Insurance Bad Faith and Punitive Damages After Sloan v. State Farm

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Introduction

Recently the New Mexico Supreme Court clarified when an instruction on punitive damages must be given in an insurance bad faith case. In so doing, the court resolved a conflict between the New Mexico Court of Appeals and the Tenth Circuit. The case, Sloan v. State Farm Mutual Automobile Association, recognized that proof of "bad faith" in an insurance context ordinarily supplies the culpable mental state necessary to sustain an award of punitive damages. The court's analysis is noteworthy for the effort to clarify the standards for both first and third party bad faith. Finally, the court rewrote UJI Civil 13-1718 to comport with its decision.

The Sloan issue arose when the New Mexico Court of Appeals in Teague-Strebeck Motors, Inc. v. Chrysler Insurance Co., concluded from its reading of Paiz v. State Farm Fire & Casualty Co. and Allsup's Convenience Stores, Inc. v. North River Insurance Company, that there was a "real distinction" between the "bad faith" sufficient to prove a simple breach of the implied covenant of good faith and fair dealing for an award of compensatory damages and the "bad faith" sufficient to sustain an award of punitive damages. Therefore, the court of appeals concluded, in order to recover punitive damages the insured must demonstrate some culpable mental state in addition to the "bad faith" necessary to establish the underlying claim. The court of appeals also indicated that the existing Uniform Jury Instruction on bad faith and punitive damages was not an accurate statement of the law and should be reconsidered. The Tenth Circuit Court of Appeals, however, flatly rejected the Teague-Strebeck analysis, thus creating a conflict between jurisdictions.

This article analyzes Sloan by examining three interrelated topics. First, Sloan is placed in context of the historical development of "bad faith" insurance law in New Mexico. Second, the circumstances in which the Sloan issue arose are
examined and the Supreme Court’s resolution of the issue is discussed. Third, 
Sloan is mined for some additional observations that may be of benefit for future bad faith cases.

**Insurance Bad Faith**

The New Mexico common law has long recognized that there is a characteristic of mind that accompanies the failure to act in good faith that may provide the basis for an award of punitive damages. From a conceptual vantage, bad faith imports an element of *scienter* because it implies a conscious choice, that is a decision not to act in good faith. Bad faith, although rarely defined, is often conjoined with other types of conduct that suggest culpable states of mind – fraud, willfulness or malice, wrongful and intentional, improper purpose, arbitrary acts, a gross abuse of discretion, or treachery. Bad faith has also been associated with other states of mind that do not include a specific intent to harm, but rather fall into a lesser category such as gross negligence, reckless conduct, breach of fiduciary duty. There is also recognition in the law that bad faith may take place on a continuum and fall between mere negligence and a specific intent to harm. The common law therefore classifies bad faith with other types of wrongful conduct that support an award of punitive damages. The long-standing Uniform Jury Instruction on punitive damages embodies the common law.

Bad faith has developed a more specialized meaning in the insurance context, but it remains grounded in conduct that demonstrates a state of mind beyond that of mere stupidity. The descriptor "insurance bad faith" is judicial short hand for a claim arising from breach of the implied covenant of good faith and fair dealing. There is implied into every contract of insurance a covenant of good faith and fair dealing. First recognized in *Lujan v. Gonzales*, the implied covenant of good faith and fair dealing is the basis for the insurer’s common law duty to treat its insured fairly. The breach of the insurer’s implied promise to act fairly is the basis for the “bad faith” claim.

If, as the saying goes, there is a thin line between love and hate, there is an equally fine line between good faith and bad faith. The court of appeals in *Lujan* recognized the difficulty in parsing the concept of bad faith and, significantly, chose to define “bad faith” in reverse, that is by giving form and content to what constitutes good faith. “What is good faith? We do not attempt to give a complete definition because of the variety of situations held to involve a question of good faith.” The court of appeals offered some guidance which remains a good measure of bad faith and a useful analytic starting place.

We use the term "good faith" in this case to mean an insurer cannot be partial to its own interests, but must give its interests and the interests of its insured equal consideration.

* * *

To fulfill the duty of giving equal consideration to the interests of the insured and the insurer there must be a fair balancing of these interests.

The concept of impartiality and fair balancing of interests remains at the heart of New Mexico’s law of insurance bad faith.

There are two basic types of insurance bad faith cases. The first type is a direct action between an insured and his insurer. This is commonly referred to as a "first party action." The second type of insurance bad faith case usually involves the situation where a third party has brought suit against the insured and the insurer either refuses to provide a defense asserting that the claims fall outside of coverage or accepts the defense and fails to pay a policy limit demand where warranted. In either case, the insured is harmed by the risk of exposure to a judgment in excess of the policy limits, and the third party is affected by the expense of litigating a claim that should have been paid. In the ordinary case, in order for the injured third party to assert a claim against the insurer, the insured must assign his bad faith cause of action against the insurer to the third party, which then allows the third party to pursue recovery for an excess judgment against the insurer, or the insured may pursue the "third party" bad faith claim in exchange for an agreement by the third party not to execute on the judgment until the bad faith action is concluded. This second type of bad faith cause is referred to as a "third party action."

