

BAD FAITH OR NO FAITH? FINDING A PLACE FOR  
WRONGFUL REFUSAL TO DEFEND IN FLORIDA’S  
BAD FAITH JURISPRUDENCE

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I.	INTRODUCTION.....	1389
II.	THE EVOLUTION AND NATURE OF BAD FAITH.....	1392
	A. <i>Evolution and Myopia in Florida Bad Faith Law</i> .....	1392
	B. <i>Evolution of the Implied Covenant of Good Faith</i> .....	1396
	C. <i>Classic Bad Faith: Tort or Contract?</i> .....	1402
	D. <i>Bad Faith Breach of the Covenant as Tort</i> .....	1405
III.	RECONCILING REFUSAL TO DEFEND WITH BAD FAITH.....	1409
	A. <i>The Duty to Defend Generally</i> .....	1409
	B. <i>Refusal to Defend: Bad Faith or No Faith?</i> .....	1414
	C. <i>Near Misses in Bad Faith Refusal to Defend: A Summary</i> .....	1419
	D. <i>Justifying the Move to Bad Faith Refusal to Defend Predicated on Breach of the Covenant</i> .....	1421
	E. <i>The Nature of Bad Faith Refusal to Defend Predicated on Breach of the Covenant</i> .....	1424
	1. <i>Conduct Constituting Bad Faith</i> .....	1424
	2. <i>Refusal to Defend: First- or Third-Party Claim?</i> .....	1425
	3. <i>Discovery in the Bad Faith Refusal-to-Defend Claim</i> .....	1428
	4. <i>Other Considerations</i> .....	1430
	F. <i>The Nature of Bad Faith Refusal to Defend Predicated on Breach of the Covenant: Damages</i> .....	1433
	1. <i>Generally</i> .....	1433
	2. <i>Punitive Damages</i> .....	1434
	3. <i>Noneconomic Losses</i> .....	1437
IV.	CONCLUSION.....	1438

I. INTRODUCTION

One night in September 1973, a man known to us only as “Kenny” stood in charge of Bon’s Laundry #1 in Pinellas County, Florida.<sup>1</sup> Michael Hancock and a few companions showed up and began banging on the doors to the laundromat, threatening to break in and take money.<sup>2</sup> Kenny chased the young men and threw sulphuric acid on Hancock during the pursuit.<sup>3</sup> Roughly one month later, Hancock filed suit against Willie and Anne Thomas as owners of Bon’s

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1. *Thomas v. W. World Ins. Co.*, 343 So. 2d 1298, 1300 (Fla. 2d DCA 1977).  
 2. *Id.*  
 3. *Id.*

Laundry #1.<sup>4</sup> The Thomases' premises liability insurer, Western World Insurance Company, reacted in a manner that is not altogether uncommon, but which has raised novel issues of Florida law that have yet to be systematically addressed: Western World refused to defend the Thomases against Michael Hancock's suit.<sup>5</sup>

Specifically, Willie Thomas reported Hancock's suit to Western World's local agent just three days after service of process.<sup>6</sup> The agent furnished a written report to Western World together with a copy of Michael Hancock's complaint which, significantly, sounded in negligence against the Thomases.<sup>7</sup> Western World refused to investigate the claim and refused its obligation to defend them because, as stated by Western World's vice president of claims, the policy excluded coverage for "claims arising out of assault and battery."<sup>8</sup> This refusal was communicated to the Thomases the day before, or perhaps on the very day, that they were required to formally answer Michael Hancock's complaint.<sup>9</sup> Though the premises liability policy afforded only \$5,000 in coverage, Willie and Anne Thomas predictably defaulted and Michael Hancock obtained a final judgment against them for a total of \$18,459.73.<sup>10</sup> In the Thomases' subsequent action against Western World,<sup>11</sup> the insurer conceded its wrongful refusal to defend given that Hancock's suit sounded in negligence which was covered under the policy.<sup>12</sup>

The appellate decision in *Thomas* probed the potential for bad faith recovery where an insurer's blatantly wrongful refusal to defend resulted in an excess judgment against its insureds.<sup>13</sup> The court concluded in essence that bad faith requires a breach of fiduciary

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4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.*

10. *Id.*

11. The Thomases' action against Western World is discussed further in Part III.B., *infra*.

12. *Thomas*, 343 So. 2d at 1300-01. Not only was Hancock's negligence action a covered occurrence under the policy, but Kenny's act of dousing acid on Hancock almost certainly fell beyond the scope of Kenny's employment. In the words of the Second District Court of Appeal: "This defense may well have been sufficient to relieve the insureds from liability that might otherwise have been imposed under the doctrine of *respondeat superior*." *Id.* at 1302-03. In other words, Hancock's case would most likely have been dismissed or disposed of on summary judgment had Western World defended against the claim.

13. *See id.* An "excess judgment" occurs when a third party brings a legal action that results in a judgment exceeding the liability policy limits applicable to the occurrence giving rise to that action. The insured defendant is personally liable for any amount exceeding liability insurance coverage and might bring (or assign to the judgment creditor) a bad faith action against the insurer claiming that had the insurer acted properly, the excess judgment would not have occurred. The damages available in bad faith include the amount of the excess judgment, among others. Damages are touched upon in Part III.F., *infra*.

duty but that the fiduciary duty arises only in connection with the actual defense and settlement of a third-party claim. It follows, said the court, that where there is a refusal to defend, there can be no breach of fiduciary duty and, hence, no bad faith; in actuality, Western World “exercised no faith at all.”<sup>14</sup>

I hope to demonstrate the inadequacy of this analysis while suggesting reasons why and methods by which liability insurers may be held liable for bad faith refusal to defend. This is no small task because the *Thomas* court was largely correct in claiming that bad faith arises only where a fiduciary duty exists and that this duty has traditionally arisen upon assumption of the insured’s defense.<sup>15</sup> There also remains a question whether bad faith might afford remedies not available under the broad recovery of foreseeable breach of contract damages recognized in *Thomas*.<sup>16</sup> In short, my analysis calls for a reassessment of Florida’s entire approach to bad faith, albeit with the limited purpose of recognizing the true nature of refusal to defend as a potential bad faith claim. I am encouraged by a sincere belief that the pieces of Florida’s refusal-to-defend puzzle have never been put together at one sitting and, indeed, that a few remain in the box. My hope is that a patient hand may reveal the need and the means for addressing this oversight in Florida’s bad faith jurisprudence.

In substance, I contend that a liability insurer’s obligation of good faith is not limited to a fiduciary duty that attaches upon the assumption of an insured’s defense. Indeed, to view the contractual relationship in this manner might give the insurer an incentive to avoid potential bad faith by breaching its contractual duty to defend. Rather, I contend that the insurer is bound contractually by the implied covenant of good faith (“Covenant”), the breach of which may give rise to bad faith liability although the insurer never formally assumed any defense of the insured.<sup>17</sup> The Covenant carries obligations that attach prior to the assumption of an insured’s defense and it demands of an insurer a fidelity that may not be lightly disregarded.

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14. *Thomas*, 343 So. 2d at 1303-04. The *Thomas* court nevertheless held the insurer liable for the excess judgment under a theory of foreseeable contract damages. *See id.* While this is an acceptable resolution for a contract claim, refusal to defend may prove more than a mere breach of contract and may well warrant the imposition of punitive and noneconomic damages as discussed in Part III.F., *infra*.

15. The evolution of this doctrine and of Florida bad faith jurisprudence generally is discussed in Part II.A., *infra*.

16. *See Thomas*, 343 So. 2d at 1304. This Article focuses on placing refusal to defend in its proper bad faith context regardless of whether it might result in damages different from or additional to those available in a strict contract action. Nevertheless, I briefly discuss damages because they are integral to the subject.

17. Given the cumbersomeness of repeating the phrase “implied covenant of good faith,” I refer to it throughout the Article as the “Covenant.” This encompasses the phrase in its numerous permutations such as the implied covenant of fair dealing and commercial reasonableness, the implied duty of fair dealing, etc.

Its breach is tortious; and an egregious breach of the Covenant (a “bad faith” breach rather than a “mere” breach), should give rise to potential tort damages encompassing noneconomic losses and punitive measures. Thus, because the Covenant precedes and informs an insurer’s decision whether to assume defense of its insured, a refusal to defend may breach the Covenant if not carried out in good faith.

To arrive at these substantive conclusions, I must take a specific course. I first address in Part II the evolution of bad faith and the Covenant in Florida, as well as the nature or spirit of these causes of action. The next logical step is to locate where refusal to defend falls within this jurisprudential framework. Therefore, in Part III, I attempt to answer the core question of whether refusal to defend should be considered “bad faith” in tort or “no faith” in contract. I argue that while the notion of “no faith” comports with bad faith law as it has developed in Florida, this is neither a necessary nor desirable approach. The discussion accordingly treats refusal to defend as bad faith and attempts to clearly delineate the elements of the potential bad faith refusal-to-defend cause of action. I also consider in Part III the remedies that might lie for bad faith refusal to defend in light of general remedies available in the modern bad faith context. Finally, I conclude by digesting these observations into what I hope will prove a coherent and workable framework for bad faith refusal to defend.

## II. THE EVOLUTION AND NATURE OF BAD FAITH

### A. *Evolution and Myopia in Florida Bad Faith Law*

Bad faith was born in Florida on November 9, 1938, with the rendering of the Florida Supreme Court’s opinion in *Auto Mutual Indemnity Co. v. Shaw*.<sup>18</sup> The case involved the now familiar excess judgment scenario in which the injured plaintiff made a demand upon the insurer that was not accepted by the insurer and thereupon obtained a judgment against the insured exceeding the available policy limits.<sup>19</sup> Departing from traditional contract principles, the court in *Shaw* embraced the concept of bad faith by seizing upon the fact that the insurer had issued a liability policy rather than an indemnity policy—the distinction being that the liability policy included a defense clause that precluded the insured from “negotiating for a settlement, or interfering in any manner except upon the request of the insurer.”<sup>20</sup>

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18. 184 So. 852 (Fla. 1938).

19. *See id.* at 853-54.

20. *Id.* at 857. In fact, a driving force behind the common law move to bad faith included a general trend away from indemnity agreements in favor of liability policies given the insurer abuses that accompanied indemnity agreements. *See generally* Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions: Refining the Stan-*

Under a traditional indemnity agreement, the insured would conduct a defense and seek indemnification from the insurer for monies expended in defending the claim and satisfying any ultimate judgment.<sup>21</sup> The liability policy, however, required that the insured refrain from any negotiation or legal maneuvering with respect to the claim so that the insurer maintained total control over defense and settlement.<sup>22</sup> The court in *Shaw* followed the lead of a seminal Wisconsin bad faith decision<sup>23</sup> and ruled that where the insurer assumed total control over the defense and settlement of claims, it “should be held to that degree of care and diligence which a man of ordinary care and prudence should exercise in the management of his own business.”<sup>24</sup> The decision in *Shaw* noted, in words reminiscent of the modern Covenant, that the insurer bore a duty “not under the terms of the contract strictly speaking, but because of and flowing from it, to act honestly and in good faith toward the insured.”<sup>25</sup>

While *Shaw* thus suggested that an insurer’s duty of good faith arose by legal implication and therefore could pose broader obligations than those attendant in the assumption of the insured’s legal defense, the decision apparently considered assumption of the insured’s defense a threshold to bad faith liability.<sup>26</sup> Indeed, the court, in dicta, considered the refusal-to-defend “class” of cases and noted that an insurer’s liability would not exceed “the limit of indemnity which it agreed to furnish.”<sup>27</sup> And so the *Shaw* decision, which harkened to a covenant of good faith implied in law, instead spoke ultimately in terms of duties arising where the insurer has assumed control of the claim at hand.<sup>28</sup>

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*dard of Culpability and Reformulating the Remedies by Statute*, 26 U. MICH. J.L. REFORM 1, 16-18 (1992). With the rise of the defense clauses that characterize liability policies came the implied or fiduciary duties relied upon in *Shaw* and discussed throughout this Article.

