FREQUENTLY ASKED QUESTIONS CONCERNING ALABAMA LAW ON BAD FAITH FAILURE TO PAY AN INSURANCE CLAIM

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1. Introduction.

The Alabama tort of bad faith was first recognized as "an extreme remedy that finds its application in extreme circumstances within the restricted parameter of an unexcused failure to pay benefits." *Waldon v. Cotton States Mut. Ins. Co.*, 481 So.2d 340, 341 (Ala. 1985). Since shortly after the tort was first recognized, however, almost every action alleging a breach of an insurance contract has been accompanied by a bad faith claim. From the beginning, Alabama bad faith law has had a relatively high standard for liability, requiring a showing that the insurer lacked a legitimate debatable reason for failing to pay the claim, coupled with actual knowledge of that fact. There has been, however, some confusion among the courts as to the application of this standard, making it difficult for lawyers to evaluate whether a bad faith claim will be submitted to the jury.

The following frequently asked questions will examine several common issues concerning the Alabama tort of bad faith.

2. Who can assert a viable bad faith failure to pay claim under Alabama law?

Alabama law recognizes the tort of bad faith only in the context of a claim by an insured against an insurer based on the existence of an insurance contract between those two parties. The Alabama Supreme Court has consistently refused to recognize a claim for bad faith breach of contract outside of the context of a breach of an insurance contract and a failure to pay insurance benefits. *See, e.g., Gaylord v. Lawler Mobile Homes, Inc.*, 477 So.2d 382 (Ala. 1985); *Lake Martin/Ala. Power Licensee Ass'n v. Ala. Power Co.*, 601 So.2d 942 (Ala. 1992). Alabama law is also clear that there cannot be a bad faith claim against parties other than the actual insurer under the contract. Thus, an insured cannot bring a viable bad faith claim against an adjuster, claim administrator, or agent. *Ligon Furniture Co. v. O.M. Hughes Ins., Inc.*, 551 So.2d 283, 285 (Ala. 1989) (the trial court properly entered summary judgment on plaintiff's bad faith claim against the company assigned the job of adjusting plaintiff's claim because the evidence showed that plaintiff had no insurance contract with the adjusting firm on which to base a claim of bad faith). Similarly, non-parties to the insurance contract, such as individuals with a covered claim against the insured, cannot bring a bad faith action because they cannot prove the requisite insurance contract between the third-party and the insurer. *Dickey v. Ala. Farm Bureau Mut. Cas. Ins. Co.*, 447 So.2d 693, 694 (Ala. 1984).

3. What are the basic elements of a bad faith claim?

In *National Security Fire & Casualty Co. v. Bowen*, 417 So.2d 179, 183 (Ala. 1982), the Alabama Supreme Court summarized the basic elements of a bad faith claim, which remain applicable today, holding as follows:

> [T]he plaintiff in a "bad faith refusal" case has the burden of proving:
>
> > (a) an insurance contract between the parties and a breach thereof by the defendant;

> (b) an intentional refusal to pay the insured's claim;
>
> (c) the absence of any reasonably legitimate or arguable reason for that refusal (the absence of a debatable reason);
>
> (d) the insurer's actual knowledge of the absence of any legitimate or arguable reason;
>
> (e) if the intentional failure to determine the existence of a lawful basis is relied upon, the plaintiff must prove the insurer's intentional failure to determine whether there is a legitimate or arguable reason to refuse to pay the claim.

Id. at 183.

4. What standard does Alabama law apply to determine whether a claim for bad faith should be submitted to a jury?

In applying the above-referenced standard requiring the absence of any reasonably legitimate or arguable reason for refusal to pay, the Alabama Supreme Court developed the "directed verdict on the contract test," which provides that, in order to survive a motion for summary judgment or a judgment as a matter of law and reach the jury, the plaintiff must show that the plaintiff is entitled to a directed verdict on the contract claim since any fact issue that would give rise to a jury question on the contract claim would provide an arguable reason for denying the claim. *Nat'l Sav. Life Ins. Co. v. Dutton*, 419 So.2d 1357, 1362 (Ala. 1982). Following the development of the directed verdict test, the Alabama Supreme Court recognized that there could be exceptions to the above directed verdict test. In *State Farm Fire & Casualty Co. v. Slade*, 747 So.2d 293 (Ala. 1999), the Alabama Supreme Court outlined the exceptions to the directed verdict test that have been recognized in Alabama as the "abnormal case," describing the exceptions as those instances in which the plaintiff produced substantial evidence showing that the insurer:

> (1) intentionally or recklessly failed to investigate the plaintiff's claim; (2) intentionally or recklessly failed to properly subject the plaintiff's claim to cognitive evaluation or review; (3) created its own debatable reason for denying the plaintiff's claim; or (4) relied on an ambiguous portion of the policy as a lawful basis to deny plaintiff's claim.

Id. at 303. When those exceptions are applicable, a bad faith claim can survive a motion for summary judgment or a judgment as a matter of law, even if the plaintiff is not entitled to a directed verdict on the contract claim.

5. Does a plaintiff insured have to show that the insurer breached the insurance contract in order to recover from bad faith?

While some states have allowed an insured to recover for bad faith without proving breach of the insurance contract, Alabama law clearly requires that the insured demonstrate that the insurer breached the insurance contract by failing to provide coverage as a prerequisite to successfully maintaining a bad faith claim. *State Farm Fire & Casualty Co. v. Slade*, 747 So.2d 293, 318 (Ala. 1999).

6. What information should be considered when evaluating whether there is sufficient evidence of bad faith?

The question of whether the insurer had a reasonable basis for denying the claim under the policy must be evaluated based on the information that it had at the time of the decision to deny the claim. *Aetna Life Ins. Co. v. Lavoie*, 505 So.2d 1050, 1053 (Ala. 1987). While information that became available after the denial decision was made may be relevant to the contract issue, it is not relevant to the bad faith claim.

7. What is the statute of limitations for a bad faith claim under Alabama law?

Under Alabama law, the statute of limitations for bad faith claims is two years from the date of accrual. *Jones v. Alfa Mut. Ins. Co.*, 1 So.3d 23, 30 (Ala. 2008). The Alabama Supreme Court has deemed the tort of bad faith to be "a species of fraud," and has held that a cause of action for bad faith accrues upon the event of the bad faith refusal or upon the knowledge of facts which would lead the insured to a discovery of the bad faith refusal, whichever is later. *Id*.

8. Does Alabama recognize a cause of action for negligent claim handling?

Alabama law is clear that a claim will not lie for negligent claim handling because negligence is insufficient to support a bad faith claim. *Singleton v. State Farm Fire & Cas. Co.*, 928 So.2d 280, 286 (Ala. 2005) (claim handling imperfections cited by the plaintiffs amount to, at most, negligence, which is insufficient to support a bad faith claim).

9. Does the Alabama tort of bad faith require showing of intent?

In recognizing the tort of bad faith, the Alabama Supreme Court held that the requirement that the insurer have actual knowledge of the absence of the debatable reason implies a conscious wrongdoing, such that bad faith is not simply bad judgment or negligence, but rather "imports a dishonest purpose and means a breach of a known duty, i.e. good faith and fair dealing, through some motive of self interest or ill will." *Gulf Atl. Life Ins. Co. v. Barnes*, 405 So.2d 916, 924 (Ala. 1981). Following the Alabama Supreme Court's opinion in *Slade* referenced above, the United States Court of Appeals for the Eleventh Circuit (which includes Alabama) held that there was no requirement of intent under Alabama law when a plaintiff established a "reckless" failure to investigate on the part of the insured. *Mut. Serv. Cas. Inc. Co. v. Henderson*, 368 F.3d 1309, 1316 (11th Cir. 2004). After *Henderson*, however, the Alabama Supreme Court has reemphasized the requirement cited above from *Barnes* in *Singleton v. State Farm Fire &*

Casualty Co., 928 So.2d 280 (Ala. 2005). In *Singleton*, the Alabama Supreme Court affirmed the trial judge's entry of summary judgment on plaintiff's bad faith claim, recognizing that plaintiffs "ha[d] failed to adduce sufficient evidence of 'dishonest purpose' or breach of known duty, i.e. good faith and fair dealing, through some motive of self interest or ill will." *Singleton*, 928 So. 2d at 287 (quoting *Slade*, 747 So.2d at 303-304).

