EXAMINING THE "SPECIAL RELATIONSHIP" AND AN INSURER'S DUTY OF GOOD FAITH AND FAIR DEALING IN INDIANA

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Indiana has long recognized an implied duty for an insurer to deal in good faith with its insured.[1] This duty arises from the unique relationship between an insurance company and the insured individual or entity, which can take many forms and sometimes places the interests of the parties at odds. An insurer's breach of its "duty of good faith and fair dealing" gives rise to a distinct tort claim, secondary to any underlying action for breach of the insurance contract.[2]

The teeth of a tort claim for insurance bad faith lies in the potential for an award of punitive damages, a remedy ordinarily unavailable in breach-of-contract claims. "To recover punitive damages in a lawsuit founded upon a breach of contract, the plaintiff must plead and prove the existence of an independent tort of the kind for which Indiana law recognizes that punitive damages may be awarded."[3] Bad faith provides such a tort.

> Indiana law developed a rule which permitted an insured, under certain circumstances, to seek punitive damages in an action for the breach of an insurance contract. Although our holding in *Best Beers* prohibits such a recovery in a breach of contract action, the recognition of an independent tort for the breach of the insurer's

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1 Erie Ins. Co. v. Hickman, 622 N.E.2d 515, 518 (Ind. 1993) ("Indiana law has long recognized that there is a legal duty implied in all insurance contracts that the insurer deal in good faith with its insured."). *See also* Vernon Fire & Cas. Ins. Co. v. Sharp, 349 N.E.2d 173 (Ind. 1976).

2 In Indiana, the "bad faith" tort exists only at common law, with the limited exclusion of worker's compensation. *See* IND. CODE § 22-3-4-12 ("whenever the worker's compensation board shall determine upon hearing of a claim that the employer has acted in bad faith in adjusting and settling said award, or whenever the worker's compensation board shall determine upon hearing of a claim that the employer has not pursued the settlement of said claim with diligence, then the board shall, if compensation be awarded, fix the amount of the claimant's attorney's fees and such attorney fees shall be paid to the attorney and shall not be charged against the award to the claimant"). Although Indiana Code § 27-4-1-4.5 establishes certain unfair claim settlement practices, it does not provide insureds with a private cause of action for bad faith.

3 *Hickman*, 622 N.E.2d at 517 (citing Miller Brewing Co. v. Best Beers of Bloomington, Inc., 608 N.E.2d 975 (Ind. 1993)). "Tort obligations do not arise from a contractual agreement, but from the force of law." *Id.*

> obligation to exercise good faith provides the tort upon which punitive damages may be based.[4]

The determination of whether a breach of an insurer's duty of good faith and fair dealing constitutes a separate tort involves a balancing of three factors: (1) the relationship between the parties; (2) the reasonable foreseeability of harm to the person injured; and (3) public policy concerns.[5] The plaintiff in a successful action for breach of the duty of good faith and fair dealing can recover damages under the contract, consequential damages beyond the policy limits,[6] and in certain circumstances, punitive damages in an amount up to three times compensatory damages or $50,000, whichever is greater.[7] Indiana further allows for an award of attorneys' fees and costs in the court's discretion where a party has litigated an action in bad faith.[8] "Nonetheless, in most instances, tort damages for the breach of duty to exercise good faith will likely be coterminous with those recoverable in a breach of contract action."[9] That is to say, bad faith actions do not necessarily generate actual tort *damages* other than those amounts contractually recoverable under the insurance policy.

Not every insuring relationship will give rise to a duty of good faith and fair dealing. Furthermore, not every breach of the duty of good faith will support an award of punitive damages against the insurer. This article explores the boundaries of an insurer's duty of good faith, the various relationships that can give rise to such a duty, and some of Indiana's limitations on bad faith claims.

I. "SPECIAL RELATIONSHIP" AS BASIS FOR A TORT DUTY

The imposition of a noncontractual, nonstatutory tort duty upon insurers arises from the special relationship that exists in the context of an insurance policy. Contracts come in a variety of flavors, ranging from an apartment lease to a contract to play major league baseball. In general, contracts provide certainty as to the role of each party. Such is not always the case in the realm of insurance, where the relationship between insurer and insured can be fluid and complex.

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4 *Id*. at 520

5 *Id.* at 518; *see also* Webb v. Jarvis, 575 N.E.2d 992, 995 (Ind. 1991).