21. See Henderson, *supra* note 20, at 16.

22. See *id.* at 16-17.

23. *Hilker v. W. Auto. Ins. Co.*, 231 N.W. 257 (Wis. 1930), *modified on reh'g*, 235 N.W. 413 (Wis. 1931).

24. *Shaw*, 184 So. at 859.

25. *Id.* (quoting *Am. Mut. Liab. Ins. Co. v. Cooper*, 61 F.2d 446, 448 (5th Cir. 1932)).

26. The decision quotes *Hilker* in holding that the insurer’s duties arise “because it has taken over this duty [to defend and settle], and because the contract prohibits the insured from settling.” *Id.* at 857 (quoting *Hilker*, 235 N.W. at 414-15). Though these are implied duties, similar to the ever-present Covenant, there is little question that as conceived by these early decisions, the duties arose only where the insurer assumed control of the claim.

27. *Id.* (quoting *Wis. Zinc Co. v. Fid. & Deposit Co.*, 155 N.W. 1081 (Wis. 1916)). The court mentioned that breach of the duty to defend would release the insured to pursue a private defense and settle the case with a right of indemnification within policy limits. The court apparently did not consider that an insured might not be capable of hiring private counsel and might therefore suffer a default, an excess judgment, or both, due solely to the insurer’s failure to defend the claim.

28. See *id.* at 857-59.

Viewing *Shaw* realistically, it seems the Florida Supreme Court, like many courts around the nation at the time,<sup>29</sup> recognized the potential for abuse where insurers maintained total control over defense and settlement on behalf of a given insured whose interests might often prove adverse to those of the insurer. The court tweaked the common law to remedy this situation. In so doing, it naturally changed the law as little as possible and hinged its decision upon the nature of the liability policy. The court might easily have held that the duty of good faith arose at the time of contracting and encompassed the duty to defend. It was not faced with that question, however, and it instead framed its holding in a manner that would ultimately isolate refusal-to-defend claims from its bad faith jurisprudence.<sup>30</sup>

The *Shaw* rationale led to a preoccupation with an insurer's failure to settle as the primary basis for bad faith recovery. Courts since *Shaw* have focused on *how* a defense was handled and with what result to determine whether bad faith occurred.<sup>31</sup> This has yielded a bad faith jurisprudence predicated upon an insurer's so-called fiduciary duties in third-party litigation with excess judgment viewed as the litmus for bad faith liability.<sup>32</sup> In light of this approach, putative first-party and refusal-to-defend bad faith claims appear anomalous because they lack these tell-tale signs of "classic," that is, third-party, bad faith.<sup>33</sup>

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29. See generally Henderson, *supra* note 20, at 17-22 (describing the larger jurisprudential landscape in which bad faith arose).

30. Incidentally, the fact that the court in *Shaw* was not faced with a refusal-to-defend claim means that its holding would not necessarily apply in the refusal-to-defend context. See Canal Ins. Co. v. Sturgis, 114 So. 2d 469, 470 (Fla. 1st DCA 1959) (analyzing *Shaw* and stating: "It is axiomatic, of course, that every judicial decision must be read in the light of the particular factual situation that gave rise to that decision.").

31. See, e.g., Kelly v. Williams, 411 So. 2d 902 (Fla. 5th DCA 1982).

32. *Id.* at 904 ("The essence of a 'bad faith' insurance suit . . . is that the insurer breached its duty to its insured by failing to properly or promptly defend the claim . . . all of which results in the insured being exposed to an excess judgment."); see also State Farm Fire & Cas. Co. v. Zebrowski, 706 So. 2d 275, 277 (Fla. 1997) ("[I]n the absence of an excess judgment, a third-party plaintiff cannot demonstrate that the insurer breached a duty toward its insured."); Boston Old Colony Ins. Co. v. Gutierrez, 386 So. 2d 783, 785 (Fla. 1980) ("[W]hen the insured has surrendered to the insurer all control over the handling of the claim, including all decisions with regard to litigation and settlement, then the insurer must assume a duty to exercise such control and make such decisions in good faith . . ."); Thompson v. Commercial Union Fire Ins. Co., 250 So. 2d 259, 260 (Fla. 1971) ("[A]n insured has the right to sue and recover damages against his own insurer for an excess judgment on the basis of fraud or bad faith in the conduct of the insured's defense by the insurer.") (citing Am. Fire & Cas. Co. v. Davis, 146 So. 2d 615 (Fla. 1st DCA 1962)); Baxter v. Royal Indem. Co., 285 So. 2d 652, 656 (Fla. 1st DCA 1973) ("It is the existence of the fiduciary relationship between the parties under the bodily injury liability provisions of the policy which imposes upon the insurer the obligation of exercising good faith . . .").

33. See Baxter, 285 So. 2d at 655 (refusing to recognize first-party bad faith because there is no fiduciary relationship as in the third-party context); State Farm Mut. Auto. Ins. Co. v. Laforet, 658 So. 2d 55, 59 (Fla. 1995) (noting that first-party bad faith did not exist

Florida's bad faith jurisprudence need not have evolved in this manner. California courts, the vanguard in the march toward bad faith liability, decided as early as 1958 in the case of *Comunale v. Traders and General Insurance Co.*<sup>34</sup> that an insurer who refused to defend and thereafter refused a settlement offer could be held in bad faith by having breached "an implied covenant of good faith and fair dealing" that exists in "every contract."<sup>35</sup> As it happened, the *Comunale* court reached this decision by relying in large part upon the very case that *Shaw* cited in recognizing Florida's bad faith cause of action.<sup>36</sup> Admittedly, the *Comunale* court held that, absent the subsequent settlement offer, the refusal to defend alone would afford only damages up to the policy limits with additional attorney's fees and costs.<sup>37</sup> But California has since recognized a cause of action for bad faith refusal to defend predicated upon breach of the Covenant.<sup>38</sup> Other jurisdictions have done likewise.<sup>39</sup> This is not to say that Florida might blindly choose the route that California has taken. Instead it illustrates that Florida's particular view of bad faith has blinded it to legally cognizable options that might have seemed more feasible had the law developed differently.

The Colorado appellate court in *Wheeler v. Reese*, for example, faced no conceptual impediment in assigning bad faith liability for an

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at common law because "the type of fiduciary duty that exists in third-party actions is not present . . . and the insurer is not exposing the insured to excess liability"); *Fid. & Cas. Co. v. Cope*, 462 So. 2d 459, 461 (Fla. 1985) (refusing to recognize bad faith claim where insured tortfeasor had been released and thus faced no further exposure); *Thomas v. W. World Ins. Co.*, 343 So. 2d 1298, 1304 (Fla. 2d DCA 1977) (holding that refusal to assume defense precludes finding of bad faith because insurer exercised "no faith"). It must be mentioned that a statutory cause of action has existed since 1982 for first-party bad faith pursuant to section 624.155, *Florida Statutes*. It is my opinion that the statute affords no relief for refusal to defend except, arguably and only then in exceptional circumstances, through the refusal-to-settle provisions of the statute. I am not aware of any statutory refusal-to-define claim in Florida. While the legislature might do well to revisit the statute in this regard, I focus here on common law remedies because my thesis is that Florida common law affords a remedy for refusal to defend even if that remedy has been long-overlooked.

34. 328 P.2d 198 (Cal. 1958).

35. *Id.* at 200.

36. *See id.* at 200-01 ("[T]he rights of the insured 'go deeper than the mere surface of the contract' . . . and that implied obligations are imposed 'based upon those principles of fair dealing which enter into every contract.'" (quoting *Hilker v. W. Auto. Ins. Co.*, 231 N.W. 257, 258 (Wis. 1930), *modified on reh'g*, 235 N.W. 413 (Wis. 1931)).

37. *See id.* at 201.

38. *See Shade Foods, Inc. v. Innovative Prods. Sales & Mktg., Inc.*, 93 Cal. Rptr. 2d 364, 387 (Cal. Ct. App. 2000); *Amato v. Mercury Cas. Co.*, 61 Cal. Rptr. 2d 909, 912 (Cal. Ct. App. 1997); *Campbell v. Super. Ct.*, 52 Cal. Rptr. 2d 385, 392 (Cal. Ct. App. 1996).

39. *See Tibbs v. Great Am. Ins. Co.*, 755 F.2d 1370, 1375 (9th Cir. 1985) (predicting California law); *Dairyland Ins. Co. v. Hawkins*, 292 F. Supp. 947, 952 (S.D. Iowa 1968) ("It is the view of this Court that the Iowa Supreme Court will likewise apply the bad faith test to excess judgment cases where the insurer wrongfully refused to defend . . .") (predicting Iowa law); *Wheeler v. Reese*, 835 P.2d 572, 578 (Colo. Ct. App. 1992); *Smith v. Am. Family Mut. Ins. Co.*, 294 N.W.2d 751 *passim* (N.D. 1980).

insurer's refusal to defend because it was seen as just one more way that an insurer might breach its implied duty of good faith.<sup>40</sup> The court avoided Florida's problem of exactly how to approach bad faith where assumption of the insured's defense is viewed as a threshold question rather than the actual matter at issue.<sup>41</sup> Instead, tortious breaches of contract in Colorado generally are viewed as giving rise to bad faith liability regardless of whether they are first- or third-party and regardless of the context in which they might arise.<sup>42</sup> Yet Florida's inability to so easily approach refusal-to-defend claims is self-imposed. Florida has embraced the Covenant in the insurance context,<sup>43</sup> but it has failed to square that concept with its underdeveloped refusal-to-defend jurisprudence. The purpose of this Article is to demonstrate that the intertwining of these two strands in Florida law is not only possible, but necessary.

### B. *Evolution of the Implied Covenant of Good Faith*

Paralleling the rise of bad faith—indeed, integral to its ascendancy—was the rise of the Covenant, which appeared in an embryonic form in *Shaw* itself. The *Shaw* decision did not speak in the modern parlance of a fiduciary duty owed by an insurer to its insured. Rather, it referred to a larger “duty, not under the terms of the contract strictly speaking, but . . . flowing from it, to act honestly and in good faith toward the insured.”<sup>44</sup> This “duty” (of good faith) was necessarily implied given that it did not arise from the contract “strictly speaking.”<sup>45</sup>

This is the essence of the Covenant in its modern form and it could be argued, therefore, that the Covenant was present at the birth of Florida bad faith although, as noted above, the *Shaw* court clearly felt that the duty arose because the insurer maintained control over the defense and settlement of the insured's claim.<sup>46</sup> The

40. See 835 P.2d at 578.

41. See *id.*; see also *Best Place, Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334, 341-44 (Haw. 1996) (recognizing a cause of action for first-party bad faith predicated on breach of the Covenant).

42. The standard of culpability differs between first- and third-party claims, but assumption of the defense is not seen as a “trigger” to an insurer's duty of good faith as it has grown to be seen in Florida.

43. See *infra* Part II.B.

44. *Auto Mut. Indem. Co. v. Shaw*, 184 So. 852, 859 (Fla. 1938) (quoting *Am. Mut. Liab. Ins. Co. v. Cooper*, 61 F.2d 446, 448 (5th Cir. 1932)).

45. See *Sharp v. Williams*, 192 So. 476, 480 (Fla. 1940) (“A contract includes not only the things written, but also terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken.”) (citing *S.F. Bowser & Co. v. Marks*, 131 S.W. 334 (Ark. 1910)); *McGill v. Cockrell*, 101 So. 199, 201 (Fla. 1924) (“[W]hat the law implies, from the relation of parties created by an express agreement is as much a part of the contract as that which is expressed.”).

