

INSURANCE BAD FAITH INSTRUCTIONS

Introduction

These instructions have been extensively revised and reorganized from the prior RAJI (CIVIL) 6th Bad Faith Instructions.

Intended Use of Instructions. These instructions are intended for use only in actions against insurance companies for breach of the covenant of good faith and fair dealing implied by law in the insurance contract. They may require modification for certain related contexts, such as suits against sureties on performance bonds, which are treated as insurance bad faith.¹ In noninsurance cases involving breach of the implied duty of good faith and fair dealing, other instructions should be used. *See, e.g.*, RAJI (CIVIL) 8th Contract 16 (“Good Faith and Fair Dealing”); RAJI (CIVIL) 8th Employment Law 2-3 (“Implied and Express Contracts (Good Faith and Fair Dealing)” and “Breach of an Implied Contract”). If the case also, or only, involves a claim for breach of the insurance contract, the RAJI (CIVIL) 8th Contract Instructions should be used for that contract claim, with such modifications or additions as may be appropriate for insurance-specific contract principles, such as the burdens of proof for coverage and exclusions from coverage.

Nature of Duty in Insurance Cases. The Arizona Supreme Court has recognized that while a covenant of good faith and fair dealing is implied in every contract, and the remedy for breach of the implied covenant is ordinarily on the contract itself, “in special contractual relationships, when one party intentionally breaches the implied covenant of good faith and fair dealing, and when contract remedies serve only to encourage such conduct, it is appropriate to permit the damaged party to maintain an action in tort and to recover tort damages.” *Rawlings v. Apodaca*, 151 Ariz. 149, 158-61 (1986). The court reasoned that tort remedies, including compensatory damages for emotional distress and punitive damages, should be available in the insurance setting because “in buying insurance an insured usually does not seek to realize a commercial advantage but, instead, seeks protection and security from economic catastrophe.” *Id.* at 154. Thus, “one of the benefits that flow from the insurance contract is the insured’s expectation that his insurance company will not wrongfully deprive him of the very security for which he bargained or expose him to the catastrophe from which he sought protection.” *Id.* at 155. In such “special, partly noncommercial relationships,” where the insurance covers the insured’s liability to another, “the insured surrenders to the insurer the right to control and manage the defense of claims made against him”; where the insurance covers the insured’s own personal losses, “the insurer sets the conditions for both presentment and payment of claims.” *Id.* at 154. “In both ... situations the contract and the nature of the relationship effectively give the insurer an almost adjudicatory responsibility.” *Id.* The Supreme Court also reasoned that in such settings, “contract damages not only fail to provide adequate

¹ *See Dodge v. Fid. & Deposit Co. of Md.*, 161 Ariz. 344, 346-48 (1989) (treating sureties providing construction performance bonds as insurers and recognizing that same duty of good faith applies to an obligee’s claim that the principal has defaulted).

compensation but also fail to provide a substantial deterrence against breach by the party who derives a commercial benefit from the relationship.” *Id.* at 159.

Insurance Policy and Statutes. In some areas, the provisions of the insurance policy are dictated by statute; indeed, some policies may expressly invoke the pertinent statute to describe the coverage and benefits available. Examples of such areas include worker’s compensation coverage; fire insurance under the New York standard fire policy, edition of 1943, A.R.S. § 20-1053; and certain aspects of motor-vehicle liability coverage, A.R.S. § 28-4009. While those insurance statutes may not directly dictate the scope of bad-faith liability under Arizona, they may inform the parties’ respective obligations under the insurance policy. The Insurance Bad Faith Instructions do not attempt to cover such statutory issues. The trial court may need to additional instructions on such statutory provisions and legal issues if warranted by the facts and issues in the case. *See* Insurance Bad Faith 3, 8, 9A, 9B.

First-Party and Third-Party Bad Faith. The Insurance Bad Faith Instructions are divided into two groups that reflect the two basic types of bad-faith actions: First-Party Bad Faith (Insurance Bad Faith 1-6) and Third-Party Bad Faith (Insurance Bad Faith 7-13). Unlike some other states, Arizona courts recognize a tort claim for both types of bad faith. *See Noble v. Nat’l Am. Life Ins. Co.*, 128 Ariz. 188, 189-90 (1981) (recognizing first-party bad faith); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 338 (1957) (recognizing third-party bad faith). In this context, these terms refer to the nature of the underlying insurance coverage. As the Arizona Supreme Court explained this distinction, “[f]irst-party coverage arises when the insurer contracts to pay benefits directly to the insured,” while “third-party coverage arises when the insurer contracts to indemnify the insured against liability to third parties.” *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 258 (1990). First-party coverages include health insurance, life insurance, disability insurance, homeowner’s fire insurance, uninsured- and underinsured-motorist coverages, and automobile property-damage coverage, while third-party coverages include commercial general liability (CGL) policies and automobile liability coverages. *See id.*