The distinction between the circumstances giving rise to a first or third party claim has resulted in slightly different tests to determine bad faith. New Mexico adheres to a broad definition of bad faith in first party cases, described as a "frivolous or unfounded refusal" to pay a compensable claim. The reason that a "frivolous and unfounded refusal" to pay constitutes bad faith is because "unfounded" in this context means a "reckless disregard" or an "utter failure" to exercise care for the insured’s interests. The implied covenant protects against the insurer’s bad faith -- i.e. "wrongful and intentional affronts to the other party’s rights, or a least affronts where the breaching party is consciously aware of, and proceeds with deliberate disregard for, the potential harm to the other party. Thus, proof of the breach of the implied covenant, or "bad faith," establishes the kind of conduct that
has traditionally been sufficient to allow an award of punitive damages.

In a third party claim, the implied covenant of good faith requires that an insurer give the interests of its insured consideration equal to its own when evaluating a settlement offer within policy limits. Good faith does impose upon the insurer the duty to settle whenever practicable. Although an insurer's evaluation of the costs and benefits of settlement is generally accorded some deference, that "judicial deference lessens whenever there is a substantial likelihood of a recovery that exceeds policy limits." The potential for an excess verdict places the insurer in an "inherent conflict of interest" with its insured and, under such circumstances, the insurer "should place itself in the shoes of the insured and 'conduct itself as though it alone were liable for the entire amount of the judgment." Ultimately it is the insurer's decision or not to exercise "honest judgment [and] acting on adequate information after competent investigation of the claim" that determines whether the insurer has acted in bad faith. The failure to exercise honest judgment would be dishonest, a circumstance that suggests a state of mind that would, given the historical definitions of bad faith, sustain an award of punitive damages.

This body of law seemed well-established until the court of appeals' decision in Teague-Strebeck Motors v. Chrysler Insurance Co. In a short opinion on a motion for reconsideration, the court of appeals determined that there were two tiers of "bad faith." The court held that there was innocent "bad faith" that allowed for a recovery of compensatory damages and a second tier of "bad faith" evidencing a culpable mental state sufficient to sustain an award of punitive damages. The court of appeals also indicated that the existing Uniform Jury Instruction on bad faith and punitive damages was no longer an accurate statement of the law and should be reconsidered. The court of appeals based its decision on its reading of two important bad faith decisions by the New Mexico Supreme Court -- Allsup's Convenience Stores, Inc. v. North River Insurance Company, and Paiz v. State Fire & Casualty Co.

At least one federal district court and the Tenth Circuit flatly rejected the Teague-Strebeck analysis. In the City of Hobbs v. Hartford Insurance Co., the federal district court closely examined and rejected the court of appeals' analysis, concluding instead that the existing jury instruction on punitive damages in a bad faith case retained its vitality.

The Uniform Jury Instruction on the bad faith punitive damages UJI Civil 13-1718 (NMRA 2004) provides in pertinent part that:

If you find that plaintiff should recover compensatory damages for the bad faith actions of the insurance company, then you may award punitive damages.

The directions for use of UJI Civil 13-1718 require that it be given in every action in which the jury is also instructed on the bad faith claim, because as noted in the Committee Comment "bad faith supports punitive damages upon a finding of entitlement to compensatory damages." The Teague-Strebeck court stated that the directions for use for UJI 13-1718 were, after Paiz and Allsup's, suspect to the extent that they required giving the instruction on punitive damages just based on a showing of a bad faith insurance practice without the addition of some extra culpable mental state. The court of appeals held that "there is a real distinction between 'bad faith' sufficient to support an award of compensatory damages and 'bad faith' meriting exemplary damages. In appropriate circumstances 'bad faith' may include a culpable mental state, but it is not necessarily so." The Tenth Circuit was just as clear that some culpable mental state in addition to "bad faith" was not necessary to sustain and award of punitive damages. Basically, the Tenth Circuit accepted the district court's analysis of New Mexico law, which it applied in denying the post-trial motions. The Tenth Circuit held that the directions for use for UJI 13-1718 remained a correct statement of New Mexico law because the New Mexico Supreme Court has never held them to be invalid. The Tenth Circuit also found persuasive the fact that the supreme court had reissued the directions for use in the general instruction on punitive damages, UJI 13-1827, subsequent to its decision in Paiz v. State Farm Fire & Casualty Co., that cross-referenced UJI 13-1718 and therefore, the court concluded, reaffirmed that 13-1718 was a proper instruction for bad faith cases. The Tenth Circuit's affirmation of the district court on this specific point thus created a clear conflict between the Tenth Circuit's and the court of appeals' reading of New Mexico law.