46. See *supra* note 26 and accompanying text.

Covenant as such was born twenty years later in California with the California Supreme Court's *Comunale* decision.<sup>47</sup> The *Comunale* court faced a refusal to defend where an offer of settlement was nevertheless tendered to the liability carrier despite the refusal to defend.<sup>48</sup> It is clear that the insurer in *Comunale* never assumed defense of the claim, which would have been required by *Shaw* and its progeny to trigger the insurer's fiduciary obligations upon which Florida bad faith apparently hinges. Yet the California court took a larger view of the insurer/insured relationship and held: "There is an implied covenant of good faith and fair dealing in every contract that neither party will do anything which will injure the right of the other to receive the benefits of the agreement. This principle is applicable to policies of insurance."<sup>49</sup> From its inception in *Comunale*, the breach was considered tortious.<sup>50</sup> This notion was reaffirmed in *Gruenberg v. Aetna Insurance Co.*<sup>51</sup> where the California Supreme Court made clear that bad faith liability was not predicated on a breach of contract but arose instead from "a duty included within the implied covenant of good faith and fair dealing."<sup>52</sup> The *Gruenberg* court interpreted *Comunale* to mean that breach of the Covenant sounded both in contract and in tort,<sup>53</sup> though it concluded that failure to settle "may give rise to a cause of action in tort for breach of an implied covenant of good faith and fair dealing."<sup>54</sup> This applied without reservation to the first-party fire insurance claims at issue in that case.<sup>55</sup>

Less than six months after the *Gruenberg* decision, Florida's First District Court of Appeal handed down its decision in *Baxter v. Royal Indemnity Co.*<sup>56</sup> Ironically, the majority opinion in *Baxter* refused to recognize a cause of action for first-party bad faith in Florida because the first-party insurer/insured relationship lacked the "fiduciary" nature of the typical third-party bad faith claim.<sup>57</sup> The *Baxter* opinion deemed the first-party relationship "the very antithesis of that estab-

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47. *Comunale v. Traders & Gen. Ins. Co.*, 328 P.2d 198 (Cal. 1958).

48. *See id.* at 200.

49. *Id.* (citations omitted).

50. *See id.* at 203. The court held that the breach was to be "treated as a tort," though it deemed it an exception to the tort limitations period and opted for the lengthier limitations period afforded contract actions.

51. 510 P.2d 1032 (Cal. 1973).

52. *Id.* at 1037 (quoting *Crisci v. Sec. Ins. Co.*, 426 P.2d 173, 177 (Cal. 1967)).

53. *See id.* at 1036.

54. *Id.* at 1037.

55. *See id.* at 1034 (discussing coverages at issue in the case).

56. 285 So. 2d 652 (Fla. 1st DCA 1973).

57. *See id.* at 656 ("Because of the fiduciary relationship arising under the bodily injury liability provision of an automobile policy, insurers have been held liable for any judgment rendered against their insured in excess of the policy limits . . .") (citing *Am. Fire & Cas. Co. v. Davis*, 146 So. 2d 615 (Fla. 1st DCA 1962), and *Auto Mut. Indem. Co. v. Shaw*, 184 So. 852 (Fla. 1938)).

lished by the bodily injury liability provisions of the same policy.”<sup>58</sup> While its logic that the first-party insured would not be harmed by an excess judgment was sound, its premise reveals the earmarks that Florida courts were looking for at the time: a purportedly nonadversarial relationship with exposure to an excess judgment. The court concluded that “[i]t is the existence of the fiduciary relationship between the parties under the bodily injury liability provisions of the policy which imposes upon the insurer the obligation of exercising good faith.”<sup>59</sup>

Despite this prevailing view, Judge Spector’s dissent in *Baxter* embraced a broad concept of bad faith premised upon the Covenant.<sup>60</sup> He cited the Florida Supreme Court decision in *Nationwide Mutual Insurance Co. v. McNulty*<sup>61</sup> for the proposition that the duty to exercise good faith “though not expressed flows from the contract.”<sup>62</sup> Ultimately, Judge Spector was quite explicit with reference to California cases in holding that the Covenant is implied by law, that it exists in every contract, that it comports with Florida’s prior judicial decisions, and that it would permit a common law first-party bad faith claim.<sup>63</sup>

The *Baxter* decision did not directly address breach of the Covenant as a cause of action in bad faith, though its narrow view of an insurer’s duty left little doubt how it might decide the question. It is precisely because of this view that the Covenant, which thrives in Florida, has yet to be incorporated formally into Florida bad faith jurisprudence. There is no reason it should not, particularly in the refusal-to-defend context.<sup>64</sup>

58. *Id.*

59. *Id.* This epitomizes the myopic view of bad faith that resulted from the *Shaw* decision.

60. *See id.* at 658.

61. 229 So. 2d 585 (Fla. 1969).

62. *Baxter*, 285 So. 2d at 659 (Spector, J., dissenting).

63. *See id.* at 661-62 (Spector, J., dissenting). Though I agree with Judge Spector’s analysis and I believe my analysis of the Covenant in this Article would permit common law first-party bad faith claims, it should be remembered that the ultimate point of this Article concerns refusal to defend which, as shall be demonstrated, is third-party in nature. As such, *Baxter* would have no impact upon my analysis. Of course, *Baxter* was abrogated by statute with the passage of section 624.155, *Florida Statutes*, which permits first-party bad faith claims.

64. A number of bad faith decisions discuss the Covenant to some extent or another as noted throughout this Article, but none has considered the point at which the Covenant attaches vis-à-vis the general premise that a bad faith breach of fiduciary duties cannot occur until assumption of an insured’s defense. One case held as much in effect, but without an express analysis of this issue. *See Am. Fid. Fire Ins. Co. v. Johnson*, 177 So. 2d 679, 683 (Fla. 1st DCA 1965) (holding a refusal to defend as “tantamount to bad faith in the performance of its contractual obligations to the insured” but without direct reference to the Covenant) (emphasis added). Also interesting are the discovery cases holding that an insurer’s “fiduciary” duties relate back to the filing of the claim once a declaratory judgment of coverage has been entered. *See Gen. Accident Fire & Life Ins. Corp. v. Boudreau*, 658 So.

A brief overview of the doctrine is necessary to prove this eventual claim before delving into the specific interplay between the Covenant and refusal to defend. Judge Van Nortwick of the First District Court of Appeal offered a concise and thoroughly cited discussion of the doctrine in *Cox v. CSX Intermodal Inc.*:

It is axiomatic that “[e]very contract includes not only its written provisions, but also the terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken.” One of the implied contract terms recognized . . . in Florida law . . . is the implied covenant of good faith, fair dealing, and commercial reasonableness. This implied covenant arises because “[a] contract is an agreement whereby each party promises to perform their part of the bargain in good faith, and expects the other party to do the same.”<sup>65</sup>

The doctrine is necessarily vague given its ethereal quality and the broad range of circumstances to which it must apply. Yet it is not difficult to imagine conduct that might amount to a breach. The Restatement has characterized it this way:

Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party’s performance.<sup>66</sup>

In Florida, there are three restrictions on causes of action for breach of the Covenant. The first two merit mention as an academic matter; the third requires more discussion. The first and second restrictions are interrelated: the Covenant may never override the express terms of a contract, and the Covenant is never breached absent the breach of an express policy provision.<sup>67</sup> These are sensible limitations given that the Covenant is in essence a code of conduct that governs the performance of express contractual terms. It neither replaces those terms nor attaches in their absence. These considera-

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2d 1006, 1007 (Fla. 5th DCA 1994) (holding that the insurer’s “fiduciary” duties relate back to “the time [the insurer] received notice of the claim.”); *Fortune Ins. Co. v. Greene*, 775 So. 2d 338, 339 (Fla. 2d DCA 2000) (same).

65. 732 So. 2d 1092, 1097 (Fla. 1st DCA 1999) (citations omitted) (quoting *First Nationwide Bank v. Fla. Software Servs., Inc.*, 770 F. Supp. 1537, 1542-43 (M.D. Fla. 1991)).

66. RESTATEMENT (SECOND) OF CONTRACTS § 205 cmt. d (1979).

67. See *Ins. Concepts & Design, Inc. v. Healthplan Servs., Inc.*, 785 So. 2d 1232, 1234-35 (Fla. 4th DCA 2001).

tions would arise rarely, if ever, in the typical liability insurance scenario because the duty to defend is a common and generally unqualified duty in every liability policy.<sup>68</sup> In short, every refusal-to-defend insurance action rests a fortiori upon the alleged breach by an insurer of an express contractual duty to defend.

The third restriction establishes that the Covenant applies only where a contracting party is exercising some measure of discretion in carrying out a contractual duty (since a nondiscretionary act can not by definition be undertaken in bad faith).<sup>69</sup> The duty to defend arising from liability insurance contracts is self-evidently discretionary in every instance: an insurer must review the allegations brought against its insured and make a determination both of coverage and of its duty to defend. It has a range of options in deciding how to proceed.<sup>70</sup> Hence, the Covenant applies to an insurer's decision whether to defend its insured against a third-party liability claim and it "raises an implied obligation of good faith to observe reasonable limits in exercising that discretion, consistent with the parties' purpose or purposes in contracting."<sup>71</sup>

Yet some anticipatory response must be made to the beguiling counterargument that an insurer never has the discretion to breach its duty to defend. An insurer might argue that defense provisions are not subject to the Covenant because the duty to defend is determined by an objective comparison of the underlying complaint with the policy provisions; that is, it is a nondiscretionary decision. But is there ever discretion to breach a contract? Every discretionary decision deemed a breach of the Covenant is ultimately found by a court to be a decision the party did not have the discretion to make (or to make in the manner it was made). Every discretionary power conferred by a given contract is naturally limited by the law governing the parties' relationship. In the liability insurance relationship, the insurer is charged with exercising unilateral judgment regarding in-

68. For a general discussion of the duty to defend, see *infra* Part III.A.

69. See *Cox*, 732 So. 2d at 1097-98 ("Thus, where the terms of the contract afford a party substantial discretion to promote that party's self-interest, the duty to act in good faith nevertheless limits that party's ability to act capriciously . . ."); see also *Cheek v. Agric. Ins. Co.*, 432 F.2d 1267, 1269 (5th Cir. 1970) ("The law of Florida imposes a duty upon the insurer to act honestly and in good faith toward the insured in the defense and settlement of claims . . . . The insurer will thus be liable for any damage caused by his failure to act in good faith.") (citing *Burton v. State Farm Mut. Auto. Ins. Co.*, 335 F.2d 317, 324 n.14 (5th Cir. 1964); *Tully v. Travelers Ins. Co.*, 118 F. Supp. 568, 569 (N.D. Fla. 1954)); *Auto Mut. Indem. Co. v. Shaw*, 184 So. 852, 859 (Fla. 1938).

70. The contractual duty to defend is discussed generally *infra* Part III.A.

71. *Cox*, 732 So. 2d at 1097 (quoting *Centronics v. Genicom Corp.*, 562 A.2d 187, 193 (N.H. 1989) (Souter, J.)); see also *Ins. Concepts & Design, Inc.*, 785 So. 2d at 1234 ("This covenant is intended to protect 'the reasonable expectations of the contracting parties in light of their express agreement.'") (quoting *Barnes v. Burger King Corp.*, 932 F. Supp. 1420, 1438 (S.D. Fla. 1996)).

dependent facts as alleged in the underlying complaint. To say that the decisionmaking process is not discretionary because it ultimately has only one correct legal outcome fails to distinguish this situation from any other that might arise under the Covenant.

As a practical matter, the insurer would likely argue before a trial judge that its decision not to defend does not breach the Covenant because the Covenant applies only to discretionary acts. Because the insurer has no discretion to breach its duty to defend, the argument goes, failure to defend the insured is not a discretionary act and therefore cannot breach the Covenant. This argument begs the question because the insurer decides whether the claim is covered in the first instance. To the extent that its decision can be second-guessed in a court of law says nothing of insurance contracts that cannot be said of all contract decisions. The liability insurer is charged under the contract language with determining whether to defend, a determination that is inherently discretionary even if bounded (like all discretionary decisions) by the letter of the law. The insurer is therefore subject to the Covenant in deciding whether to defend.