6 *Hickman*, 622 N.E.2d at 519 ("In tort, all damages directly traceable to the wrong and arising without an intervening agency are recoverable"). This remedy is potentially available for breach of contract even in the absence of tortious bad faith. *See also* Rockford Mut. Ins. Co. v. Pirtle, 911 N.E.2d 60, 68 (Ind. Ct. App. 2009) ("Delayed payment, whether as a result of good or bad faith, will undoubtedly result in the failure of the owner's business . . . . The damages incurred from such inability to pay bills flow directly, and are proximately caused by, the insurer's failure to pay.").

7 IND. CODE § 34-51-3-4.

8 IND. CODE § 34-52-1-1; *see also* Kuhn v. Cundiff, 533 N.E.2d 165 (Ind. 1989).

9 *Hickman*, 622 N.E.2d at 519.

The relationship between a policyholder and an insurance company usually begins at arm's length. Customers meet with an agent or apply on-line, select endorsements and policy limits, compare rates between insurers, and ultimately make their decision. Once a policy is issued, the arm's length relationship generally continues with each policy renewal.

This relationship changes once a claim is made. For instance, if a policyholder seeks defense and indemnity from his insurer under a policy of liability insurance, the relationship between insurer and insured becomes fiduciary in nature.[10] The insurer will work with the insured to learn the facts of the claim, evaluate the merits of the allegations, and select counsel to defend the insured. Indiana even recognizes a type of privilege for statements made by the insured to the insurer regarding the facts forming the basis for a claim.[11] The insurer, insured, and defense counsel will form a tripartite relationship in the defense of the claim.[12]

However, even as their interests are aligned in defending a claim brought by a third party, both the insurer and insured will remain bound by the duties and obligations established by the policy. For instance, the insured must actively cooperate in his defense as required by any cooperation clause, otherwise the insurer may have grounds to deny coverage. Friction may also arise if the value of a claim approaches or exceeds the applicable policy limits. The insurer may feel confident that a case is defensible, or at least that a verdict could be reasonably contained within the policy limits, while the policyholder may be less sanguine about his predicament. If the insurer is hesitant to settle a case, but the insured is uncomfortable risking a potential excess verdict, the relationship between the two parties can become adversarial.

Perhaps the clearest example of an adversarial relationship between insurer and insured is seen in first-party litigation, when a claim is made by the insured directly against the insurance company. For instance, an insured bringing a claim for uninsured or underinsured motorist benefits must pursue the insurer as a placeholder for another tort-feasor, who is either absent or who has insufficient assets to compensate the insured. In this situation, the insurer can generally assert any of the defenses available to the tort-feasor and may challenge the fault or extent of damages claimed by the insured. At the most basic level, the interests of the two parties are directly opposed: the insured presumably wants to recover as much as possible, and the insurer presumably wants to pay as little indemnity as is reasonably owed.[13]

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[10] *Id.* at 518.

[11] *See* Richey v. Chappell, 594 N.E.2d 443 (Ind. 1992).

[12] *See* Cincinnati Ins. Co. v. Wills, 717 N.E.2d 151 (Ind. 1999).

[13] This is, of course, an extreme oversimplification of the motivations of insurers and insureds.

Indiana courts have expressed concerns regarding the balance of power in the insurer-insured relationship. Apart from the obvious differences in size and assets of an insurance company and an individual policyholder, the insurance contract itself is generally one of adhesion.[14] "An insurance policy is not an ordinary contract. It is a complex instrument, unilaterally prepared and seldom understood by the insured. The parties are not similarly situated. The company and its representatives are expert in the field; the insured is not."[15] This concern is reflected in the widely held rule that ambiguities in an insurance contract are to be construed against the insurer.[16]

Indeed, "it is the unique character of the insurance contract which supports the conclusion that there is a 'special relationship'" between insurer and insured.[17] "Given the *sui generis* nature of insurance contracts . . . it is in society's interest that there be fair play between insurer and insured."[18] The shifting relationship and unbalanced power between the parties are what form the public policy underlying a distinct tort action for bad faith.

II. WHEN DOES THE INSURANCE RELATIONSHIP RISE TO A "SPECIAL RELATIONSHIP" SUCH TO IMPOSE A TORT DUTY?

A duty of good faith and fair dealing is naturally owed to the primary or named insured on a policy of insurance. "Clearly, a relationship exists between an insurer and its insured because they are in privity of contract."[19] After all, the primary insured was directly involved in the policy from the point of its negotiation. Contractual privity is not necessarily prerequisite to the duty of good faith, as explored below, but it firmly supports the basis for a primary insured's rights under Indiana's bad faith regime.

