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The Misinterpretation Of Pa.'s Bad Faith Claims Handling Rule

By **George Stewart and Max Louik** (April 12, 2022, 3:52 PM EDT)

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Some courts applying Pennsylvania law in insurance coverage disputes have reflexively posited that no claim for bad faith claims handling will lie where an insurer establishes that the subject claim is not covered by the insurer's policy. Particularly as it relates to first-party coverage claims, that is a misleading and inaccurate statement of Pennsylvania law.

Indeed, under Pennsylvania law, a statutory bad faith claim brought in the first-party context is entirely independent of a breach of contract claim, and allows for punitive damages awards "even without any other successful claim." That rule makes sense for a variety of sound policy reasons. Thus, courts should be mindful of the type of claim involved before making such sweeping and inaccurate pronouncements.

In Walker v. Foremost Insurance Co. Grand Rapids,[1] the U.S. District Court for the Eastern District of Pennsylvania articulated an oft-repeated "rule" of Pennsylvania bad faith claim handling law: Where a court finds that an insurer was not obligated to cover a disputed claim, "by definition the insurer had a reasonable basis to deny the benefits" available under a policy and, hence, could not be liable for bad faith claims handling.

On that basis, the court granted summary judgment in favor of the insurer on the policyholder's statutory, as opposed to common law, bad faith claim arising out of a third-party liability claim.

Pennsylvania courts are not alone in employing such an ends-justify-the-means rationale. Indeed, cases across the country are replete with statements — championed by the insurance industry — to the following effect: It is well established that where no coverage exists under an insurance policy, the insurer cannot be in bad faith for having denied coverage.[2]

Such statements are seemingly accepted without much analysis. But, as careful consideration of the case law and potential ramifications of such a so-called rule dictate, the courts must adopt — and, in some cases, have adopted — a more nuanced approach to the interplay between a claim for which there may be no coverage and the manner in which the insurer handles such a claim.

At least under Pennsylvania law, the assertion that a bad faith claim will only lie if the policyholder first establishes coverage is misleading. To be sure, there are cases brought under third-party policies where the court held that a bad faith claim cannot survive a determination that there was no duty to defend because a determination that there was no potential coverage means that the insurer had good cause to refuse to defend.[3]

Of course, if the insurer breaches its obligation to defend, then it does so at its own peril. In such a circumstance, the policyholder is not without recourse.

In the context of a first-party property policy, however, it is actually well established under Pennsylvania law that a statutory bad faith claim is entirely independent of a breach of contract claim, and allows for punitive damages awards "even without any other successful claim."[4]

The Pennsylvania Superior Court rejected outright, in its 1994 decision March v. Paradise Mutual Insurance Co., an insurer's suggestion that where an insured's claim for insurance coverage fails, its claim for recovery under Pennsylvania's bad faith statute must also fail.[5]

On the contrary, the Superior Court recognized that "the statute does not indicate that success on the bad faith claim is reliant upon the success of the contract claim," and Pennsylvania courts have consistently held that a claim asserted under the statute is "separate and distinct" from the underlying contractual claim.[6]

Accordingly, a statutory bad faith claim is "not dependent upon success on the merits" of an insured's breach of contract claim.[7]

Many other states, including Washington, Wyoming and Hawaii, are in accord with the Pennsylvania rule.[8]

That rule makes good sense. Principally, it eliminates, or mitigates, the moral hazard associated with a rule that would allow an insurer to escape bad faith so long as it ultimately seizes upon a basis for denying a claim with which a court agrees.

Under an end-justifies-the-means regime, an insurer can deny claims with near impunity, safe in the knowledge that it faces no liability — irrespective of the manner in which it handles a claim — so long as it eventually seizes on a viable basis for denying the claim.

Consider a situation in which an insurer initially denies a claim based on Exclusion A, and in the ensuing coverage litigation, the policyholder establishes that Exclusion A is inapplicable. However, if, during the course of discovery in that litigation, the insurer subsequently stumbles upon a separate basis for denying the claim with which the court agrees, then — under the end-justifies-the-means rule — the insurer would skate free from both coverage and bad faith liability.

In the absence of a self-standing, unconditional claim for bad faith, the policyholder's successful thwarting of the insurer's invocation of Exclusion A yields nothing more than a Pyrrhic victory — it has endured the time, trouble and expense of proving the inapplicability of the exclusion on which the insurer initially denied the claim, yet the policyholder has nothing to show for it — other than, perhaps, a precedent that may be useful to other policyholders whose claims have been denied on the basis of an identical exclusion.