Finally, there is the critical question of *when* the Covenant attaches. Because it imposes “terms and matters which, though not actually expressed, are implied by law” that are “as binding as the terms which are actually written or spoken,”<sup>72</sup> it follows that the Covenant exists from the time of contracting, though it would not be triggered until one of the contracting parties undertakes performance of a discretionary duty, for example, considering whether to assume the defense of a third-party claim.<sup>73</sup> Stated differently, the Covenant “attaches only to the performance of a specific contractual obligation,”<sup>74</sup> and therefore it arises, *at the latest*, when performance of that obligation is begun. Similar to any code of ethics, the Covenant is ever-present in a normative sense, yet it is never brought to bear unless breached. In this sense, it “attaches” to the performance of a given obligation, but to attach it must necessarily preexist the performance. Alternatively, it might be thought of as nonexistent until a performance is undertaken whereupon it arises in tandem with the event giving rise to the performance, for example, a notice of claim.

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72. *Cox*, 732 So. 2d at 1097.

73. Most hold that the Covenant imposes broad duties arising from the very nature of the contract and the relationship it creates. *See, e.g., Decker v. Browning-Ferris Indus., Inc.*, 931 P.2d 436, 443 (Colo. 1997) (“An insurer’s tort liability for breach of an implied duty of good faith and fair dealing arises from the nature of the insurance contract as well as from the relationship between the insurer and the insured.”).

74. *Ins. Concepts & Design, Inc.*, 785 So. 2d at 1235 (quoting *Johnson Enter. of Jacksonville, Inc. v. FPL Group, Inc.*, 162 F.3d 1290, 1314 (11th Cir. 1998)).

Under no circumstances, however, could the Covenant attach after the obligation of performance has arisen. This means, in the refusal-to-defend context, that when an insurer receives notice of a claim, the Covenant governs every aspect of its consideration of that claim including its ultimate decision whether to assume a defense of the insured. And this is the axis where Florida bad faith law and Florida Covenant law meet—for Florida law since *Shaw* has characterized bad faith as the breach of a fiduciary duty that arises upon assumption of the insured's defense, yet it also recognizes a duty implied by law to act in good faith *before* assumption of the insured's defense.<sup>75</sup> Unless these two lines of Florida jurisprudence are woven together, refusal to defend will remain stranded from bad faith despite the absence of any compelling logic or policy demanding this result.

For reasons that will become evident, it is important to reiterate that the Covenant applies to every contract, that it is implied by law, and that it "cannot, by definition, be waived by either party to the agreement."<sup>76</sup> It applies without reservation to insurance contracts in Florida,<sup>77</sup> and it attaches no later than the event giving rise to the insurer's duty to carry out the obligation deemed breached.

### C. Classic Bad Faith: Tort or Contract?

Now that the relevant contours of Florida bad faith and Covenant jurisprudence have been laid out, it is necessary to visit briefly upon the nature of these claims including whether they arise in tort or in contract. Due in large part to its myopic view of an insurer's duties, Florida has developed a fractured if workable bad faith jurisprudence. Characteristic of Florida's approach is its hesitance to squarely address the issue of whether bad faith arises in tort or in contract. Admittedly, the question is a difficult one that has been resolved by some with the compromise that bad faith represents a move toward "ConTort," the fusion of contract with tort.<sup>78</sup> In *Miller v.*

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75. For an interesting discussion of how the insurer/insured relationship differs from a true fiduciary one, see *Love v. Fire Insurance Exchange*, 271 Cal. Rptr. 246, 252-53 (Cal. Ct. App. 1990).

76. *Cox*, 732 So. 2d at 1098 n.2 (quoting *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 801 n.4 (Utah 1985)).

77. See, e.g., *N. Am. Van Lines, Inc. v. Lexington Ins. Co.*, 678 So. 2d 1325, 1330-31 (Fla. 4th DCA 1996) ("[A] good faith obligation is implied in all insurance contracts.") (citing *DeCespedes v. Prudence Mut. Cas. Co.*, 193 So. 2d 224 (Fla. 3d DCA 1966)).

78. See, e.g., *Christmas v. V.I. Water & Power Auth.*, 527 F. Supp. 843, 845 n.1 (D.C. V.I. 1981) ("[P]rinciples of contract and tort are merging into a single doctrine of civil liability.") (citing GRANT GILMORE, *THE DEATH OF CONTRACT* 89-90 (1974)); see also James M. Mock, *Tort Law—New Mexico Adopts Proportional Indemnity and Clouds the Distinction Between Contract and Tort: Amrep Southwest, Inc. v. Shollenbarger Wood Treating, Inc.*, 26 N.M. L. REV. 603, 613-14 (1996) (discussing developments in New Mexico signifying "the reabsorption of contract principles into tort"); Michael Sean Quinn, *The Defending Li-*

*Allstate*,<sup>79</sup> for example, the court addressed damages for lost opportunities in contract. It refused to limit such losses to aleatory (hazardous) contracts citing the general trend toward absorption of contract within “the expanding theory of tort.”<sup>80</sup> Notably, the *Miller* court cited bad faith as illustrating this trend,<sup>81</sup> though it hedged its language by characterizing certain “[t]raditional breach of contract cases” as “bad-faith or tortious breaches.”<sup>82</sup> The court can hardly be faulted given the lack of firm guidance by other Florida courts.

For example, *Butchikas v. Travelers Indemnity Co.*<sup>83</sup> is widely regarded as a benchmark in bad faith jurisprudence;<sup>84</sup> yet the *Butchikas* court refused to employ the term “bad faith”<sup>85</sup> and unquestionably deemed the case before it one in contract.<sup>86</sup> Likewise, as recently as 1996, the Fourth District Court of Appeal claimed in *North American Van Lines, Inc. v. Lexington Insurance Co.* that “bad faith is simply a subcategory of breach of contract.”<sup>87</sup> Were there any doubt concerning the court’s commitment to this viewpoint, it is resolved by the subsequent, unequivocal statement: “In Florida, a bad faith claim is an action ex contractu.”<sup>88</sup> Despite other holdings to this effect,<sup>89</sup> some reason exists to disagree.

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*ability Insurer’s Duty to Settle: A Meditation Upon Some First Principles*, 35 TORT & INS. L.J. 929, 951-52 (2000) (questioning the actual acceptance of “contorts” and discussing the phenomenon generally).

79. 573 So. 2d 24 (Fla. 3d DCA 1990).

80. *Id.* at 30 (citing GILMORE, *supra* note 78); see also *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 680 (1987) (Brennan, J., concurring in part and dissenting in part) (“It may well be that ‘it is the fate of contract to be swallowed up by tort (or for both of them to be swallowed up in a generalized theory of civil obligation)’”) (quoting GILMORE, *supra* note 78, at 94).

81. See 573 So. 2d at 30 n.10 (“Traditional breach of contract cases, particularly those between parties in a special relationship such as employer/employee or insurer/insured, are frequently brought as bad-faith or tortious breaches . . . departing from the limited remedies historically available in contract.”).

82. *Id.* Obviously, a bad faith or tortious breach is not “traditional” or there would be no need for the qualifying concepts of “bad faith” or “tortious” breach.

83. 343 So. 2d 816 (Fla. 1976).

84. The *Butchikas* decision has been cited nearly fifty times and is cited as support for the standard jury instruction covering bad faith failure to settle within policy limits. See FLA. STANDARD JURY INSTRUCTION MI 3.1.

85. The case discusses the insurer’s “fiduciary responsibility to its insured” with the parenthetical qualifier “no matter how labeled.” *Butchikas*, 343 So. 2d at 818.

86. See *id.* at 819 n.9 (stating that its holding did not affect the availability of noneconomic or punitive damages “in a non-contract lawsuit,” thus obviously labeling the case before it a contract action). The *Butchikas* decision is criticized *infra* Part III.F.

87. 678 So. 2d 1325, 1327 (Fla. 4th DCA 1996).

88. *Id.* at 1330.

89. See, e.g., *Gov’t Employees Ins. Co. v. Grounds*, 332 So. 2d 13, 14 (Fla. 1976) (expunging as inconsistent with Florida law the district court’s statements that “[w]hile this [bad faith action] is an action growing out of a contract, it is not a contract action strictly speaking. It is a hybrid which has some of the aspects of a tort action and some aspects of an action ex contractu . . . [A]n excess judgment action, though bearing certain aspects of a suit upon a contract is, strictly speaking, not one . . . .”); *Swamy v. Caduceus Self-Ins.*

There is no question that bad faith arises in connection with the contract at issue. This fact undergirds the holding in *North American Van Lines* that bad faith is an action ex contractu.<sup>90</sup> Yet not every legal wrong arising from a breach of contract sounds in contract law.<sup>91</sup> For instance, Florida has long-recognized the notion of tortious breach.<sup>92</sup> In *Greene v. Well Care HMO, Inc.*,<sup>93</sup> the Fourth District reversed a trial court in order to permit amendment of the plaintiffs' complaint to include a claim of tortious breach against their HMO.<sup>94</sup> Perhaps more explicit was the discussion in *Opperman v. Nationwide Mutual Fire Insurance Co.*<sup>95</sup> There, the Fifth District Court of Appeal relied heavily upon California's *Gruenberg*<sup>96</sup> decision and stated clearly that the Covenant "is independent of any contractual obligation" and "has been described as a 'tortious breach of contract.'"<sup>97</sup> Reiterating this notion, the *Opperman* court also emphasized that "[t]he function of the bad faith claim is to provide the insured with an extra-contractual remedy."<sup>98</sup>

This claim is consonant with numerous references throughout Florida cases to the "tort" of bad faith. In *Laforet*,<sup>99</sup> for instance, the Florida Supreme Court outlined the history of bad faith in Florida and referred to "the tort of bad faith" that "occurred between an in-

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Fund, Inc., 648 So. 2d 758, 760 (Fla. 1st DCA 1994) (limiting available damages because, "[i]n Florida, when an insured brings an action against his carrier for failure to settle a third party's claim, the action sounds in contract").

90. See 678 So. 2d at 1330 ("[T]he cause of action for . . . bad faith . . . is bottomed on the contract' . . . Thus, when bad faith in negotiating a settlement is alleged, the cause is one for breach of a contractual obligation implied in law, namely good faith.") (quoting *Nationwide Mut. Ins. Co. v. McNulty*, 229 So. 2d 585, 586 (Fla. 1969)); see also *Am. Fid. Fire Ins. Co. v. Johnson*, 177 So. 2d 679, 682-83 (Fla. 1st DCA 1965) (treating a breach that was "tantamount to bad faith" as a claim in contract).

91. *Banfield v. Addington*, 140 So. 893, 896 (Fla. 1932) ("The omission to perform a mere contract duty may not be a tort; but if a legal duty arises independently of or concurrently with the contract, a breach of the legal duty may be a tort . . . for the infraction of a duty implied by law . . .").

92. See, e.g., *Braidi Trading Co. v. Anthony R. Abraham Enters., Inc.*, 469 So. 2d 955, 956-57 (Fla. 3d DCA 1985) (recognizing viability of various claims including tortious breach of contract); *Evans v. Fla. Farm Bureau Cas. Ins. Co.*, 384 So. 2d 959, 961-62 (Fla. 1st DCA 1980) (noting that questions of fact whether insurer "act[ed] reasonably with its insured" precluded summary judgment on claim for punitive damages arising from tortious breach of contract); *Coral Gables First Nat'l Bank v. Constructors of Fla., Inc.*, 119 So. 2d 741, 748 (Fla. 3d DCA 1960) (noting in dicta that tortious breach comported with the rules of "torts generally").

93. 778 So. 2d 1037 (Fla. 4th DCA 2001).

94. See *id.* at 1041-42.

95. 515 So. 2d 263 (Fla. 5th DCA 1987).

96. *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032 (Cal. 1973).

97. *Opperman*, 515 So. 2d at 267. Likewise, the *Gruenberg* court stated clearly that the Covenant was imposed by law and that "[b]reach of this duty [the Covenant] is a tort." *Gruenberg*, 510 P.2d at 1037.

98. *Opperman*, 515 So. 2d at 267.