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[14] *See* Eli Lilly & Co. v. Home Ins. Co., 482 N.E.2d 467, 470 (Ind. 1985); *but see also* Allstate Ins. Co. v. Hammond, 759 N.E.2d 1162, 1167 (Ind. Ct. App. 2001) ("Although automobile insurance policies may have certain features of a contract of adhesion, in that the insurer generally is significantly more sophisticated than the insured, we assume [the insured] was free to contract with Allstate to be entitled to a higher amount of uninsured motorist coverage, if she was willing to pay the additional premium necessary to obtain such coverage.").

[15] Indiana Ins. Co. v. Noble, 265 N.E.2d 419, 435 (Ind. Ct. App. 1970) (quoting Allstate Ins. Co. v. Pietrosh, 454 P.2d 106 (Nev. 1969)).

[16] *Eli Lilly*, 482 N.E.2d at 470.

[17] *Hickman*, 622 N.E.2d at 518 ("This contractual relationship is at times a traditional arms-length dealing between parties . . . but is also at times one of a fiduciary nature . . . and, at other times, an adversarial one").

[18] *Id.*

[19] Note that even with regard to the primary or named insured, a bad faith claim is not actionable against any individual employee of the insurance company handling the claim. *See* Schwartz v. State Farm Mut. Auto. Ins. Co., 174 F.3d 875 (7th Cir. 1999).

A. NO DUTY OF GOOD FAITH AND FAIR DEALING OWED TO THIRD-PARTY CLAIMANT

In *Menefee v. Schurr*,[20] the Indiana Court of Appeals considered whether an injured third party may maintain a cause of action directly against the alleged tort-feasor's insurer for handling a claim in bad faith, an issue of first impression in Indiana. Following a motor vehicle collision, the injured plaintiffs brought suit against the tort-feasor and his insurance provider, specifically alleging that the tort-feasor's insurer engaged in delay tactics and acted in bad faith when processing the plaintiffs' claims. The tort-feasor's insurer, MetLife, moved to dismiss the action, stating that Indiana law bars the direct action by a third-party against an insurer. MetLife's motion to dismiss was granted, and the plaintiffs initiated an appeal.

At the Indiana Court of Appeals, the plaintiffs alleged that those injured by an insured are "third-party beneficiaries" of the liability insurance policy and are therefore entitled to "seek redress when insurance companies evade their obligations to pay for injuries that are caused by their insureds."[21] The court criticized the plaintiffs for their heavy reliance on authority from other jurisdictions and traced a line of Indiana case law challenging plaintiffs' allegations.

> The excess liability of [a liability insurance] company arises out of the relationship between insured and company. Claimant is a stranger to that relationship. Not only is company without any duty to claimant to accept claimant's reasonable settlement offer, but also, if there is a sizeable disparity between the settlement offer and the amount of the judgment obtained in the trial which follows refusal of the offer, claimant is benefited, rather than harmed, by the company's refusal to settle.[22]

The court in *Menefee* determined that the plaintiffs "failed to show that the insurance companies . . . intended to benefit third parties injured by their insureds' negligence."[23] Observing that the "overwhelming majority of courts in other jurisdictions have rejected the third party bad faith theory,"[24] the court ultimately declined to recognize such a cause of action in Indiana.[25]

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20 751 N.E.2d 757 (Ind. Ct. App. 2001).

21 *Id*. at 760.

22 *Id.* at 761 (quoting Bennett v. Slater, 289 N.E.2d 144, 149 (Ind. Ct. App. 1972)); *see also* Robert F. Keeton; *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1176 (1954).

23 *Menefee,* 751 N.E.2d at 761.

24 "The insurance companies note that there are only four states, Kentucky, Louisana, Massachusetts and West Virginia, that permit third party direct action bad faith claims contemporeanous with court actions agasint he insureds." *Id.* at 761 n.2.

25 "There are, of course, exceptions to the prohibition against tort actions brought by an injured third-party against a liability carrier. An injured party may proceed against a liability carrier in contract or

B. LIMITATIONS ON A THIRD-PARTY BENEFICIARY'S ABILITY TO SUE

Under Indiana law, a third-party beneficiary is distinct from a third-party claimant such as the plaintiffs in *Menefee*. A third-party beneficiary is an individual or entity, not a party to the insurance contract, for whose benefit the contract is made.[26] The most common example of a third-party beneficiary is the named beneficiary of a life insurance policy. Similarly, a claimant under no-fault medical payments coverage has been considered a third-party beneficiary under Indiana law.

