically have one of three uses: (a) they can serve as a complete defense to bad faith claims; (b) the existence of a genuine dispute/fairly debatable issue of law or fact is but a factor in the analysis of bad faith; and (c) they may counter a rebuttable presumption of unreasonableness.

A. Complete Defense to Bad Faith Claims

A number of courts hold that the genuine dispute/fairly debatable doctrines may provide a complete defense to a bad faith claim. For example, in *Kmart Corp. v. Footstar, Inc.*, No. 09 CV 3607, 2013 WL 6670746, *4 (N.D. Ill. Dec. 18, 2013) (applying New Jersey law), a customer, injured by a falling infant car seat, sued Kmart and later Footstar because it was believed both companies had employees involved in the accident. *Id.*, at *1. Footstar's insurer, Liberty Mutual Fire Insurance Company, defended Footstar in the action but refused to defend or indemnify Kmart as an additional insured in the action. *Id.*, at *2. Kmart then settled the underlying action and sought reimbursement for the settlement amount from Footstar and Liberty. *Id.* On a motion for summary judgment, the court held that Liberty's duty to defend was triggered on the date Kmart requested coverage, and for the duty to indemnify, it was unclear as to whether Footstar was implicated in the underlying accident, requiring a trial to determine fault. *Id.*, at *2-*3. Kmart now claimed that Liberty acted in bad faith when it refused to indemnify and defend the underlying case. *Id.*, at *3. The court explained that even when summary judgment is granted finding coverage, "if the coverage issue was still 'fairly debatable' at the time, the insurer's decision does not constitute bad faith." *Id.* Due to differing accounts of the underlying incident, the insurer's position "was not so 'obviously

incorrect'" as "there was the potential that the accident did not involve Footstar's work." *Id.* Additionally, Liberty's refusal to indemnify could not be held to be in bad faith as "Kmart could not establish as a matter of law a right to summary judgment," a requirement under New Jersey case law. *Id.*, at *3-*4. As the court was unable to resolve the issue as a matter of law on summary judgment, the court could not extend bad faith to Liberty's refusal to indemnify. *Id.*, at *4; *see also Gaylord v. Nationwide Mutual Insurance Co.*, 776 F. Supp. 2d 1101, 1105, 1127 (E.D. Cal. 2011)(The court found (The court determined that summary judgment in favor of the insurer on the bad faith claim was appropriate because the insurer had conducted an adequate investigation and based on that investigation and a reasonable construction of the policy determined that the cattle was not included in the policy.)

B. One Factor in a Bad Faith Analysis

Oklahoma is among the states that do not allow its version of the fairly debatable doctrine to serve as a complete defense to a bad faith claim. Instead, Oklahoma courts may consider a legitimate dispute or reasonable justification as a factor in determining bad faith. The insurer in *Haberman v. The Hartford Insurance Group*, 443 F.3d 1257, 1269 (10th Cir. 2006), argued that because there was a legitimate dispute regarding coverage, it could not be found to have acted in bad faith. However, the 10th Circuit, applying Oklahoma law, has held that a "legitimate dispute as to coverage will not act as an impenetrable shield against a valid claim or bad faith." *Timberlake Constr. Co. v. U.S. Fidelity & Gaur. Co.*, 71 F.3d 335, 242 (10th Cir. 1995). If the insurer did not actually rely on an existing legitimate defense, a plaintiff may bring a bad faith action. *Haberman*, 443 F.3d at 1270. In *Haberman*, the issue identified by the insurer in its motion for summary judgment was whether Plaintiff was an insured under the policy for purposes of underinsured motorist coverage; however, in its denial letter, the insurer stated that it denied the claim because Plaintiff was not riding in a "covered vehicle" at the time of the accident. The court found that "the 'legitimate' reason for denying [Plaintiff's] claim [was] different from the reason [Plaintiff] was given;" therefore, it was appropriate for the district court to deny the insurer's motion for summary judgment on the bad faith claim. *Id.* at 1270-1271. *See also Wolf v. Prudential Ins. Co.*, 50 F.3d 793, 796 (10th Cir. 1995) (finding that even

though an insurer has a reasonable interpretation of an ambiguity in a policy, this does not mean the insurer acted reasonably if it construed the ambiguous term against the insured).