99. *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 58 (Fla. 1995).

surer and its insured . . . .”<sup>100</sup> Similarly, the dissent in *Kelly v. Williams*<sup>101</sup> described the plaintiff’s breach of good faith count as “an extension in tort for a bad faith breach of the contractual duties involved.”<sup>102</sup> Again, in *Shupack v. Allstate Insurance Co.*,<sup>103</sup> the appellate court took note of the plaintiff’s “tort claim for bad faith failure to pay.”<sup>104</sup> A tort theory of bad faith recovery would be in keeping with numerous other jurisdictions as well.<sup>105</sup>

Thus, while the decision in *North American Van Lines* observed correctly that bad faith arises from a breach of contract, that fact alone does not resolve the question. The only cited basis for this determination was the statement in *Nationwide Mutual Insurance Co. v. McNulty* that bad faith “is bottomed on the contract [and therefore] the nature of an action thereon is ex contractu rather than in tort.”<sup>106</sup> Yet we have seen that tort actions may arise from breach of contract and yield extracontractual damages. Moreover, the *McNulty* analysis occurred more than thirty years ago and was necessarily limited to the bad faith jurisprudence that existed at the time. That interpretation simply is not in keeping with modern notions of bad faith liability.<sup>107</sup>

#### D. Bad Faith Breach of the Covenant as Tort

Despite the admitted lack of clarity on the nature of bad faith generally, there is no question that a bad faith action premised upon breach of the Covenant would sound in tort. This follows from the fact that “[a]n action in contract differs from an action in tort in that the former is based on the breach of a duty imposed by agreement while a tort action is based on the breach of a duty imposed by law.”<sup>108</sup> The Covenant, though it arises by virtue of a contractual relationship, is a duty implied by law.<sup>109</sup> Therefore, breach of this legal

100. *Id.*

101. 411 So. 2d 902 (Fla. 5th DCA 1982).

102. *Id.* at 905 (Coward, J., dissenting).

103. 367 So. 2d 1103 (Fla. 3d DCA 1979).

104. *Id.* at 1103. The court did not take issue with this characterization of the claim, though it affirmed summary judgment because “under the facts of [the] case, appellant had no cause of action for punitive damages against appellee for its alleged bad faith refusal to pay.” *Id.* at 1104.

105. See, e.g., Henderson, *supra* note 20, at 26 (noting that as of writing in 1992, at least twenty-four courts of last resort “ha[d] held that an insurer may be liable to an insured for consequential or punitive damages under a tort theory, most often referred to as the tort of bad faith”).

106. *N. Am. Van Lines, Inc. v. Lexington Ins. Co.*, 678 So. 2d 1325, 1330 (Fla. 4th DCA 1996) (quoting *Nationwide Mut. Ins. Co. v. McNulty*, 229 So. 2d 585, 586 (Fla. 1969)).

107. See Henderson, *supra* note 20; see also *supra* text accompanying note 105.

108. *Miller v. Allstate Ins. Co.*, 573 So. 2d 24, 27 (Fla. 3d DCA 1990) (citing *Banfield v. Addington*, 140 So. 893 (Fla. 1932)).

109. See *Cox v. CSX Intermodal, Inc.*, 732 So. 2d 1092, 1097 (Fla. 1st DCA 1999) (“It is axiomatic that [e]very contract includes not only its written provisions, but also the terms

duty, though arising incident to the contract, gives rise to a tort cause of action in Florida.<sup>110</sup>

Technically speaking, then, the matter is a simple syllogism: the breach of a legal duty constitutes a tort; the Covenant imposes a legal duty; therefore, breach of the Covenant constitutes a tort. But courts in other jurisdictions have balked at the notion of opening up tort damages to breach of the Covenant in the context of commercial contracts. Apparently based on the notion that breach of the Covenant might prove more economically reasonable in the commercial context, California has limited tort recovery for breach of the Covenant to insurance contracts because an insurer's breach of its implied duties directly implicates public concerns.<sup>111</sup>

Another, perhaps clearer and more genuine approach would be to delineate between breach of the Covenant, admittedly a tort by the rationale laid out above, and "bad faith" breach of the Covenant, also a tort but one that carries greater damage potential. In other words, there are three tiers of conduct in refusing to defend: (1) a good faith or negligent breach of the duty to defend that does not constitute breach of the Covenant and sounds only in contract;<sup>112</sup> (2) a breach of the duty to defend not in good faith that accordingly gives rise to a tort claim for breach of the Covenant but that does not *necessarily*

and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken.") (alteration in original) (quoting *First Nationwide Bank v. Fla. Software Servs., Inc.*, 770 F. Supp. 1537, 1542 (M.D. Fla. 1991)); *see also* *Kransco v. Am. Empire Surplus Lines Ins. Co.*, 2 P.3d 1, 8 (Cal. 2000) ("[C]ourts have held that [an insurer's] breach of the implied covenant will provide the basis for an action in tort.") (alteration in original) (quoting *Foley v. Interactive Data Corp.*, 765 P.2d 373 (Cal. 1988)); *Baxter v. Royal Indem. Co.*, 285 So. 2d 652, 660 (Fla. 1st DCA 1973) (Spector, J., dissenting) (noting the "universally recognized rule that in every insurance policy there is implied by law a covenant of good faith and fair dealing").

110. The fact that a breach of the Covenant sounds in tort would not preclude an accompanying breach of contract action. The breach of contract claim might be preferable in certain situations, for example, where coverage for the claim is a consideration. *See, e.g.*, *Fla. Ins. Guar. Ass'n v. Giordano*, 485 So. 2d 453, 457 (Fla. 3d DCA 1986) (recognizing that bad faith claim cannot lie against FIGA).

111. *See, e.g.*, HENRY D. MILLER, 1 CAL. REAL ESTATE § 1:63 (3d ed. 2000) ("The tort of bad-faith breach of the implied covenant of good faith and fair dealing is limited to circumstances in which there is a 'special relationship.' This required relationship is limited to insurance . . ."); *see also* *Best Place, Inc. v. Penn Am. Ins. Co.*, 920 P.2d 334, 341-44 (Haw. 1996) (holding that breach of the Covenant would constitute a tort cause of action in the insurance context based upon policy concerns).

112. A similar approach was noted in *Gordon v. Nationwide Mut. Ins. Co.*, 285 N.E.2d 849, 855-56 (N.Y. 1972) (applying the Covenant but finding that "[w]here there is a breach of the terms of a contract of insurance, not found to have been made in bad faith, the damage for refusal to settle is limited, both in New York and elsewhere, by the policy coverage or, additionally, to that and the cost of defense where there is also a refusal to defend"); *see also* Steven J. Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 HARV. L. REV. 369, 376 n.35 (1980) ("[T]he common law cases generally do not suggest that a negligent or inadvertent action is a breach of contract by failing to perform in good faith.").

rise to the level of “bad faith” (this I label a “mere” breach of the Covenant);<sup>113</sup> and (3) an egregious breach of the Covenant that gives rise to a tort claim and will likely garner extreme tort damages (which I label a “bad faith” breach of the Covenant).<sup>114</sup> The first breach is of no moment, because it does not involve a breach of the Covenant and thus could never give rise to bad faith liability.<sup>115</sup>

Within the two remaining categories there exists nothing more than a fictional, semantic divide between “contractual” breach of the Covenant and the “tort” of bad faith. Any breach of the Covenant is tortious, except that what I have dubbed a “mere” breach of the Covenant is a tort that will garner little if any damages not already available in contract, while a “bad faith” breach of the Covenant would realize the same damages that any common law bad faith action might. Stated differently, both a “mere” breach of the Covenant and a “bad faith” breach of the Covenant are technically tortious; but only a bad faith breach would in the course of things incur liability for extracontractual damages because the behavior distinguishing bad faith breach from mere breach is the very thing that would warrant more severe damages.<sup>116</sup> Thus, a Pareto-efficient<sup>117</sup> breach of the Covenant in the sterile commercial context would hardly call for an award of mental anguish damages. Yet the abandonment of an insured to years of litigation with exposure to a substantial excess judgment would indeed call for at least consideration of such

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113. This is in keeping with the general notion that a breach of the covenant of good faith is not necessarily the same as “bad faith.” See, e.g., Burton, *supra* note 112, at 372 n.17 (“Good faith performance also should not be equated with ‘good faith’ . . . as a fiduciary duty, because the doctrine obviously could not mean that every contract requires ‘something stricter than the morals of the marketplace.’”) (quoting *Meinhard v. Salmon*, 164 N.E. 545, 546 (N.Y. 1928)).

114. It is critical to distinguish here between a breach that is “not in good faith” and a “bad faith” breach. While the Covenant implies “good faith,” its breach is not *necessarily* an act of “bad faith” as that term is generally meant in the insurance litigation context.

115. Beneath this, of course, is a refusal to defend that is entirely proper.

116. There might, for example, be a wrongful refusal to defend that tortiously breaches the Covenant; but if no coverage exists on the underlying third-party claim, no duty to settle that claim would attach. Hence, no meaningful tort damages could arise from the refusal to defend. See *Steil v. Fla. Physicians’ Ins. Reciprocal*, 448 So. 2d 589, 592 (Fla. 2d DCA 1984) (party must prove claim was within coverage to prevail on claim for wrongful refusal to defend); *Keller Indus., Inc. v. Employers Mut. Liab. Ins. Co.*, 429 So. 2d 779 (Fla. 3d DCA 1983).

117. An example of a Pareto-efficient breach would be one in which Party A (seller) breaches with Party B (buyer) in order to sell his product to Party C at such an enhanced profit that Party A might pay Party B’s expectation damages in contract and still make a profit (benefitting Party A and Party C while leaving Party B, theoretically, no worse off). See Mark Pettit, Jr., *Private Advantage and Public Power: Reexamining the Expectation and Reliance Interests in Contract Damages*, 38 HASTINGS L.J. 417, 432 (1987). Despite the overly clinical nature of law and economics generally, the Pareto-efficient breach between purely commercial actors provides a generic example where the Covenant might technically afford tort damages that, in reality, would rarely be sought and even more rarely awarded.

losses.<sup>118</sup> Both breaches are technically tortious, but only one garners traditional bad faith damages.<sup>119</sup> Likewise, a “mere” breach of the Covenant sounding in tort might theoretically expose the breaching party to punitive damages; but if punitive damages were warranted, the breach would by definition prove a case of bad faith.<sup>120</sup> This is no different, ultimately, than any bad faith case as presently contemplated. A plaintiff under the current rubric is free to *plead* bad faith for a mere breach of contract; but *proving* bad faith is another matter altogether.

This is, in a sense, the manner in which Florida has treated bad faith all along. Like all things, bad faith is more a continuum than a compartmentalization. The distinction between bad faith as a contract cause of action and bad faith as a tort cause of action may be unclear for the simple reason that it is of little practical importance. Bad faith *behavior* ultimately warrants greater damages whether brought under a theory of strict contract,<sup>121</sup> tortious breach, bad faith in contract, bad faith in tort, or breach of the Covenant. Under my analysis, *any* breach of the Covenant gives rise to tort damages and potential bad faith liability; but as a practical matter, the court may decide no breach of the Covenant has occurred,<sup>122</sup> or the trier of fact may find that the breach was not in bad faith.<sup>123</sup>

The three tiers of breach in the duty-to-defend context accordingly collapse into two. An insurer may breach its duty to defend in good faith giving rise to contract damages alone, or it may culpably breach its duty to defend and thus breach the Covenant. The breach of the Covenant is tortious in every instance, though the severity of misconduct may render it either a “mere” breach or a “bad faith” breach. These are in fact just semantic descriptions of the severity of miscon-

118. Noneconomic damages are addressed *infra* Part III.F.3.

119. Given that even a “mere” breach of the Covenant sounds in tort, even the commercial actor would be free to plead mental anguish. But recovery for mental anguish in a strict commercial setting between business entities is so implausible that even were it routinely pled, it would rarely if ever have any meaningful effect on the course or resolution of a given claim.

120. Whether a breach rises to the level of bad faith is a question of fact determined by looking to the totality of the circumstances. *See* State Farm Mut. Auto. Ins. Co. v. Laforet, 658 So. 2d 55, 62 (Fla. 1995) (rejecting the “fairly debatable” standard and adopting a “totality-of-the-circumstances approach” in first- and third-party bad faith claims).