Although the terms “first-party” and “third-party” refer to the nature of the coverage, they are at times also used somewhat confusingly to refer to the party that brought the bad-faith claim, i.e., whether the claim was brought by an insured (a first-party claim) or a tort claimant injured by an insured tortfeasor (a third-party claim). For example, in *Ramlings v. Apodaca*, the Arizona Supreme Court commented that “[c]laims brought directly against an insurer by its own insured are commonly referred to as ‘first-party’ claims, while those brought against the insured by a third person are called ‘third-party’ claims.” 151 Ariz. at 153 n.2; *cf. Leal v. Allstate Ins. Co.*, 199 Ariz. 250, 254, ¶ 21 (App. 2000) (holding that “a third-party claimant, a stranger to the contract, cannot sue the insurer for tortious breach of the duty of good faith”). In *Clearwater v. State Farm*, however, the Supreme Court recognized that, in light of the assignability of bad-faith claims, “[t]he type of claim is not determined by the identity of the party bringing the bad faith action against the insured.” 164 Ariz. at 258. The Court explained, “For example, a third-party action might be brought by the insured in the event that he is subjected to excess liability by reason of the insurer’s bad faith refusal to settle. In that event, the standards applicable to third-party claims

would govern the action, although it was brought by the insured, rather than a third-party assignee.” *Id.*

It is conceivable that first- and third-party claims could be asserted in the same action, but that would be an unusual situation involving the allegedly improper handling of claims under separate coverages, e.g., a claim that the insurer mishandled a claim for first-party medical-payment or property-damage benefits for an insured party, and also unreasonably failed to defend or settle a tort victim’s claim against the insured. As a result, the lawsuit will almost always call for using either the First-Party or Third-Party Bad Faith Instructions, but not both.

Insured’s Duty of Good Faith and Fair Dealing. The duty of good faith and fair dealing applies to both the insurer and the insured. *Rawlings v. Apodaca*, 151 Ariz. at 153. Arizona courts have not yet defined the legal consequences of an insured’s breach of the duty of good faith and fair dealing. Accordingly, the Committee has not attempted to draft any instructions regarding these issues.

INSURANCE BAD FAITH 1

First-Party Bad Faith: Duty of Good Faith and Fair Dealing

[*Name of plaintiff*] claims that [*name of defendant*] breached its duty of good faith and fair dealing. An insurance company has a duty to act fairly and in good faith. The duty of good faith and fair dealing requires an insurance company to give as much consideration to an insured's interests as it gives to its own interests when it is investigating, evaluating, and processing the insured's claim.

SOURCE: *Deese v. State Farm Mut. Auto. Ins. Co.*, 172 Ariz. 504, 507 (1992); *Rawlings v. Apodaca*, 151 Ariz. 149, 157 (1986); *Noble v. Nat'l Life Ins. Co.*, 128 Ariz. 188, 190 (1981).

INSURANCE BAD FAITH 2

First-Party Bad Faith: Elements

On the claim for breach of the duty of good faith and fair dealing, *[name of plaintiff]* must prove:

1. *[Name of defendant]* breached the duty of good faith and fair dealing;
2. *[Name of defendant]*'s breach was a cause of *[name of plaintiff]*'s damages; and
3. The amount of *[name of plaintiff]*'s damages.

SOURCE: *Rawlings v. Apodaca*, 151 Ariz. 149, 153 (1986).

INSURANCE BAD FAITH 3

First-Party Bad Faith: Standard for Breach of Duty

To prove that [name of defendant] breached the duty of good faith and fair dealing, [name of plaintiff] must prove:

1. [Name of defendant] [describe challenged action] without a reasonable basis for that action; and
2. [Name of defendant] either knew that it had no reasonable basis for that action or was reckless in determining whether it had a reasonable basis for that action.
 - [a. An insurance company is reckless if it is aware that its investigation or evaluation was inadequate or incomplete.]
 - [b. An insurance company is reckless if it fails to perform an investigation or evaluation adequate to determine whether it has a reasonable basis for that action.]

SOURCE: *Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234, 238, ¶ 22 (2000); *Deese v. State Farm Mut. Auto. Ins. Co.*, 172 Ariz. 504, 507 (1992); *Ramlings v. Apodaca*, 151 Ariz. 149, 157, 160 (1986); *Noble v. Nat'l Am. Life Ins. Co.*, 128 Ariz. 188, 190 (1981); *Cavallo v. Phoenix Health Plans, Inc.*, 250 Ariz. 525, 530, ¶ 15 (App. 2021); *Twin City Fire Ins. Co. v. Leija*, 243 Ariz. 175, 182, ¶ 27 (App. 2017); *Sobieski v. Am. Standard Ins. Co. of Wis.*, 240 Ariz. 531, 534, ¶ 11 (App. 2016); *Nardelli v. Metro. Grp. Prop. & Cas. Ins. Co.*, 230 Ariz. 592, 597-98, ¶ 19 (App. 2012).

USE NOTES:

1. Description of Challenged Action: The instruction should describe the category of conduct that the plaintiff alleges constituted bad faith, such as “denied the claim,” “failed to pay the claim,” “failed to properly investigate the claim,” “delayed payment of the claim,” or some other action that may not involve payment of claims, such as actions that were deceitful or designed to obfuscate the facts.

2. Recklessness: In addition to paragraphs (1) and (2), the court should give paragraphs (a) and/or (b), depending on the theories and evidence at trial.