The Sloan Issue -- Bad Faith Plus

The Tenth Circuit, recognizing the conflict, certified the issue to the New Mexico Supreme Court when the opportunity presented itself in the form of Sloan v. State Farm Mutual Automobile Insurance Co. The question certified was:

Is an instruction for punitive damages required in every insurance bad faith case in which the plaintiff has produced evidence supporting compensatory damages as suggested by UJI 13-1718 NMRA 2003, or is the New Mexico Court of Appeals correct that subsequent New Mexico Supreme Court authority requires a culpable mental state beyond bad faith for imposition of punitive damages in insurance bad faith cases? Teague-Strebeck Motors, Inc. v. Chrysler Ins. Co., [1999 NMCA 109, PP76-90, 27 N.M. 603, 985 P.2d 1183].

Sloan was a third party "failure to
The simple holding was that in the typical insurance bad faith case, evidence sufficient to sustain the claim for compensatory damages ordinarily will at least create a question of fact for the jury on the claim of punitive damages.

The bad faith case was tried to a jury. The jury found that State Farm had acted in bad faith and awarded damages. The district court refused to instruct the jury on punitive damages, however, granting defendant a judgment on the issue as a matter of law. The plaintiffs argued that the New Mexico jury instructions, specifically the Committee Comment to 13-1718, required an instruction on punitive damages when the evidence is sufficient to instruct on the bad faith failure to settle claim thus squarely raising the issue in conflict on appeal. This was the posture of the case when the Tenth Circuit certified the issue.

The New Mexico Supreme Court began its analysis by first clarifying the distinction between first and third party bad faith cases. The court characterized a first party case as the "failure-to-pay case (those arising from a breach of the insurer’s duty to timely investigate, evaluate, or pay an insured’s claim in good faith) and the third party claim or failure-to-settle cases (those involving breach of the insurer’s duty to settle a third-party claim against the insured in good faith)." The court then reaffirmed the position that the imposition of punitive damages requires evidence of some "culpable mental state." In a departure from the analysis of the court of appeals in Teague-Strebeck, however, the court determined that "bad faith conduct by an insurer typically involves a culpable mental state." Rather than adopt a per se rule, as suggested by the Committee Comment to UJI Civil 13-1718, the court specifically invested the trial court with "the discretion to withhold a punitive damages instruction in those rare instances in which the plaintiff has failed to advance any evidence to support an award of punitive damages." Thus, the simple holding was that in the typical insurance bad faith case, evidence sufficient to sustain the claim for compensatory damages ordinarily, though not invariably, will at least create a question of fact for the jury on the claim of punitive damages.

The court based its ruling in part on the following language from Allsup’s Convenience Stores, Inc. v. North River Insurance Co.: "[W]hile bad faith and unreasonableness are not always the same thing, there is a certain point, determined by the jury, where unreasonableness becomes bad faith and punitive damages may be awarded." The "complex factual determinations surrounding the insurer’s conduct and corresponding motives," will ordinarily require the jury to sort out whether the evidence establishes a culpable mental state. "As a general proposition, therefore, once a plaintiff has made a prima facie showing sufficient to submit his or her bad faith claim to the jury, the determination whether the insurer’s bad-faith conduct is deserving of punitive damages is for the jury to decide."

What showing is required? The court concluded that in a first party failure to pay claim, the failure or refusal to pay has to be frivolous or unfounded, which the court determined was the practical equivalent of reckless disregard, a mental state traditionally sufficient to award punitive damages. For a third party failure to settle claim, the plaintiff must establish that the failure to pay was the result of a "dishonest judgment," which the court defined as "a failure by the insurer to honestly and fairly balance its own interests and the interests of the insured."

Wait a minute. This sounds very much like the evidence that is required to establish the prima facie case for insurance bad faith, to reach the threshold for compensatory damages. And it is.

The court reasoned that frivolous and unfounded refusal to pay is the equivalent of "reckless disregard for the interests of the insured and that a dishonest balancing of interests is no less reprehensible than reckless disregard." "Reckless disregard" is a culpable mental state that historically had justified an award of punitive damages. Indeed, it was the Sloan court’s recognition that "bad faith" in the insurance context has a definitional basis which imports a culpable mental state that formed the heart of its analysis.

This recognition led the court to conclude that whether "the bad faith evinced by a particular defendant warrants punitive damages is ordinarily a question for the jury to resolve." The court therefore overruled Teague-Strebeck to the extent that it would require an additional culpable mental state in "every insurance bad faith case." The court departed, however, from the Committee Comment to 13-1718 and what it referred to as the "per se Jessen rule," which required that the jury be instructed on punitive
Perhaps the most salient feature of the decision is the supreme court’s discussion of the “continuum” on which conduct evidencing bad faith may occur.