Conversely, if the policyholder is allowed the opportunity to recoup its investment — via a claim for consequential damages in the form of attorney fees and costs, for example — based on the manner in which its insurer handled the claim, then while it nevertheless may be without coverage for the claim, it may avoid being penalized for having successfully challenged the insurer's improper invocation of Exclusion A as the initial basis for denying the claim.

The Pennsylvania rule also promotes judicial efficiency.

Under an end-justifies-the-means rule, there is little downside — and, in fact, there may be an incentive — for an insurer to engage in a fishing expedition via discovery to conjure alternative bases for denying a claim where the original basis of its claim denial is suspect or vulnerable, or otherwise indicative of bad faith claims handling. Both parties will absorb the additional costs associated with such an effort.

However, if the insurer's efforts are rewarded with an alternative basis for denying a claim when its original denial was improper, then it will have realized a benefit from its investment in the form of a no-coverage finding.

For the policyholder lacking a bad faith claim, however, its only so-called reward is the additional cost, time and effort associated with the insurer's discovery. That would not necessarily be the case if the policyholder had the ability to recoup its costs even in the face of a no-coverage finding.

And, depending on the size of the claim at issue, the insurer might think twice about expansive discovery if it faces the prospect of reimbursing the policyholder for its fees and related costs associated with discovery and litigation of alternative bases for denial, even if one of those

alternatives proves dispositive of the claim.

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[1] Walker v. Foremost Ins. Co. Grand Rapids , No. 20-4966, 2022 U.S.Dist. LEXIS 36390 at *1, *17 (E.D. Pa. Mar. 2, 2022).

[2] See, e.g., Republic Ins. Co. v. Stoker , 903 S.W.2d 338, 341 (Tex. 1995) ("As a general rule there can be no claim for bad faith when an insurer has promptly denied a claim that is in fact not covered."); Lister v. Bankers Life & Cas. Co. , 218 F. Supp. 2d 49, 52 (D.N.H. 2002) ("Logic dictates that if an insured is not entitled to the coverage in dispute, then the insured cannot maintain an action for breach of contract—in bad faith or otherwise—for failure to provide said coverage."); Allstate Ins. Co. v. Saladhutdin , 815 F. Supp. 1309, 1313 (N.D. Cal. 1992) ("[I]t appears that courts which have found that coverage does not exist under an insurance policy have uniformly rejected the insureds' claims of bad faith.").

[3] See, e.g., Frog, Switch & Mfg. Co. v. Travelers Ins. Co. , 193 F.3d 742, 750-51 n.9 (3d Cir. 1999) (applying Pennsylvania law and recognizing that "bad faith claims cannot survive a determination that there [is] no duty to defend" where the insurer has "good cause to refuse to defend.").

[4] Wolfe v. Allstate Prop. & Cas. Ins. Co. , 790 F.3d 487, 499 n.10 (3d Cir. 2015) (applying Pennsylvania law).

[5] See March v. Paradise Mut. Ins. Co. , 646 A.2d 1254, 1256 (Pa. Super. Ct. 1994).

[6] Id.; see also Wolfe, 790 F.3d at 499 n.10.

[7] Nealy v. State Farm. Mut. Auto. Ins. Co. , 695 A.2d 790, 793 (Pa. Super. Ct. 1997); Polselli v. Nationwide Mut. Fire Ins. Co. , 126 F.3d 524 (3d Cir. 1997) (quoting same). See also Nealy, 695 A.2d at 793 ("[I]t is therefore settled law that an insured may pursue a bad faith claim upon [Pennsylvania's bad faith statute] without regard to the status of a parallel contractual claim.").

[8] See, e.g., Coventry v. American States Ins. Co. , 961 P.2d 933, 937 (Wash. 1998) ("[A]n insured may maintain an action against its insurer for bad faith investigation of the insured's claim … regardless of whether the insurer was ultimately correct in determining coverage did not exist. An insurer's duty of good faith is separate from its duty to indemnify if coverage exists."); Ahrenholtz v. Time Ins. Co. , 968 P.2d 946, 951 (Wyo. 1998) ("While an insured may state claims for breach of contract and breach of the duty of good faith and fair dealing, the insured does not need to prevail on the contract claim to pursue the claim for bad faith."); Best Place v. Penn Am. Ins. Co. , 920 P.2d 334, 336 (Haw. 1996) ("The implied covenant [of good faith and fair dealing] is breached, whether the carrier pays the claim or not, when its conduct damages the very protection or security which the insured sought to gain by buying insurance.").