COMMENTS: 1. Fair Debatability: Some cases discussing first-party bad faith use the term “fairly debatable.” See *Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234, 237 (2000); *Lennar Corp. v. Transamerica Ins. Co.*, 227 Ariz. 238, 244-45 (App. 2011). Although the Arizona Supreme Court has indicated that this concept is appropriate for an instruction in a first-party bad faith case, the court has also held that the failure to give an instruction containing the phrase “fairly debatable” in a first-party bad faith case is not error. Compare *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256 (1990), with *Sparks v. Republic Nat'l Life Ins. Co.*, 132 Ariz. 529, 538 (1982). The Committee decided not to include the words “fairly debatable” in these instructions, reasoning that the phrase was susceptible to misconstruction, and the concept was adequately and more clearly covered by the “reasonable basis” language.

INSURANCE BAD FAITH 4

First-Party Bad Faith: Intentional Conduct

To prove that [name of defendant] breached its duty of good faith and fair dealing, [name of plaintiff] must prove that [name of defendant] intended its conduct, but [name of plaintiff] does not need to prove that [name of defendant] intended to cause injury. [Name of defendant]'s conduct is not intentional if it is inadvertent or due to a good-faith mistake.

SOURCE: *Zilisch v. State Farm Mut. Auto. Ins. Co.*, 196 Ariz. 234 (2000); *Rawlings v. Apodaca*, 151 Ariz. 149, 160 (1986); *Rowland v. Great States Ins. Co.*, 199 Ariz. 577 (App. 2001); *Deese v. State Farm Mut. Auto. Ins. Co.*, 168 Ariz. 337 (App. 1991).

USE NOTE: In *Rawlings v. Apodaca*, the Arizona Supreme Court defined the intent requirement in first-party bad faith cases as “the intent to do the act.” 151 Ariz. at 160. This was distinguished from “inadvertence, loss of papers, misfiling of documents and like mischance.” *Id.* at n.5. In many or even most cases, the element of intentionality will not be an issue because the insurance company does not contend that its conduct was inadvertent or otherwise unintentional. In those cases, this instruction should not be given.

INSURANCE BAD FAITH 5

First-Party Bad Faith: Causation

A breach of the duty of good faith and fair dealing is a cause of damages if it helps produce the damages, and if the damages would not have occurred without the breach.

SOURCE: Fault 2 Instruction; *Schwartz v. Farmers Ins. Co. of Ariz.*, 166 Ariz. 33, 36-3 (App. 1990) (finding no error in giving causation instruction).

INSURANCE BAD FAITH 6**First-Party Bad Faith:
Measure of Damages**

If you find that [name of defendant] is liable to [name of plaintiff] for breach of the duty of good faith and fair dealing, you must then decide the full amount of money that will reasonably and fairly compensate [name of plaintiff] for each of the following elements of damage proved by the evidence to have been caused by [name of defendant]'s breach:

1. The unpaid benefits of the policy;
2. Attorneys' fees and litigation expenses reasonably incurred by [name of plaintiff] to obtain the benefits of the insurance policy;
3. Monetary loss or damage to credit reputation experienced and reasonably probable to be experienced in the future; and
4. Emotional distress, humiliation, inconvenience, and anxiety experienced, and reasonably probable to be experienced in the future.

SOURCE: *Rawlings v. Apodaca*, 151 Ariz. 149, 153 (1986); *Farr v. Transamerica Occidental Life Ins. Co.*, 145 Ariz. 1, 7 (App. 1984); *Schwartz v. Farmers Ins. Co. of Ariz.*, 166 Ariz. 33, 35-36 (App. 1990).

USE NOTE: 1. Elements of Damages: The jury should be instructed only on those elements of damages for which there is proof. If the plaintiff has suffered physical injury as a result of defendant's bad faith, consider using an appropriately modified version of Personal Injury Damages 1.

2. Attorneys' Fees. This instruction concerns the jury's award of attorney's fees and litigation expenses as tort damages, rather than the court's award of attorney's fees as fees under A.R.S. § 12-341.01(A) or another fee-shifting statute, or the court's award of taxable costs under A.R.S. § 12-331. Certain categories of fees and expenses may be recoverable by either means, but some may not. *See, e.g., Schwartz v. Farmers Ins. Co. of Ariz.*, 166 Ariz. 33, 35-36 (App. 1990) (attorney's fees recoverable as tort damages are limited to those incurred to pursue the contract claim and may not include any fees or costs incurred in bad-faith claim).

3. Prejudgment Interest: Plaintiff may be entitled to prejudgment interest on liquidated elements of damages, including unpaid benefits under the policy. The computation of prejudgment interest is not ordinarily submitted to the jury. If there is no dispute about the amount of unpaid benefits, the court can, after the verdict, calculate prejudgment interest as a matter of law at the legal rate under A.R.S. § 44-1201(A)-(B) and (F) and include it in the judgment. *See* A.R.S. § 20-462(A) (providing for award of interest at the legal rate on first-party insurance benefits that are not paid within thirty days after the insurer receives an acceptable proof of loss); *N. Ariz. Gas Serv. v. Petrolane Transp., Inc.*, 145 Ariz. 467, 479 (App. 1984) (interest on liquidated claim). If there is a dispute about the amount of the unpaid benefits, special interrogatories to the jury may be necessary.