In order to assure that the jury is given the proper instruction on punitive damages in an insurance bad faith context, the court modified UJI Civil 13-1718 to read as follows:

If you find that plaintiff should recover compensatory damages for the bad faith actions of the insurance company, and you find that the conduct of the insurance company was in reckless disregard for the interests of the plaintiff, or was based on a dishonest judgment, or was otherwise malicious, willful, or wanton, then you may award punitive damages. 76

The court further refined its rewriting of 13-1718 by requiring that the instruction include the definition of “dishonest judgment” as “a failure by the insurer to honestly and fairly balance its own interests and the interests of the insured.” 77

Following the supreme court’s decision, the Tenth Circuit reversed and remanded for a new trial. 78

Other Points from Sloan

Perhaps the most salient feature of the decision is the supreme court’s discussion of the “continuum” on which conduct evidencing bad faith may occur. 79 This concept that unreasonable conduct occurs along a continuum and that there is some point at which negligent or unreasonable conduct reaches a higher state of culpability was found by the court to be inherent in the Uniform Jury Instructions 80 that set forth the basic elements of first and third party bad faith cases and to have been articulated in the Allsup’s case. 76 The court concluded that because the degree of unreasonableness will ordinarily be a question of fact, the usual bad faith case will require that the question of punitive damages be submitted to the jury where the plaintiff has made out a prima facie case for compensatory damages. 79

The court, while acknowledging that New Mexico has thus far refused to find a cause of action for the negligent failure to settle, nevertheless determined that evidence of negligence or unreasonable conduct “provides one possible means of demonstrating that an insurer has acted in bad faith.” 81

Significantly, the court recognized that the touchstone for a bad faith failure to settle cause of action is the insurer’s failure to exercise an honest judgment in treating the interests of its insured equal to its own. 81 The court found that there may be circumstances in which an insurer has in fact conducted a competent and timely investigation of a claim, but nevertheless has failed to exercise an honest judgment and thereby become liable for both compensatory and punitive damages. 82 The court appropriately noted that in those circumstances the insurer’s conduct may be fairly regarded as more reprehensible than in the case where the investigation of the claim was simply incompetent. 83

What, then, is the import of the court’s discussion of a continuum of reasonable or unreasonable conduct? First, as noted above, the question is a factual one requiring submission of punitive damages instructions to the jury in all but the unusual case. 84 Second, unreasonable conduct in the investigation and evaluation of a claim may very well establish a prima facie case of bad faith failure to settle, particularly when the unreasonable conduct demonstrates a failure on the part of the insurer to give equal consideration to the interest of the insured. Third, Sloan opens the door for a reconsideration of the court’s holding in Ambassador Insurance Co. v. St. Paul Fire & Marine that the negligent failure to settle is not a cause of action in and of itself. 85
state, or his or her intentional use of the contract to the detriment of another party is wrongful, constitutes bad faith, and clearly is a breach of the implied covenant of good faith and fair dealing.


- Lujan v. Gonzales, 1997-NMSC-032, 127 N.M. 752, 965 P.2d 601 (1998) ("[A]rbitrarily" is synonymous with bad faith or failure to exercise honest judgment and an arbitrary act is one performed without a legitimate determination derived from a breach of the implied covenant of good faith and fair dealing thereof)."

- In the insurance context, the duty of good faith is a concept separate from negligence, and is a concept with its insured is an implied covenant in the insurance contract or a fraud. The mere failure to make an adequate determination of principle or fact is insufficient to demonstrate bad faith. "There must be actual knowledge or bad faith. Bad faith may be shown by a wilful disregard of and refusal to learn the facts as available and at hand."


- 288 P.2d 691, 693 (1955) (Ct. of Appeals). "A duty of good faith can be derived from the principle of equal protection of the laws."

- Toward a uniform Law of Evidence."

- "We do hold that such a duty exists. Also, the duty of good faith is a concept separate from negligence. And ii is a concept with its insured is an implied covenant in the insurance contract or a fraud."

- "In a very helpful discussion the supreme court examined the difference between first and third party bad faith cases. This discussion is particularly useful because historically New Mexico appellate courts have been somewhat lax in their recognition of this important distinction and have repeatedly blurred the lines between these two distinct species of bad faith."

- "See also Lujan v. Gonzales, 84 N.M. at 229-30, 501 P.2d at 679; State Farm Fire & Casualty Co., 1997-NMSC-032, 127 N.M. at 203-11, 965 P.2d at 301-303."

- "In the insurance context, the duty of good faith is a concept separate from negligence, and is a concept with its insured is an implied covenant in the insurance contract or a fraud."

- "It is a concept separate from fraud."