> A third party beneficiary contract requires first, that the intent to benefit the third party be clear, second, that the contract impose a duty on one of the contracting parties in favor of the third party, and third, that the performance of the terms necessarily render to the third party a direct benefit intended by the parties to the contract.
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> The weight of authority suggests that medical payment provisions regarding injured third parties are third party beneficiary contracts. Since recovery by the injured party under the medical payment provision is completely independent of liability on the part of the insured, insurance under this provision is closely akin to a personal accident policy. Medical provisions are a form of group accident insurance provided at minimal cost with a named insured as the entity through whom the coverage is issued. Such coverage creates a direct liability to the contemplated beneficiaries.[27]

A third-party beneficiary may sue to enforce a contract but may not sue for bad faith.[28] In *Cain v. Griffin*, a plaintiff filed suit directly against the insurer of a restaurant where she was injured in a fall.[29] After seeking no-fault medical payments benefits, the plaintiff brought a lawsuit against the insurer alleging that she was a third-party beneficiary of the restaurant's

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tort if the carrier refuses to honor its contract after the injured party obtains a judgment against the tort-feasor. Similarly, a judgment creditor may proceed against a liability carrier when the insured has assigned the claim and refuses to bring suit." Chuhar v. AMCO Ins. Co., 2012 U.S. Dist. LEXIS 22238, at *7 (N.D. Ind. Feb. 22, 2012). A third party may also assert the Uniform Declaratory Judgment Act for the purpose of establishing a tort-feasor's liability insurance coverage. *See* IND. CODE § 34-14-1-1.

26 Note that a policy of liability insurance is made for the protection of the insured against the claims of a third party. Although a third party may ultimately receive the benefit of such policy in the form of indemnity payments, the contract is formed for the benefit of the *insured*, whose personal assets are protected by the indemnity promised.

27 Donald v. Liberty Mut. Ins. Co., 18 F.3d 474, 481 (7th Cir. 1994) (internal quotations and citations omitted).

28 Cain v. Griffin, 849 N.E.2d 507 (Ind. 2006). In *Cain*, the Supreme Court of Indiana analyzed and disagreed with the Seventh Circuit's holding in *Donald* that allowed a third-party beneficiary to bring suit for bad faith.

29 *Id.*

policy, such that she was entitled to maintain a tort claim for bad faith against the insurer in addition to her contract-based lawsuit. The Indiana Supreme Court agreed that plaintiff was entitled to bring a claim for breach of the insuring contract but found no special relationship to support a tort claim for insurance bad faith.

> [A] third-party beneficiary may sue the insurer directly to enforce the contract between the insurer and the insured . . . . To be enforceable, it must clearly appear that it was the purpose or a purpose of the contract to impose an obligation on one of the contracting parties in favor of the third party. It is not enough that performance of the contract would be of benefit to the third party. It must appear that it was the intention of one of the parties to require performance of some part of it in favor of such third party and for his benefit, and that the other party to the agreement intended to assume the obligation thus imposed. The intent of the contracting parties to bestow rights upon a third party must affirmatively appear from the language of the instrument when properly interpreted and construed.[30]

The court next analyzed the language of the policy and determined that, as a no-fault provision, the medical payment coverage was intended for the benefit of third parties such as the injured plaintiff. "It is clear from the language of the contract that the Griffins intended to require Auto-Owners to pay medical expenses for 'bodily injury' to a third party—in this case, Cain—caused by an accident on the Griffins' premises, 'regardless of fault.' It is also clear that [the insurer] intended to assume the obligation thus imposed."[31]

However, the court refused to find that this third-party relationship supports the imposition of the separate duty of good faith and fair dealing. This was based on the absence of a requisite special relationship.

> The relationship between a third-party beneficiary and the insurer is not one intentionally created by a close, fiduciary, or potentially adversarial contract and, as such, is not the "special relationship" anticipated by this Court in *Erie*. Thus, a third-party beneficiary cannot sue an insurer in a tort action for the insurer's failure to deal in good faith with a third-party beneficiary.
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> We hold that Cain, as a third-party beneficiary to the medical payments coverage of the insurance contract between Auto-Owners and the Griffins may sue Auto-Owners directly to enforce the contract. However, because Auto-Owners does not owe to Cain a

[30] *Id.* at 514.

[31] *Id.* at 515.

duty of good-faith dealing, Cain may not proceed on a tort claim against Auto-Owners for failure to deal in good faith.[32]

C. DUTY OF GOOD FAITH AND FAIR DEALING OWED TO ADDITIONAL INSURED, PERMISSIVE USER, OR PASSENGER

Additional insureds present an interesting twist since they are seldom involved in the negotiation of an insurance contract giving rise to privity of contract with the insurer. Additional insureds may or may not be named on the declarations page of a policy and often gain their insured status through policy language that provides coverage to unnamed individuals or entities. For example, insurance contracts may include permissive drivers under an automobile liability policy or passengers under an automobile policy for uninsured or underinsured motorist benefits. However, even in the absence of contractual privity, additional insureds in most cases may take advantage of the special relationship between the primary insured and the insurer to file suit for breach of the duty of good faith and fair dealing.