INSURANCE BAD FAITH 7

Third-Party Bad Faith: Duty of Good Faith and Fair Dealing

[Name of plaintiff] claims that [name of defendant] breached its duty of good faith and fair dealing. An insurance company has a duty to act fairly and in good faith. The duty of good faith and fair dealing requires an insurance company to give as much consideration to an insured's interests as it gives to its own interests.

SOURCE: *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256 (1990); *Gen. Accident Fire & Life Assur. Corp. v. Little*, 103 Ariz. 435, 437 (1968); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 338-39 (1957).

USE NOTE: Third-party bad-faith claims may be brought against an insurer for failure to defend, failure to indemnify, or failure to settle a liability claim. Such bad-faith claims may be asserted by the insured or by the insured's assignee. In claims by the insured's assignee, the assignee is ordinarily the person who was injured by the insured and has obtained a judgment against the insured. *See, e.g., Gen. Accident Fire & Assur. Corp. v. Little*, 103 Ariz. 435 (1968). Where the plaintiff is the insured tortfeasor, the plaintiff may be entitled to consequential tort damages that would not be available to an assignee plaintiff. If both the injured judgment creditor and the insured tortfeasor are plaintiffs, the instructions should be modified to make clear which of the plaintiffs is entitled to each of the elements of damage.

INSURANCE BAD FAITH 8

Third-Party Bad Faith: Elements

On the claim for breach of the duty of good faith and fair dealing, [name of plaintiff] must prove:

1. [Name of defendant] breached the duty of good faith and fair dealing by [failing to defend] [failing to indemnify] [failing to settle] the claim against [name of insured];
2. [Name of defendant]'s breach was a cause of [name of insured]'s damages; and
3. The amount of [name of insured]'s damages.

SOURCE: *Clearwater v. State Farm Mutual Automobile Ins. Co.*, 164 Ariz. 256, 260 (1990); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 338-39 (1957).

COMMENT: In a third-party claim for failure to settle a claim against an insured, once the plaintiff establishes that the defendant failed to give equal consideration to the insured's interests, the defendant usually is liable for the full amount of the judgment entered against the insured. *Henderson*, 82 Ariz. at 341.

USE NOTE: If the plaintiff in the bad faith case is the insured tortfeasor, then the plaintiff may be entitled to consequential damages that have resulted from the defendant's breach. With respect to a claim of consequential damages, the plaintiff must establish both the nature and extent of the damages as well as the fact that such damages were caused by the defendant's breach. Such consequential damages are personal to the insured and may not be assigned to the injured tort-creditor. *Harleysville Mut. Ins. Co. v. Lea*, 2 Ariz. App. 538 (1966); *State Farm Mut. Ins. Co. v. St. Joseph's Hosp.*, 107 Ariz. 498 (1971). Consequential damages may be awarded only if the bad faith case is brought by the insured. Insurance Bad Faith 12 and 13A are designed for use in cases where consequential damages are at issue.

INSURANCE BAD FAITH 9

Third-Party Bad Faith: Standard for Breach of Duty to Settle

To prove that [name of defendant] breached the duty of good faith and fair dealing by failing to settle the claim against [name of the insured], [name of plaintiff] must prove:

1. [Name of underlying claimant] made an offer to settle the claim against [name of insured] for an amount within the policy limit of [name of insured]'s insurance coverage;
2. [Name of defendant] did not give equal consideration to the interests of [name of insured] when it failed to settle the claim against [name of insured];
3. A monetary judgment was entered against [name of insured] for an amount greater than the policy limit.

“Policy limit” means the maximum amount available for the claim against [name of insured] under [name of insured]'s insurance policy with [name of defendant].

The test for determining whether [name of defendant] gave equal consideration to the interests of its insured is whether a prudent insurance company whose insurance policy had no policy limits would have accepted the settlement offer. The insurer's conduct is evaluated based on the case as it fairly appeared to the insurance company at the time it failed to accept the settlement offer.

SOURCE: *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 260 (1990); *Gen. Accident Fire & Life Assur. Corp. v. Little*, 103 Ariz. 435, 440, 441-42 (1968); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 338-39 (1957); *Acosta v. Phoenix Indem. Ins. Co.*, 214 Ariz. 380, 383, ¶ 16 (App. 2007).

COMMENT: An insurer's bad-faith refusal to settle is not excused by “[t]he mere fact that an insurer has erroneously concluded that there is no coverage and therefore in good faith refuses to defend To hold otherwise would result in penalizing the more prudent insurer who initially correctly recognizes the duty to defend, but subsequently wrongfully refuses a settlement offer.” *State Farm Auto. Ins. Co. v. Civ. Serv. Emps. Ins. Co.*, 19 Ariz. App. 594, 603 (1973).

USE NOTES: 1. General: This instruction should be used where the plaintiff claims that the insurance company failed to give equal consideration to the interests of its insured in declining to accept a settlement offer.