10. Can an insured still recover for bad faith failure to investigate when the insurer demonstrates that it has a legitimate arguable reason for denying the claim?

There has been some argument, primarily based on the Eleventh Circuit Court of Appeals' opinion in *Mutual Service Casualty Incorporated Co. v. Henderson*, 368 F.3d 1309 (11th Cir. 2004), that an insured may succeed on a claim for bad faith failure to investigate, even when the insurer presents a legitimate arguable reason for denying the claim. *Id.* at 1314-1315. The *Henderson* opinion held that the Alabama Supreme Court had moved away from its holding in a previous case that "regardless of the imperfections of [insurer's] investigation, the existence of a debatable reason for denying the claim at the time that the claim was denied defeats a bad faith failure to pay claim." *Id.* (citing *Weaver v. Allstate Ins. Co.*, 574 So. 2d 771, 774 (Ala. 1990)). In making this argument, the *Henderson* opinion misconstrues the two cases upon which it relies, including the Alabama Supreme Court's opinion in *Slade* and in *Employees Benefit Association v. Grissett*, 732 So.2d 968, 975 (Ala. 1998), neither of which found that there was a legitimate arguable reason to deny the claims in those cases. In fact, Alabama case law is clear that the existence of a legitimate arguable basis for denying a claim at the time of the denial precludes a finding of bad faith – either normal or abnormal – as a matter of law. There has never been an Alabama Supreme Court case to the contrary.

Moreover, the "debatable reason" rule is consistent with the fundamental elements of the tort of bad faith on which the bad faith failure to investigate theory is based. The question of whether a bad faith claim was properly investigated and whether the results of the investigation were subject to cognitive evaluation or review has always been the test for deciding whether there was an intentional failure to determine whether there was any lawful basis for denying the claim. *Gulf Atl. Life Ins. Co. v. Barnes*, 405 So.2d 916, 924 (Ala. 1981). It is self-evident that, if there was a known lawful basis for the denial of a claim, there could not possibly have been an intentional failure to determine whether there was a lawful basis for the claim denial. The Alabama Supreme Court's holding from *Barnes* - that the insurer cannot be liable for bad faith if a legitimate or arguable reason for failing to pay the claim actually exists - remains good law. *Id.* at 916.

11. What damages are recoverable for bad faith under Alabama law?

If the jury finds for the insured on the bad faith claim, Alabama law allows the jury to award damages for mental anguish and punitive damages, in addition to the insurance benefits available under the contract. Alabama law does not have any objective guidelines or restrictions on mental anguish damages. Under Alabama law, punitive damages are limited by statute to three times compensatory damages, including mental anguish damages, or $500,000.00, whichever is greater. Ala. Code § 6-11-21(a).

12. Does the Employee Retirement Income Security Act ("ERISA") preempt a claim for bad faith where ERISA is applicable?

Particularly when evaluating a bad faith claim in the life, health, and disability context, insurers and their lawyers should be aware that the Employee Retirement Income Security Act ("ERISA") preempts a claim for bad faith where ERISA is applicable. *Gilbert v. Alta Health & Life Ins. Co.*, 276 F.3d 1292 (11th Cir. 2001); *Walker v. So. Co. Serv., Inc.*, 279 F.3d 1289 (11th Cir. 2002). Insurers and lawyers evaluating these claims need to make sure that they aggressively evaluate whether ERISA may apply, even when its application is not obvious on the face of the complaint.

13. Does Alabama recognize contributory bad faith?

In *White v. State Farm Fire & Casualty Co.*, 953 So.2d 340, 351 (Ala. 2006), the Alabama Supreme Court raised the issue of whether Alabama should recognize "contributory bad faith" on the part of an insured as a defense to the insured's bad faith claim, but did not decide that issue. *Id.* at 351. Given the reference in *White*, counsel should make the contributory bad faith argument on behalf of insurers whenever it is appropriate and potentially applicable, and should make sure that they preserve that issue throughout the case.