In *Spencer v. Bridgewater*,[33] a vehicle was borrowed with permission and was struck by an uninsured tort-feasor. The injured permissive driver and his injured passenger brought an action for uninsured motorist coverage against the vehicle owner's insurance carrier. The plaintiffs further claimed the insurer acted in bad faith by refusing to provide coverage. Although not discussed at length, the Indiana Court of Appeals relied upon the language in *Menefee* establishing that an "insurer owes a duty of good faith *to its insured*, the breach of which gives rise to a tort action."[34] Upon determining that the permissive user and passenger plaintiffs were "insureds" under the provisions of the owner's policy, the court found they were therefore "owed a duty of good faith," even in the absence of contractual privity.[35]

D. ASSIGNMENT OF CLAIM FOR BAD FAITH

A bad faith claim may also be assigned.[36] This occurs most often if an excess verdict is entered at the conclusion of trial. Rather than using personal assets to satisfy the portion of a judgment exceeding his policy limits, an insured may choose to assign any potential bad faith claims to the victo-

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[32] *Id.*

[33] 757 N.E.2d 208 (Ind. Ct. App. 2001).

[34] *Id.* at 211 (emphasis added).

[35] *Id.* at 211 n.1.

[36] *See* State Farm Mut. Auto. Ins. Co. v. Estep, 873 N.E.2d 1021 (Ind. 2007).

rious plaintiff as settlement for the unsatisfied share. However, such an assignment must be made voluntarily.[37]

III. Breach of the Duty and Punitive Damages

The obligation of good faith and fair dealing requires an insurer to refrain from: (l) making an unfounded refusal to pay policy proceeds; (2) causing an unfounded delay in making payment; (3) deceiving the insured; and (4) exercising any unfair advantage to pressure an insured into a settlement of his claim.[38] Significantly, a tort claim for bad faith "does not arise every time an insurance claim is erroneously denied."

An insurer's good faith dispute regarding the value or validity of a claim alone will not support a tort-based recovery even if it is later determined that the insurer breached its contract. "That insurance companies may, in good faith, dispute claims, has long been the rule in Indiana."[39] Lack of diligent investigation alone is also insufficient to support a tort award.[40] "On the other hand, for example, an insurer which denies liability knowing that there is no rational, principled basis for doing so has breached its duty."[41]

Although the tort of bad faith opens the door to punitive damages, Indiana's standard for a punitive damage award is not altered by an insurer's duty of good faith and fair dealing.

> Nonetheless, just as a jury's determination that a claim was, in retrospect, incorrectly denied is not sufficient to establish a breach of the duty to exercise good faith, proof that a tort was committed is not sufficient to establish the right to punitive damages.
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> . . .
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> Punitive damages may be awarded only if there is clear and convincing evidence that the defendant "acted with malice, fraud, gross negligence, or oppressiveness which was not the result of a mistake of fact or law, honest error or judgment, overzealousness, mere negligence, or other human failing, in the sum [that the jury believes] will serve to punish the defendant and to deter it and others from like conduct in the future." Thus, the mere finding by a preponderance of the evidence that the insurer committed the

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[37] *Id*. (holding that the trial court erred by forcing an insured to assign his cause of action for bad faith against his insurer to the successful plaintiff where the insured did not believe his insurer had acted in bad faith in the handling of his defense).

[38] *Hickman*, 622 N.E.2d at 519.

[39] *Id.* at 520.

[40] *Id.*

[41] *Id.* (citing Town & Country Mut. Ins. Co. v. Hunter, 472 N.E.2d 1265, 1268 (Ind. Ct. App. 1985); Hoosier Ins. Co. v. Mangino, 419 N.E.2d 978, 983 (Ind. Ct. App. 1981)).

tort will not, standing alone, justify the imposition of punitive damages.[42]

IV. CONCLUSION

Standing to sue for bad faith requires a special relationship or insured status but does not hinge solely on contractual privity. Even once the ability to sue for bad faith has been established, the bar is high with regard to proof of the tort and even higher to warrant an award of punitive damages. Ultimately, while the common-law establishment of the bad faith tort reflects concerns arising from the nature of insurance relationships, the steep standard to succeed in a bad faith claim for punitive damages reflects the rarity with which insurers take advantage of any disparities between the parties.

[42] *Id.*