2. Offer and No-offer Cases. Ordinarily, liability for an insurer's wrongful failure to settle arises only when a settlement offer has been made. See *State Farm Mut. Auto. Ins. Co. v. Paynter*, 122 Ariz. 198, 204-05 (App. 1979); *Rogan v. Auto Owners Ins. Co.*, 171 Ariz. 559, 565 (App. 1991). This instruction is intended only for cases in which a settlement offer was made. Other instructions will be necessary in failure-to-settle cases where no settlement offer was made. See *Fulton v. Woodford*, 26 Ariz. App. 17, 22 (1976).

3. Coverage. This instruction assumes that the subject claim against the insured is covered by the insurance company's policy. If issues relating to coverage or policy defenses are to be tried to the jury, additional instructions on those issues may be necessary.

INSURANCE BAD FAITH 10**Third-Party Bad Faith:
Standard for Breach of Duty to Defend**

To prove that [name of defendant] breached the duty of good faith and fair dealing by failing to provide [name of insured] with a defense to the claim asserted by [name of underlying claimant], [name of plaintiff] must prove:

1. [Name of defendant] failed to provide [name of insured] with a defense to the claim; and

Option A

2. [Name of defendant] had no reasonable basis for that failure; and
3. [Name of defendant] either knew that it had no reasonable basis for that failure or was reckless in determining whether it had a reasonable basis for that failure.

Option B

2. [Name of defendant] failed to provide a defense because it incorrectly decided that there was no coverage under its policy.

Option C

2. [Name of defendant] failed to provide a defense because it incorrectly decided that there was no coverage under its policy, and there was no reasonable basis for that decision.

SOURCE: *Regal Homes, Inc. v. CNA Ins.*, 217 Ariz. 159, 170, ¶¶ 48-50 (App. 2007); *Kepner v. W. Fire Ins. Co.*, 109 Ariz. 329, 332 (1973); *State Farm Auto. Ins. Co. v. Civ. Serv. Emps. Ins. Co.*, 19 Ariz. App. 594, 603 (1973); *Quihuis v. State Farm Mut. Auto. Ins. Co.*, 235 Ariz. 536, 547, ¶ 40 (2014).

USE NOTE: 1. Options. As explained in the Comments to this instruction, the Committee has concluded that, as of the date of publication, Arizona law is unclear regarding the standard for establishing a breach of the duty of good faith in a failure to defend a claim. Based on the trial court's conclusion as to the applicable standard, the court should determine which option (A, B, or C) sets forth the proper standard. The three options are based on different decisions of the Arizona Supreme Court and Court of Appeals. The order of the options does not reflect any preference of the Committee.

2. Extracontractual Damages. This instruction is intended only for cases where the plaintiff has asserted a claim for extracontractual damages (such as emotional distress). Where an insured (or the insured's assignee) seeks only contract damages (i.e., indemnity for a judgment or the cost of defending the liability claim), the plaintiff need show only that the claim asserted against the insured was within the scope of the insurance coverage. *See, e.g., Kepner* 109 Ariz. at 332 (if insurer refuses to defend, it acts at its peril and if it guesses wrong, it must bear the consequences of its breach of contract); *see also Granite State Ins. Corp. v. Mountain States Tel. & Tel. Co.*, 117 Ariz. 432, 436 (1977); *State Farm Mut. Auto. Ins. Co. v. Paynter*, 122 Ariz. 198, 200-01, 204 (App. 1979).

Continued

INSURANCE BAD FAITH 10

Third-Party Bad Faith: Standard for Breach of Duty to Defend

Continued

COMMENTS:

1. Option A. Option A is based on the Arizona Court of Appeals' 2007 opinion in *Regal Homes*, which applied the first-party bad-faith standard to a third-party bad-faith claim based on the insurer's breach of the duty to defend. Since *Regal Homes*, the Arizona Supreme Court has reiterated that the first-party standard does not apply in third-party cases, at least where the insurer owes a duty of defense under its policy. *Apollo Educ. Grp., Inc. v. Nat'l Union Fire Ins. Co. of Pittsburgh, Pa.*, 250 Ariz. 408, 413-14, ¶¶ 25-26 (2021) (citing *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 164 Ariz. 256, 259-60 (1990)). While *Apollo* was not a third-party duty-to-defend case and did not address *Regal Homes*, and *Clearwater* was a third-party duty-to-settle case, the Committee is concerned that Arizona appellate courts may not follow *Regal Homes* in future cases involving third-party bad-faith claims alleging breach of the duty to defend. Accordingly, the Committee offers Option B and C as alternative instructions.

2. Option B. Option B is based on *Kepner*, a 1973 opinion in which the Arizona Supreme Court stated, "If the insurer refuses to defend and awaits the determination of its obligation in a subsequent proceeding, it acts at its peril, and if it guesses wrong, it must bear the consequences of its breach of contract." 109 Ariz. at 332. *Kepner* was a garnishment proceeding seeking policy benefits, not a bad-faith action. Two weeks after *Kepner*, the Arizona Court of Appeals issued its opinion in *Civil Service*, which involved a third-party failure-to-settle claim. The court in *Civil Service* did not refer to *Kepner*, but, nevertheless, it adopted a similar standard. Comparing the contractual obligations to settle and to defend, the court stated: "The mere fact that an insurer has erroneously concluded that there is no coverage and therefore in good faith refuses to defend, cannot excuse subsequent breaches by the insurer of other provisions of the contract, including the implied obligations pertaining to settlement." 19 Ariz. App. at 602. The court continued, "To hold otherwise would result in penalizing the more prudent insurer who initially correctly recognizes the duty to defend, but subsequently wrongfully refuses a settlement offer." *Id.* The court in *Civil Service* expressly rejected the insurer's "contention that its initial good faith denial of coverage has any direct bearing on the question of its liability for the alleged breach of its settlement obligations." *Id.* at 603.