121. *See, e.g.*, Thomas v. W. World Ins. Co., 343 So. 2d 1298, 1304 (Fla. 2d DCA 1977) (permitting recovery of excess judgment and attorney’s fees as foreseeable contract damages arising from refusal to defend).

122. As a contract obligation implied by law, the court may determine on summary judgment whether a breach of the Covenant has occurred as long as the facts are so crystallized that “the determination of the issues of a lawsuit depends upon the construction of [the] written instrument and the legal effect to be drawn therefrom.” *Cox v. CSX Intermodal, Inc.*, 732 So. 2d 1092, 1096 (Fla. 1st DCA 1999). Naturally, the issue of good faith performance will often prove subtle and factually intense.

123. *See supra* note 120 and accompanying text.

duct itself that must necessarily be determined by the trier of fact with a damage exposure corresponding to the insurer's culpability.

Practically speaking, the approach I have suggested might be seen as bootstrapping the Covenant to existing bad faith jurisprudence in order to recognize a sorely needed cause of action for bad faith refusal to defend. Seen from the opposite end, however, it merely recognizes that Florida has for some time (though without admitting it) viewed bad faith as a tortious breach of the Covenant. That is to say, the "fiduciary" duties attaching to an insurer's assumption of the insured's defense has since *Shaw* been nothing more than a demand that the insurer honor its obligations under the Covenant; the preexisting case law did not, however, speak clearly in terms of the Covenant and, for reasons we have seen, hinged liability upon assumption of the defense. While this has yielded hostility to common law first-party claims and has sown confusion with regard to refusal-to-defend cases, it is in essence what has prompted the development of bad faith law from the start. Perhaps, then, the simplest solution is for Florida to do just as California and Colorado have done and recognize that all bad faith claims are at root an egregious breach of the Covenant.<sup>124</sup>

It ultimately matters not in the refusal-to-defend context which is the point of this Article. The fact remains that there exists in Florida a third-party common law bad faith cause of action that has not comfortably incorporated refusal-to-defend. Alongside that body of law exists a viable Covenant jurisprudence that requires an insurer's utmost fidelity when deciding whether to defend its insured. If the two are brought together, they form the basis for a very clear cause of action in tort: bad faith refusal to defend.

### III. RECONCILING REFUSAL TO DEFEND WITH BAD FAITH

#### A. *The Duty to Defend Generally*

We saw at the beginning of this Article that bad faith was born at least in part as a response to the rise of liability insurance policies.<sup>125</sup> While an indemnification agreement merely reimbursed the insured for sums expended with respect to third-party claims, the liability policy placed the sole right and responsibility of defense with the insurer. The proliferation of liability policies has, in turn, affected the

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124. It would be foolhardy to suggest that elements of contract and tort will not continue to overlap regardless of the approach taken to bad faith liability. Issues arise about which choices must be made including those of limitations periods, assignability of claims, available defenses, and the like. Suffice it to say that these issues would be no less and no more difficult under a pure theory of bad faith premised upon tortious breach of the Covenant than they are under the present, relatively confused, state of bad faith law in Florida.

125. See *supra* note 20 and accompanying text.

manner in which insurance is promoted to the public and, hence, the expectations that insureds bring to an insurance agreement.<sup>126</sup>

Because the typical individual lacks familiarity with the intricacies of tort or property law, liability and casualty insurers advertise their services as a source of security and protection during times of need.<sup>127</sup> Relatively unsophisticated consumers thus rely upon liability policies not only as a means of indemnification but as “litigation insurance.”<sup>128</sup> That is, the duty to defend proves not only a valuable but an integral part of the purchased bargain. One Arizona appellate court has stated that “[a] purchaser of liability insurance has a right to expect not only indemnification at the end but also a shield against liability claims at the outset.”<sup>129</sup> The North Dakota Supreme Court likewise noted that “the defense and vindication of an insured by his insurance carrier against third-party claims is one of the chief benefits of the insurance contract.”<sup>130</sup> The point can hardly be disputed given the nearly universal commercial insurance themes of security, protection, and peace of mind.<sup>131</sup> This is all to say what seems quite obvious in the end: prospective insureds are fully aware when purchasing coverage that the insurer will be obliged to defend them in the event of a third-party claim and the duty to defend is second in value only to the duty of indemnification.

What might prove less obvious is that insurers themselves benefit from defense provisions in a number of ways. The right to defend lawsuits gives the insurer virtually total control over the course of litigation. The insurer dictates how much money will be spent on litigation, what tactical choices will be made, and whether and when the case will be tried or settled. The insurer may even strategize on a regional or national level to maintain consistency and control over similar actions. It may choose to appeal a given ruling depending upon whether it is willing to risk an adverse precedent or whether a given jurisdiction is the most likely to find favor with the insurer’s position. While the power to render such decisions is perfectly appro-

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126. Note that the Covenant is “designed to protect the contracting parties’ reasonable expectations.” *Cox*, 732 So. 2d at 1097 (citing *Scheck v. Burger King Corp.*, 798 F. Supp. 692, 693 n.5 (S.D. Fla. 1992)).

127. See, e.g., Karen O. Bowdre, “*Litigation Insurance*”: *Consequences of an Insurance Company’s Wrongful Refusal to Defend*, 44 *DRAKE L. REV.* 743, 745-46 (1996) (discussing this phenomenon and citing specific examples).

128. *Id.* at 745.

129. *State Farm Mut. Auto. Ins. Co. v. Paynter*, 593 P.2d 948, 950 (Ariz. Ct. App. 1979) (quoting *Orleans Vill. v. Union Mut. Fire Ins. Co.*, 335 A.2d 315, 318 (Vt. 1975)).

130. *Smith v. Am. Family Mut. Ins. Co.*, 294 N.W.2d 751, 759 (N.D. 1980).

131. Similarly, insurers choose connotative names such as “Prudential” and “Safeco” while employing metaphorically evocative logos such as Prudential’s “rock,” Allstate’s “good hands,” or the Travelers’ “red umbrella.” It may seem trite to point this out, but one must consider their importance in light of the resources insurers invest in conceiving and promoting such matters.

appropriate, there exists in each choice a potential conflict of interest between insurer and insured, as evidenced by the numerous bad faith lawsuits filed across the country each year.<sup>132</sup> Naturally, this conflict also inheres in the decision whether to defend an insured at the outset. Ultimately, the duty to defend is not merely of contractual benefit to the insured who is paying a premium for it. It is also of tremendous value to the insurer who may or may not choose to assume its contractual duties based upon the very considerations noted above.

For these reasons and others, the duty to defend is distinct from and far broader than the duty to indemnify.<sup>133</sup> In Florida, the duty to indemnify may be based upon the underlying facts of the third-party claim,<sup>134</sup> but the duty to defend is determined solely by reference to the allegations of the third-party complaint.<sup>135</sup> This means that a liability insurer may be required to defend a lawsuit even if no coverage exists for the claims brought against its insured.<sup>136</sup> It is difficult to overstate the breadth of an insurer's duty to defend where there is any potential coverage for a claim. Florida's First District Court of Appeal has summarized the governing law:

An insurer's duty to defend is to be determined from the allegations in the complaint against the insured. The insurer must defend if the allegations in the complaint could bring the insured

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132. A crude but somewhat illustrative Westlaw search for <"BAD FAITH" /7 INSUR! & DA(AFT 12/31/2000)> run in the ALLCASES database on December 20, 2001, generated 561 hits. Expanding the search to <"BAD FAITH" /12 INSUR! & DA(AFT 12/31/1999)> generated 90 more hits for a total of 651.

133. See, e.g., *Cont'l Cas. Co. v. United Pac. Ins. Co.*, 637 So. 2d 270, 271 (Fla. 5th DCA 1994) ("[T]he agreement to defend is not only completely independent of and severable from the indemnity provision of the policy, but is completely different. Indemnity contemplates merely the payment of money. The agreement to defend contemplates the rendering of services.") (quoting *Argonaut Ins. Co. v. Md. Cas. Co.*, 372 So. 2d 960, 963 (Fla. 3d DCA 1979)).

134. See *Hagen v. Aetna Cas. & Sur. Co.*, 675 So. 2d 963, 965 (Fla. 5th DCA 1996) ("Regardless of the allegations of the complaint, it is the underlying facts that determine the duty to indemnify.") (emphasis omitted); see also *State Farm Fire & Cas. Co. v. CTC Dev. Corp.*, 720 So. 2d 1072, 1077 n.3 (Fla. 1998) ("The duty to indemnify is determined by the underlying facts of the case.").

135. See *Nat'l Union Fire Ins. Co. v. Lenox Liquors, Inc.*, 358 So. 2d 533, 536 (Fla. 1977) ("The allegations of the complaint govern the duty of the insurer to defend.") (footnote omitted); *State Farm Fire & Cas. Co. v. Higgins*, 788 So. 2d 992, 995 (Fla. 4th DCA 2001) ("It is clear that a liability insurer's obligation to defend a claim made against its insured must be determined solely from the allegations in the complaint."); *Scheer v. State Farm Fire & Cas. Co.*, 708 So. 2d 312, 313 (Fla. 4th DCA 1998) ("The trial court correctly looked to the allegations in the complaint to determine whether State Farm had a duty to defend.").

136. See *MCO Envtl., Inc. v. Agric. Excess & Surplus Ins. Co.*, 689 So. 2d 1114, 1115 (Fla. 3d DCA 1997) ("The law is clear that the duty to defend is broader than the duty to provide coverage and the insurer is required to defend even if the facts later show that there is no coverage."); *Baron Oil Co. v. Nationwide Mut. Fire Ins. Co.*, 470 So. 2d 810, 814 (Fla. 1st DCA 1985) ("[T]he duty to defend continues even though it is ultimately determined that the alleged cause of action is groundless and no liability is found within the policy provisions defining coverage.").

within the policy provisions of coverage. If the complaint alleges facts partially within and partially outside the coverage of the policy, the insurer is obligated to defend the entire suit. The duty to defend is separate and apart from the duty to indemnify and the insurer is required to defend the suit even if the true facts later show there is no coverage. All doubts as to whether a duty to defend exists in a particular case must be resolved against the insurer and in favor of the insured. So long as the complaint alleges facts that create potential coverage under the policy, the insurer must defend the suit. If it later becomes apparent (such as in an amended complaint) that claims not originally within the scope of the pleadings are being made, which are now within coverage, the insurer upon notification would become obligated to defend.<sup>137</sup>

This makes clear the extent of an insurer's duty to defend its insured against claims by third parties. It may be applied by way of example to the suit in *Thomas v. Western World Insurance Co.*,<sup>138</sup> discussed at the beginning of this Article. In *Thomas*, the laundromat employee Kenny allegedly threw acid on the eventual plaintiff Michael Hancock.<sup>139</sup> While Kenny's act might be characterized as an intentional tort such as battery, Hancock brought suit in negligence.<sup>140</sup> The insurer refused to defend on grounds that it did not cover claims "arising out of assault and battery."<sup>141</sup> Although the underlying acts may have constituted an "assault and battery," the complaint alleged negligence so that ultimately even Western World conceded the wrongfulness of its refusal to defend the claim.<sup>142</sup> This was true even though Kenny's act might well have exceeded the scope of his employment, warranting dismissal of Hancock's claim.<sup>143</sup> Thus, where the allegedly tortious act by an insured arguably fell outside of coverage and may have avoided the allegations of the complaint, the duty to defend applied with full force nevertheless.

The facts in *Thomas* elucidate at least one reason for demanding a broad duty to defend. The suit ultimately resulted in an excess judgment against the insureds,<sup>144</sup> while a competent defense by the insurer would have likely shielded both it and its insured from liability

137. *Grissom v. Commercial Union Ins. Co.*, 610 So. 2d 1299, 1306-07 (Fla. 1st DCA 1992) (citations omitted).

138. 343 So. 2d 1298 (Fla. 2d DCA 1977).

139. *See id.* at 1300.