The court in *Barnes v. Oklahoma Farm Bureau Mutual Insurance Co.*, 11 P.3d 162 (Okla. 2000), stated that in an action for bad faith, "it is the unreasonableness of the insurer's actions that is the essence of the tort." *Id.* at 174. Further, even though reliance on counsel's advice can be a defense to a bad faith claim, "the reliance on counsel's advice must be reasonable." *Id.* Additionally, "advice of counsel is but one factor to be considered in deciding whether the carrier's reason for denying a claim was arguably reasonable." *Id.* (citations removed). In *Barnes*, insurer counsel's advice conflicted with the Oklahoma Supreme Court's prior expression of the meaning of an underinsured motorist statute, and the court found this position was "absolutely insupportable." *Id.*

In *Zilisch v. State Farm Mutual Automobile Insurance Co.*, 995 P.2d 276, 279 (Ariz. 2000), the Arizona Supreme Court, en banc, held that "in defending against a fairly debatable claim, an insurer must exercise reasonable care and good faith." That action involved a first-party bad faith claim regarding underinsured motorist coverage. The insurer argued that the extent of the injuries and thus the value of the claim was fairly debatable. However, the insurer did not evaluate the claim or offer to settle the claim until almost ten months after receiving the demand, the insurer's claim that it was waiting for an expert report was unreasonable because it had reports from several other physicians, and the insurer did not ask for an independent medical examination until after it had offered to settle the claim. *Id.* at 280. The court of appeals essentially stated that as long as the amount offered to the insured is fairly debatable, "nothing else [the insurer] does in investigating the claim, evaluating the claim, and paying the claim really matters." *Id.* at 279. The court of appeals held that the fairly debatable doctrine was a "'threshold question' which is outcome determinative." *Id.* The Arizona Supreme Court, however, reversed, finding that the court of appeals "erred in concluding that fair debatability is both the beginning and the end of the analysis." *Id.* at 280. The court set out the appropriate inquiry for bad faith, looking at the insurer's "investigation, evaluation, and processing of the claim" to determine if "the insured acted unreasonably and either knew or was conscious of the fact that its conduct was unreasonable." *Id.* Further, "while fair debatability is a necessary

condition to avoid a claim of bad faith, it is not always a sufficient condition." *Id.* at 281. The court concluded that the trial court was correct by submitting the case to a jury because there was sufficient evidence for a jury to find that the insurer acted unreasonably and knew it acted unreasonably. *Id.* at 280-81.

The Colorado Court of Appeals, in *Sanderson v. American Family Mutual. Insurance Co.*, 251 P.3d 1213, 1216 (Colo. 2010), chose to follow the standard in *Zilisch* in a similar first-party bad faith action in Colorado. The trial court granted summary judgment for the insurer because the claims were fairly debatable, as there were genuine issues concerning the facts establishing liability and a legal issue as to the amount owed under the policy. The Court of Appeals reversed, following the standard set forth in *Zilisch* the court held that "fair debatability is not a threshold inquiry that is outcome determinative as a matter of law, nor is it both the beginning and the end of the analysis in a bad faith case. *Id.* at 1218 (quoting *Zilisch*, 977 P.2d at 279–80).

Other courts have similarly followed the standard in *Zilisch*. *See, e.g., Skaling v. Aetna Ins. Co.*, 799 A.2d 997, 1011 (R.I. 2002); *Allen v. State Farm Mut. Auto. Ins. Co.*, No. 3:15-cv-0019-HRH, 2018 WL 1474526, *5 (D. Alaska March 26, 2018); *Farmland Mut. Ins. Co. v. Johnson*, 36 S.W.3d 368, 375 (Ky. 2000).

C. Dispute a Rebuttable Presumption of Unreasonableness

Less common is the application of the fairly debatable doctrine as a way to dispute a rebuttable presumption of unreasonableness. In Michigan, attorneys' fees are allowed against the insurer if a court finds the insurer "unreasonably refused to pay the claim or unreasonably delayed in making proper payment." Mich. Comp. Laws § 500.3148(1). If the insurer refuses or delays paying benefits, a rebuttable presumption of unreasonableness is created. *Durmishi v. National Cas. Co.*, 720 F. Supp. 2d 862, 873 (2010). The insurer has the burden of showing that the initial refusal or delay of payment was caused by a legitimate question of law or fact at the time of the initial refusal or delay. *Id.* (quoting *Ross v. Auto Club Grp.*, 748 N.W.2d 552, 558 (2008).) In *Durmishi*, the insured refused to undergo a medical and psychological examination as required under Michigan law and the insurance policy. The insurer claimed the extent of the insured's injuries was fairly debatable. However, the insurer removed the case to federal court prior to seeking the examinations, and the insured insisted compliance with the federal rules

surrounding these types of examinations. The court determined that "[t]he plaintiff's insistence on compliance with Rule 35 does not by itself justify the defendant's delay in payment of benefits that otherwise were 'overdue.'" *Durmishi*, 720 F. Supp. 2d at 877. Further, the court stated that the insurer may be able to rebut the presumption of unreasonableness. *Id.*

V. Conclusion

The genuine dispute and fairly debatable doctrines can be powerful tools for insurance companies when facing potential bad faith claims. Depending on which state's laws apply, these doctrines may be used for matters of law or fact and in defense of first party or third party bad faith claims. Policyholders may hedge against application of these doctrines by focusing on the insurer's investigation of the claim, which generally must be adequate and thorough regardless of whether a genuine dispute or fairly debatable defense to coverage is available.