3. Option C. Option C is based on *Quibuis*, a 2014 opinion in which the Arizona Supreme Court stated that "[a]n insurer that refuses to defend additionally opens itself up to the possibility of contract damages if it is found to have breached its duty to defend. And, depending on whether reasonable grounds exist for refusing to defend and denying coverage, the insurer could also face bad faith tort claims." 235 Ariz. at 547, ¶ 40 (internal citations omitted) (citing, inter alia, *Rawlings v. Apodaca*, 151 Ariz. 149, 153-55, 160 (1986)). The Court's statement was *dicta* because *Quibuis* concerned the scope of issue preclusion in a *Morris* situation, and the Supreme Court did not decide any issues concerning bad faith.

INSURANCE BAD FAITH 11

Third-Party Bad Faith: Intentional Conduct

To prove that [name of defendant] breached its duty of good faith and fair dealing, [name of plaintiff] must prove that [name of defendant] intended its conduct, but [name of plaintiff] does not need to prove that [name of defendant] intended to cause injury. [Name of defendant]'s conduct is not intentional if it is inadvertent.

SOURCE: *Miel v. State Farm Mut. Auto. Ins. Co.*, 185 Ariz. 104, 110 (App. 1995) (citing *Rawlings v. Apodaca*, 151 Ariz. 149, 160 (1986)).

USE NOTE: In *Rawlings v. Apodaca*, the Arizona Supreme Court defined the intent requirement in first-party bad-faith cases as “the intent to do the act.” 151 Ariz. at 160. This was distinguished from “inadvertence, loss of papers, misfiling of documents and like mischance.” *Id.* at n.5. In *Miel v. State Farm*, the Arizona Court of Appeals extended this principle to third-party bad-faith cases, reversing the verdict where the trial court gave only an “equal consideration” instruction and “[t]he jury was not told that mere negligence or inadvertence could not constitute bad faith and that the insurer had to ‘intend the act or omission and must form that intent without reasonable or fairly debatable grounds.’” 185 Ariz. at 110 (quoting *Rawlings*, 151 Ariz. at 160). The court reasoned that the “equal consideration” instruction was “incomplete and not specific to the facts of this case” because it “is geared more to a case in which the issue is the insurer’s considered decision not to pay a claim than it is to a case like this one, in which the insurer admits that its negligence resulted in an untimely acceptance of a settlement offer.” *Id.* In many or even most cases, the element of intentionality will not be an issue because the insurance company does not contend that its conduct was inadvertent or otherwise unintentional. In such cases, this instruction may not be appropriate.

INSURANCE BAD FAITH 12

Third-Party Bad Faith: Causation

A breach of the duty of good faith and fair dealing is a cause of damages if it helps produce the damages, and if the damages would not have occurred without the breach.

SOURCE: Fault 2 Instruction; *Schwartz v. Farmers Ins. Co. of Ariz.*, 166 Ariz. 33, 36-37 (App. 1990) (finding no error in giving causation instruction in first-party bad-faith case).

USE NOTE: In a third-party bad-faith case based on the failure to settle, once the plaintiff establishes that the defendant breached the duty of good faith and fair dealing, the defendant is usually liable for the full amount of the judgment entered against the insured. *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 341 (1957). In such cases, there may be no need for an additional causation instruction. The instruction should be used if the plaintiff seeks consequential damages. *See* Insurance Bad Faith 13 use note 2.

In contrast, “when an insurer denies coverage in bad faith, it is not liable for the amount of a judgment entered against its insured that exceeds the policy limits absent a refusal of a reasonable settlement offer, unless the insured can establish other causal connections between the insurer’s act and the excess judgment.” *Rogan v. Auto-Owners Ins. Co.*, 171 Ariz. 559, 565 (App. 1991). In such cases, this instruction should be used if causation is disputed.

INSURANCE BAD FAITH 13A

Third-Party Bad Faith: Measure of Damages—Action by Insured

If you find that [name of defendant] breached the duty of good faith and fair dealing, you must then decide the full amount of money that will reasonably and fairly compensate [name of plaintiff] for each of the following elements of damage proved by the evidence to have resulted from [name of defendant]'s breach of the duty of good faith and fair dealing:

1. The full amount of the judgment that was entered against the insured;
2. Attorneys' fees and litigation expenses reasonably incurred by [name of insured] to defend the action against [him/her/it/them] because the insurance company did not do so;
3. Monetary loss or damage to credit reputation experienced and reasonably probable to be experienced in the future; and
4. Emotional distress, humiliation, inconvenience, and anxiety experienced and reasonably probable to be experienced in the future.