140. *Id.* Though the opinion does not discuss the specific grounds of the suit, one can imagine a claim against the owners of the laundromat for negligent retention and hiring, negligent supervision, or something along those lines.

141. *Id.* (quoting a letter written by the company's vice president of claims).

142. *See id.* at 1300-01.

143. *See id.* at 1302-03 ("The potential defense in this case was that the insured's agent Kenny committed an act outside the scope of his employment. This defense may well have been sufficient to relieve the insureds from liability . . .").

144. *See id.* at 1300 (noting an eventual judgment that more than tripled the applicable policy limits).

altogether.<sup>145</sup> This highlights the importance of an actual defense as distinguished from the mere indemnification of an insured. The concurring judge in *Thomas* believed that a liability policy is one of indemnification “which incidentally also includes an undertaking to defend (so that the carrier may, rightfully, protect its own interest).”<sup>146</sup> But the duty to defend is separate and distinct from the duty to indemnify and an insurer that merely acts to protect its own interests may be held liable for having done so. The duty to defend constitutes more than a mere capital outlay by the insurer with an incidental benefit to the insured.<sup>147</sup> Rather, it is an integral part of the bargain contracted and paid for by an insured that incidentally but substantially benefits the insurer.

For present purposes, it suffices to recognize that an insurer’s failure to defend is naturally suspect by virtue of its broad duty to do otherwise. Although Florida courts have historically deemed assumption of defense as the starting point in a bad faith analysis, the duty to defend is, after all, the broadest duty a liability insurer bears. It is odd, then, that an insurer may act in bad faith by observing its own interests in connection with indemnification while doing so with respect to the broader duty to defend has never expressly been held bad faith.<sup>148</sup> The insurer’s knowledge of its nearly inescapable duty to defend coupled with a breach of the Covenant in determining whether to assume an insured’s defense should, in theory, prove bad faith more readily than virtually any other scenario. Yet, as we shall see, Florida courts have generally either misunderstood or ignored this connection.

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145. It may seem counterintuitive at first blush that an insurer should be required to defend a lawsuit absent a duty to indemnify for any resulting judgment. But the duty to defend is distinct from the duty to indemnify. The insured has contracted and paid for protection from lawsuits arising in connection with the acts or items insured. The fact that a given lawsuit might ultimately prove beyond the relevant coverage is of no consequence to the very real time, expense, and inconvenience of the suit itself, frivolous or otherwise, brought in that connection. Conversely, were an insurer allowed to duck its duty to defend based upon its own investigation of the facts underlying a given claim, then the defense could be delayed and might often be denied over specious factual disputes.

146. *Thomas*, 343 So. 2d at 1304 (McNulty, J., concurring).

147. See, e.g., BARRY R. OSTRAGER & THOMAS R. NEWMAN, HANDBOOK ON INSURANCE COVERAGE DISPUTES § 5.03[a] (9th ed. 1998) (“The majority view is that an insurer cannot discharge its defense obligations by tendering its policy limits unless the policy expressly authorizes tender.”). Ostrager and Newman cite to *Aetna Casualty & Surety Co. v. Sullivan*, 597 N.E.2d 62 (Mass. App. Ct. 1992), in which the court addressed a policy provision ending the duty to defend upon exhaustion of policy limits. The *Sullivan* court stated: “Uniformly, courts construing such policies have ruled that an insurer’s tender of the policy limits does not end its duty to defend a claim against its policyholder unless payment is made after a judgment or settlement.” *Id.* at 66. This comports with Florida’s general rule that bad faith turns upon an insurer having acted in its own interests rather than those of its insured. See, e.g., *State Farm Mut. Auto Ins. Co. v. Laforet*, 658 So. 2d 55, 58 (Fla. 1995).

148. But see *Am. Fidelity Fire Ins. Co. v. Johnson*, 177 So. 2d 679 (Fla. 1st DCA 1965).

*B. Refusal to Defend: Bad Faith or No Faith?*

We may now revisit the case of *Thomas v. Western World Insurance Co.*<sup>149</sup> against this backdrop. Recall that the defendants in the case owned the laundromat where the incident occurred. They were sued in negligence based upon their employee's alleged battery on the plaintiff.<sup>150</sup> Western World insured the defendants' premises against liability claims, but refused to honor its defense obligations under the policy. The plaintiff obtained a judgment against the insureds far exceeding the limits of liability coverage under their policy with Western World.<sup>151</sup>

The insureds then sued Western World for the full amount of the judgment based upon Western World's refusal to defend.<sup>152</sup> Western World tendered its policy limits to the insureds and moved for summary judgment claiming that the excess could not be recovered unless the insureds proved that Western World had acted in bad faith.<sup>153</sup> The trial court granted summary judgment relying "primarily on the absence of [a] showing of 'bad faith.'"<sup>154</sup>

Western World almost certainly raised the specter of bad faith refusal to defend because it felt that its acts had not risen to the level of bad faith.<sup>155</sup> In an ironic twist, the Third District Court of Appeal held Western World liable for the excess judgment by rejecting the concept of bad faith refusal to defend.<sup>156</sup> Thus, Western World ultimately proved liable for the excess judgment as a matter of contract law, but insurers at large would be absolved from any future bad faith exposure for refusal to defend under the *Thomas* rule.<sup>157</sup>

The *Thomas* court noted in dicta that the extent of Western World's misconduct would prove a "triable issue of 'bad faith'" if bad faith was indeed the issue, but it ultimately concluded that refusal to defend simply does not implicate bad faith considerations.<sup>158</sup> Its path

149. 343 So. 2d 1298.

150. *Id.* at 1300.

151. *Id.*

152. *Id.*

153. *See id.* at 1301.

154. *Id.* at 1303.

155. One might speculate that Western World wished to raise the bad faith argument only to then argue that it could not be achieved as a matter of law. But the trial court's disposition of the case quoted above indicates that it accepted bad faith refusal to defend as a legal notion while holding that the plaintiff/insureds had not made the requisite *factual* "showing."

156. *Thomas*, 343 So. 2d at 1304.

157. This becomes important because bad faith has developed into a pure tort, or at least tort-like, cause of action affording potential damages beyond those available in contract.

158. *Thomas*, 343 So. 2d at 1303. The court referred to but rejected the logic of *American Fidelity Fire Insurance Co. v. Johnson*, 177 So. 2d 679 (Fla. 1st DCA 1965), which held an insurer liable for an excess judgment based upon refusal to defend that was deemed

to this conclusion is by now a familiar one. The court cited *Shaw* as the quintessential bad faith case “decided within the context of an insure[r]’s failure to exercise good faith in the defense or settlement of claims against an insured.”<sup>159</sup> Implicit in this scheme is “the exercise of judgment by the insurer.”<sup>160</sup> But a refusal-to-defend case, according to the court, involved no such exercise of judgment and thus could not implicate bad faith. According to the *Thomas* court: “In the case before us, there is no threshold question of ‘good faith’ vs. ‘bad faith.’ For here, the company exercised no faith at all.”<sup>161</sup>

In a roundabout fashion, the *Thomas* court engaged in the typical Florida bad faith analysis that deems assumption of an insured’s defense a predicate to the duty of good faith. The analysis goes something like this: if an insurer’s duty of good faith arises from its “fiduciary” role as the sole decisionmaker with respect to litigation, then it follows that it cannot be liable for bad faith where it has not become the sole decisionmaker with respect to litigation. Of course, it becomes the sole decisionmaker only upon assumption of the defense; hence, it cannot be liable in bad faith unless it assumes the defense. This has an appealing symmetry, and frankly it comports with Florida’s general approach to bad faith since *Shaw*. Yet this logic ignores the legal requirement that all discretionary decisions be undertaken in good faith. That is, it ignores the Covenant. The legal duty of good faith simply will not square with the notion of “no faith” because the exercise of “no faith” is merely bad faith by omission rather than commission. The *Thomas* rationale treats the refusal to defend as no decision at all, when in fact it is a deliberate decision to deny an insured’s claim to its contractual defense, albeit by inaction.

Inaction is a strange creature in the law, and it can pose difficult problems in traditional tort claims. For example, these problems arise where one has the power to prevent injury or death but is under no legal duty to do so and, in fact, chooses not to do so. But the character of inaction is altogether different where the parties have contractually agreed to *act* upon certain contingencies such as the filing of a lawsuit. Nor will it do to deem inaction a breach of contract that is categorically incapable of amounting to bad faith. For bad faith is not necessarily a single act or episode that can be pointed to

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“tantamount to bad faith in the performance of its contractual obligations to the insured.” *Id.* at 683.

159. *Thomas*, 343 So. 2d at 1303-04 (citing *Auto Mut. Indem. Co. v. Shaw*, 184 So. 852 (Fla. 1938)).

160. *Id.* at 1304.

161. *Id.*

after the fact; it is a measure of the insurer's total culpability in breaching the contract. It encompasses the severity of the breach.<sup>162</sup>

The *Thomas* decision stated that "[t]he concept of bad faith . . . presupposes the company is attempting to exercise skill, judgment and fidelity on [the insured's] behalf."<sup>163</sup> The court concluded that bad faith could not apply, therefore, since the insurer never assumed the insured's defense at which point, presumably, it would in fact have to exercise skill, judgment, and fidelity.<sup>164</sup> By corollary this statement implies that an insurer need not exercise skill, judgment, or fidelity at any point in the claims process or in the very decision of whether to honor its contractual duty to defend. At a minimum, the court's logic suggests that an insurer is free to exercise something less than skill or fidelity until it assumes an insured's defense, yet the Covenant stands in direct opposition to any such notion. To what standard would the *Thomas* court hold an insurer prior to assumption of an insured's defense or with respect to the actual decision whether to defend? If it is not one of skill, judgment, or fidelity, then I am at a loss to explain what it might be.

Moreover, the *Thomas* court, perhaps in an effort to broaden an insurer's liability for refusal to defend in contract, sidestepped an important case that could easily have disposed of the action on bad faith grounds. The *Thomas* decision only briefly mentioned the First District Court of Appeal's opinion in *American Fidelity Fire Insurance Co. v. Johnson*,<sup>165</sup> which involved similar issues. In *American Fidelity*, the court addressed a liability insurer who failed "to investigate and appraise the probability and the extent of [its insured's] liability" in connection with a wrongful death claim.<sup>166</sup> The insurer refused to defend and thus never assumed Florida's "fiduciary" duty of good faith accompanying control of an insured's defense. Nevertheless, the *American Fidelity* court deemed the insurer's failure to investigate the claim "tantamount to bad faith in the performance of its contractual obligations to the insured."<sup>167</sup> The *Thomas* court brushed *American Fidelity* aside by claiming that there would be a triable is-

162. See, e.g., *Thomas v. Lumbermens Mut. Cas. Co.*, 424 So. 2d 36, 38 (Fla. 3d DCA 1982) ("Each [bad faith] case is to be determined on its own facts, and the question of the insurer's failure to act in good faith with due regard for the interests of the insured is for the jury.").

163. *Thomas*, 343 So. 2d at 1304.

164. *Id.*

165. 177 So. 2d 679 (Fla. 1st DCA 1965).

166. *Id.* at 683.

167. *Id.* It is interesting to note the equivocation in *American Fidelity* that the insurer's refusal to investigate and resulting refusal to defend were "tantamount," that is, "equivalent to" bad faith. This wordplay made no practical difference in the outcome of the case, but it stopped short nevertheless from declaring outright that refusal to defend could constitute bad faith as such. The *American Fidelity* case did not discuss the Covenant in reaching its conclusions but relied instead upon well-reasoned policy grounds.

sue in the case before it if it “were to follow the outline of *American Fidelity*,” which, as we have seen, it did not.<sup>168</sup> Had the *Thomas* court embraced *American Fidelity*, it might simply have remanded for a trial on the issue of bad faith. Instead, it clung to Florida’s attachment of fiduciary duties upon assumption of defense and found “no faith” rather than “bad faith.” In this sense, *Thomas* directly conflicted with *American Fidelity*, though the *Thomas* decision declined to say as much.