SOURCE: *Rawlings v. Apodaca*, 151 Ariz. 149 (1986); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 341 (1957); *Farr v. Transamerica Occidental Life Ins. Co.*, 145 Ariz. 1, 6 (App. 1984).

USE NOTE: 1. Elements of Damages: Instruct only on those elements of damage for which there is proof. If the plaintiff has suffered physical injury as a result of the defendant's bad faith, consider using an appropriately modified version of Personal Injury Damages 1. Where an insured seeks only contract damages (i.e., indemnity for a judgment or the cost of defending the liability claim), the plaintiff need only show that the claim asserted against the insured was within the scope of the insurance coverage. See Insurance Bad Faith 10 use note.

2. Plaintiff Is Insured: This instruction is intended for cases in which the plaintiff is the insured. Where the plaintiffs include both the insured and an assignee (e.g., the insured tortfeasor and the injured judgment creditor), the instructions must make clear which of the plaintiffs is entitled to each of the elements of damage.

3. Prejudgment Interest: See Insurance Bad Faith 6 use note 2.

INSURANCE BAD FAITH 13B

Third-Party Bad Faith: Measure of Damages—Action by Assignee

[Name of insured] has transferred [his/her/their/its] rights under the insurance policy to [name of plaintiff], including any right to recover [name of insured]'s damages caused by [name of defendant]'s breach of duty. If you find that [name of defendant] breached the duty of good faith and fair dealing, and you find that [name of insured] suffered damages caused by that breach, you must then decide the full amount of money that will reasonably and fairly compensate [name of plaintiff] for each of the following elements of damage proved by the evidence:

1. The full amount of the judgment that was entered against [name of insured]; and
2. Attorneys' fees and litigation expenses reasonably incurred by [name of insured] to defend the action against [him/her/them/it] because the insurance company did not do so.

SOURCE: *Rawlings v. Apodaca*, 151 Ariz. 149 (1986); *Farmers Ins. Exch. v. Henderson*, 82 Ariz. 335, 341 (1957); *Farr v. Transamerica Occidental Life Ins. Co.*, 145 Ariz. 1, 6 (App. 1984).

USE NOTE: Prejudgment Interest: See Insurance Bad Faith 6 use note 2.

COMMENTS: Consequential tort damages are personal to the insured and may be recovered only on a bad-faith claim brought by the insured; they may not be assigned to or recovered by the injured tort creditor. *Harleysville Mut. Ins. Co. v. Lea*, 2 Ariz. App. 538, 541-42 (1966); *State Farm Mut. Ins. Co. v. St. Joseph's Hosp.*, 107 Ariz. 498, 503 (1971). "The third party's claim is in reality the insured's claim, but the third party cannot recover damages personally suffered by the insured such as pain and suffering, embarrassment, mental anguish and humiliation. The assignee can only recover the insured's pecuniary losses." *Clearwater v. State Farm Mut. Auto. Ins. Co.*, 161 Ariz. 590, 594 (App. 1989), *vacated in part*, 164 Ariz. 256 (1990).

INSURANCE BAD FAITH 14**Third-Party Bad Faith:
Burden of Proof in *Morris* Reasonableness Hearings**

[*Name of plaintiff*] claims that [*name of defendant*] is liable for the amount of the [settlement between [*name of plaintiff*] and [*name of defendant*]'s insured] [judgment against its insured]. On this claim, [*name of plaintiff*] must prove:

1. The [settlement] [judgment] was neither fraudulent nor collusive; and
2. The amount of the [settlement] [judgment], or a portion of it, was fair and reasonable under the circumstances.

The standard for determining whether the [settlement] [judgment], or any portion of it, was fair and reasonable is what a reasonably prudent person in the insured's position would have settled for on the merits of [*name of plaintiff*]'s case against [*name of defendant*]'s insured. This determination should be based on the facts bearing on the liability and damage aspects of the [*name of plaintiff*]'s case against the insured as well as the risks of going to trial.

If you find that the [settlement] [judgment] was not fraudulent or collusive and that the amount of the [settlement] [judgment] was reasonable under the circumstances, then your verdict must be for [*name of plaintiff*] for the full amount of the [settlement] [judgment]. If you find that only a portion of the [settlement] [judgment] was reasonable under the circumstances, then you should enter a verdict in favor of [*name of plaintiff*] for that amount. If you find that no portion of the [settlement] [judgment] was reasonable under the circumstances, then you should enter a verdict in favor of [*name of defendant*].

SOURCE: *United Services Auto. Ass'n v. Morris*, 154 Ariz. 113, 120-21 (1987). See also *Safeway Ins. Co. v. Guerrero*, 210 Ariz. 5, 9, ¶ 10 (2005); *Himes v. Safeway Ins. Co.*, 205 Ariz. 31, 39, ¶ 22 (2003); *Munzer v. Feola*, 195 Ariz. 131, 136 (App. 1999); *Associated Aviation Underwriters v. Wood*, 209 Ariz. 137, 169-70 (App. 2004).

USE NOTE: 1. *Morris* Hearings. In cases involving *Morris* agreements (see Comment 1 below), an insurance company can challenge the reasonableness of the underlying settlement agreement or judgment. A *Morris* hearing is held where there is a dispute over whether the settlement agreement resulting in the stipulated judgment was reasonable. Arizona courts have not addressed whether a *Morris* hearing can be conducted only before the trial court, or if there is a right to a jury. *Himes*, 205 Ariz. 31 at 36 n.5. This instruction is intended for use if the issue of reasonableness is submitted to a jury.

2. Fraudulent or Collusive. In *Morris*, the Arizona Supreme Court stated a two-part burden of proof, reflected in subparagraphs (1) and (2) of this instruction. In cases where the issue of fraud or collusion is not raised, subparagraph (1) may be omitted.

Continued

INSURANCE BAD FAITH 14

Third-Party Bad Faith: Burden of Proof in *Morris* Reasonableness Hearings

Continued

COMMENTS: 1. *Morris* Agreements. The Arizona Supreme Court recognized that “[t]he term ‘*Morris* agreement’ is generally used to describe a settlement agreement in which an insured defendant admits to liability and assigns to a plaintiff his or her rights against the liability insurer, including any cause of action for bad faith, in exchange for a promise by the plaintiff not to execute the judgment against the insured. Such an agreement can be prompted by a number of circumstances.” 210 Ariz. at 7 n.1, ¶ 1. The Supreme Court identified those circumstances as an agreement entered into after the insurer’s reservation of rights (citing *Morris*); an agreement entered after the insurer’s alleged anticipatory breach of its duty to indemnify (citing *Ariz. Prop. & Cas. Ins. Guar. Fund v. Helme*, 153 Ariz. 129 (1987)); and an agreement entered into after the insurer’s alleged bad-faith refusal to settle (citing *Miel v. State Farm Mut. Auto. Ins. Co.*, 185 Ariz. 104 (App. 1995)).

2. Reasonableness Hearings. In situations involving *Morris* agreements, the insurer may contest the reasonableness of the amount of the settlement or stipulated judgment. *See Morris*, 154 Ariz. at 120-21. The Arizona Court of Appeals has explained that, under *Morris*, “the primary purpose of a reasonableness hearing is to attempt to re-create the same result that would have occurred if there were an arm’s-length negotiation on the merits of the case between interested parties.” *Himes*, 205 Ariz. 31, 38, ¶ 22.

3. Scope of Review. An insurer is not entitled to contest the amount of the insured’s liability if the underlying case goes to judgment based on evidentiary or legal rulings and the insurer had adequate notice of the proceedings. Under the doctrine of collateral estoppel, “[an insurer] is precluded from relitigating those issues determined in the action against the [insured] as to which there was no conflict of interest between the [insurer] and the [insured].” *Farmers Ins. Co. v. Vagnozzi*, 138 Ariz. 443, 448 (1983) (quoting Restatement (Second) of Judgments § 58 (1982)); *see also Gilbreath v. St. Paul Fire & Marine Ins. Co.*, 141 Ariz. 92, 96-97 (1984) (insurer may not collaterally attack valid judgment rendered against its insured); *State Farm Mut. Auto. Ins. Co. v. Paynter*, 122 Ariz. 198, 201 (App. 1979) (absent fraud and collusion, insurer may not raise defenses that were not raised by insured in the underlying case).

4. Fraudulent or Collusive: The words “fraudulent” and “collusive” are terms of art that have been used by Arizona courts in published opinions. These words may be misleading to juries without further definition or explanation. The Committee believes that these terms warrant clarification, but the published Arizona precedent does not yet provide such clarification in the specific context of *Morris* agreements. For a discussion of “fraudulent or collusive” in the context of *Damron* agreements, *see State Farm Mut. Auto. Ins. Co. v. Paynter*, 122 Ariz. 198, 200-02 (App. 1979). For a discussion of collusion in the context of settlement agreements generally, *see Sandretto v. Payson Healthcare Management, Inc.*, 234 Ariz. 352, 362-363, ¶¶ 47-50 (App. 2014); *see also In re Alcorn*, 202 Ariz. 62, 68-71, ¶¶ 18-33 (2002).

Continued

INSURANCE BAD FAITH 14

**Third-Party Bad Faith:
Burden of Proof in *Morris* Reasonableness Hearings**

Continued

5. Timing and Evidence. The instruction does not address temporal restrictions on the evidence that may be considered in a *Morris* reasonableness hearing. The Committee believes that Arizona precedent is unclear as to whether, in determining the reasonableness of a settlement, the trier of fact is limited to information that was actually known to the defendant at the time of settlement, or that a reasonably prudent person would have known at that time. Therefore, it is unclear whether the trier of fact may consider information that did not exist or was not available at the time of settlement but was presented at the reasonableness hearing. *See Associated Aviation Underwriters v. Wood*, 209 Ariz. 137, 171, ¶ 111 (App. 2004) (recognizing that “[i]ndividualized evidence on all those elements [legal merits of liability claims, validity of affirmative defenses, and nature and extent of damages] presumably would be presented and considered”); *Munzer v. Feola*, 195 Ariz. 131, 136, ¶ 31 (App. 1999) (explaining that “the trial court must consider all relevant evidence”).