On one hand, the *Thomas* court can be commended for tackling the refusal-to-defend issue squarely, which few Florida courts have done.<sup>169</sup> But on the other hand, its analysis isolates refusal to defend in the realm of contract while its logical counterpart, bad faith refusal to settle, has burgeoned into its own class of civil liability. And although the *Thomas* court correctly allowed for a full recovery of the excess judgment as a matter of foreseeable contract damages, its categorization of refusal-to-defend claims into pure contract would deny relief that might prove available now or in the future under the bad faith rubric. Likewise, this categorization would alter the procedural landscape within which refusal-to-defend cases might be prosecuted as contract rather than tort actions.

At least one other Florida case has addressed the issue of refusal to defend. *Robinson v. State Farm Fire and Casualty Co.*<sup>170</sup> stands apart from other Florida cases for its extensive survey of refusal-to-defend claims.<sup>171</sup> While the *Robinson* court lamentably came to no authoritative conclusion, it remanded the plaintiff’s bad faith refusal-to-defend action for further proceedings.<sup>172</sup>

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168. *Thomas*, 343 So. 2d at 1303.

169. See, e.g., *Caldwell v. Allstate Ins. Co.*, 453 So. 2d 1187, 1190 (Fla. 1st DCA 1984) (affirming summary judgment against a bad faith refusal to defend claim on the nebulous (and factually disputable) basis that “[i]t cannot reasonably be said that Allstate or its counsel was guilty of the kind of conduct which has typified those cases in which the courts have found the existence of bad faith”); *Fla. Farm Bureau Mut. Ins. Co. v. Rice*, 393 So. 2d 552, 555 (Fla. 1st DCA 1980) (avoiding the issue by “[a]ssuming that bad faith is required for recovery over policy limits in a case such as this where there is a refusal to defend . . . .”); *First of Ga. Ins. Co. v. Dube*, 376 So. 2d 910, 911 (Fla. 3d DCA 1979) (suggesting without discussion that an excess judgment might be awarded for refusal to defend where “bad faith is involved”); *St. Paul Fire & Marine Ins. Co. v. Thomas*, 273 So. 2d 117, 121 & n.7 (Fla. 4th DCA 1973) (permitting recovery of excess judgment in contract and thus expressly declining to address the trial court’s finding of bad faith for refusal to defend); *Am. Fidelity*, 177 So. 2d at 683 (characterizing an egregious refusal to defend as “tantamount to bad faith” though declining to declare it so outright).

170. 583 So. 2d 1063 (Fla. 5th DCA 1991).

171. The *American Fidelity* decision included ample discussion of refusal to defend within the larger context of failure to investigate, but it based its ultimate holding on equitable policy grounds and included little in the way of doctrinal discussion, for example, of the Covenant.

172. *Robinson*, 583 So. 2d at 1069.

The facts in *Robinson* were rather convoluted. In short, State Farm's insured, Lockley, caused an auto accident in which Robinson was severely injured. State Farm denied coverage for the accident without adequate investigation and it refused to defend Lockley against Robinson's personal injury action.<sup>173</sup> Robinson won a jury verdict totaling nearly ten times the coverage under Lockley's policy with State Farm.<sup>174</sup> Robinson then filed suit for the excess judgment against State Farm, citing its bad faith failure to investigate, failure to defend, and failure to settle within the policy limits.<sup>175</sup> State Farm won summary judgment in the trial court in part because the trial judge ruled that the denial of the plaintiff's motion for summary judgment on coverage in the underlying action meant that State Farm had not, as a matter of law, acted in bad faith.<sup>176</sup>

The appellate decision in *Robinson* surveyed Florida's checkered history of refusal-to-defend cases. It began by recognizing the dilemma that has arisen when courts have considered "'bad faith' [as] essentially a breach of implied fiduciary duties that arise out of the insurer's right to control the defense and settle claims against the insured."<sup>177</sup> The opinion then mentioned *American Fidelity*, which it characterized broadly as a case involving the failure to examine coverage or investigate properly.<sup>178</sup> *Robinson* briefly addressed other cases scattered about Florida's bad faith landscape and then proposed a set of factors that might tend to prove bad faith, presumably encompassing refusal to defend.<sup>179</sup> These factors include whether the insurer could have obtained a reservation of rights, whether it took efforts to limit potential prejudice to its insured, the weight of legal authority supporting its coverage dispute, the diligence of its investigation, and any settlement efforts it may have made.<sup>180</sup> The *Robinson* court ultimately reversed the summary judgment and remanded the case for further proceedings.<sup>181</sup>

The important point to take from *Robinson* is that a court may find that an insurer acted in bad faith even where it never assumed

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173. *Id.* at 1064-65.

174. *Id.* at 1065.

175. *Id.*

176. *Id.*

177. *Id.* at 1067.

178. *See id.* at 1068. It is surprising that *Robinson* did not address *American Fidelity* at greater length because *American Fidelity* is arguably the only Florida case at the time to have permitted a bad faith action despite refusal to defend.

179. The *Robinson* opinion never returned directly to the refusal-to-defend issue but instead subsumed refusal to defend within the broader considerations relevant to proof of bad faith, thus incorporating refusal to defend within bad faith by default.

180. *Robinson*, 583 So. 2d at 1068.

181. *See id.* at 1069.

the defense of its insured.<sup>182</sup> Thus, *Robinson* began its discussion by noting Florida's history of predicating bad faith upon the assumption of an insured's defense but ultimately concluded that the question may be determined by examining the circumstances surrounding the insurer's denial of coverage. The Florida Supreme Court expressly approved this approach in *Laforet*.<sup>183</sup>

Like so many other refusal-to-defend cases, *Robinson* is important for what it did *not* say. It did *not* deem refusal to defend a bar to bad faith. It did *not* expressly conflict with *Thomas* insofar as it read *Thomas* to mean only that one need not prove bad faith to recover an excess judgment for refusal to defend (while it, *Robinson*, would also allow a bad faith recovery where refusal to defend was involved).<sup>184</sup> Moreover, *Robinson* did *not* mention the doctrine that might unify all of these considerations: the Covenant.

### C. Near Misses in Bad Faith Refusal to Defend: A Summary

A number of decisions have thus applied Florida law and permitted a claim in the nature of bad faith for refusal to defend. In *American Fidelity*,<sup>185</sup> the First District Court of Appeal ruled on policy grounds that an insurer who refused to defend should not be in a better position than one who assumed defense of the insured and thereafter acted in bad faith. The court accordingly permitted recovery of an excess judgment for inadequately investigating the claim and failing to explore settlement possibilities, behavior it deemed "tantamount to bad faith in the performance of its contractual obligations to the insured."<sup>186</sup> It affirmed the trial court's summary judgment in favor of the insured. The Fifth Circuit Court of Appeals reached a similar conclusion in predicting Florida law in *Seward v. State Farm Mutual Automobile Insurance Co.*<sup>187</sup> There, the insured sustained an excess judgment arising from State Farm's refusal to

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182. To appreciate this point, one must distinguish between refusal to defend as a positive cause of action and refusal to defend as a bar to bad faith liability. Under *Shaw* and its progeny, the duty of good faith arises upon assumption of an insured's defense so that refusal to defend may be seen as a barrier to bad faith liability rather than simply as a bad faith cause of action.

183. *State Farm Mut. Auto Ins. Co. v. Laforet*, 658 So. 2d 55, 62-63 (Fla. 1995) (discussing the factors set forth in *Robinson* and expressly adopting them as applicable to first- and third-party bad faith claims).

184. See *Robinson*, 583 So. 2d at 1068. *Robinson* does, in fact, conflict with *Thomas* to some degree while sidestepping the issue much in the same way *Thomas* sidestepped *American Fidelity*. The *Thomas* court declared refusal to defend an act of "no faith" while *Robinson* avoided that question by characterizing the acts culminating in the refusal to defend as potentially giving rise to bad faith. Of course, the Florida Supreme Court's express approval of *Robinson* in *Laforet*, 658 So. 2d at 63, resolves any such dispute in favor of *Robinson*.

185. 177 So. 2d 679, 683 (Fla. 1st DCA 1965).

186. *Id.*

187. 392 F.2d 723 (5th Cir. 1968).

defend him in a wrongful death action and subsequently brought suit under Florida law. State Farm was removed on diversity grounds.<sup>188</sup> The court addressed whether State Farm could be held liable for an excess judgment against its insured, whom it refused to defend, where the plaintiff in the underlying action never made an offer of settlement.<sup>189</sup> Though the *Seward* court did not formally address the viability of an action for bad faith refusal to defend, the court (and apparently the parties) accepted the cause of action as a given.<sup>190</sup> Finally, the *Robinson* case discussed above reversed a summary judgment in favor of an insurer, thus permitting a bad faith refusal-to-defend case to proceed.<sup>191</sup>

All three of these cases recognized Florida's rule predicating bad faith on the insurer's failure to perform duties that arise only upon assumption of an insured's defense.<sup>192</sup> Each approved, to some degree, of bad faith refusal-to-defend theories, but none squarely addressed the incompatibility of bad faith refusal to defend with the prevailing assumption-of-defense-as-threshold view.<sup>193</sup> This is no mere technicality. Under *Shaw*, and virtually every bad faith decision in Florida's history, control of the claim has been seen as *the* circumstance giving rise to a duty of good faith.<sup>194</sup> Though *American Fidelity*, *Seward*, and *Robinson* arguably reached proper conclusions by recognizing a claim for bad faith refusal to defend, all danced around

188. *Id.* at 725.

189. *Id.* at 724.

190. *See id.* at 728 (“[T]he insurer is not liable for bad faith or conduct tantamount to bad faith in the absence of an offer to settle.”); *cf.* *Hendry v. Grange Mut. Cas. Co.*, 372 F.2d 222, 225 (5th Cir. 1967) (affirming trial court's refusal to permit a bad faith refusal-to-defend cause of action where “[t]he record disclosed no evidence of ‘bad faith’, and the question of a settlement was not involved in the instant case”).

191. Other cases have obliquely suggested the propriety of a bad faith refusal-to-defend cause of action. *See Fla. Farm Bureau Mut. Ins. Co. v. Rice*, 393 So. 2d 552, 555 (Fla. 1st DCA 1980) (“Assuming that bad faith is required for recovery over policy limits . . . where there [has been] a refusal to defend . . .”); *First of Ga. Ins. Co. v. Dube*, 376 So. 2d 910, 911 (Fla. 3d DCA 1979) (reversing judgment against insurer and limiting recovery to policy limits where no bad faith was involved).

192. *Seward*, 392 F.2d at 726 (“[A]n insurer who undertakes to defend but in bad faith refuses to settle a claim within the policy limits thereby subjects itself to liability for any excess over the policy limits that may be recovered.”); *Robinson v. State Farm Fire & Cas. Co.*, 583 So. 2d 1063, 1067 (Fla. 5th DCA 1991) (“[W]hen the insured has surrendered to the insurer all control over the handling of the claim, including all decisions with regard to litigation and settlement, then *the insurer must assume a duty to exercise such control and make such decisions in good faith . . .*”) (quoting *Boston Old Colony Ins. v. Gutierrez*, 386 So. 2d 783, 785 (Fla. 1980)); *Am. Fid. Fire Ins. Co. v. Johnson*, 177 So. 2d 679, 681 (Fla. 1st DCA 1965) (“[A] liability insurance carrier which undertakes to defend and in bad faith refused to settle a claim within policy limits will thereby subject itself to liability for any excess which may be recovered.”).

193. The *Robinson* opinion effectively incorporated refusal to defend within the total-of-the-circumstances approach, but it failed to expressly resolve the critical tension between refusal to defend and assumption of defense as a trigger for the duty of good faith.

194. *See cases cited supra* notes 32-33.

the defining element of bad faith in Florida jurisprudence. Most notably, none of these cases discussed the Covenant, though it readily resolves this incompatibility.

*D. Justifying the Move to Bad Faith Refusal to Defend Predicated on Breach of the Covenant*

By now, it should be abundantly clear that refusal to defend cannot be squared with existing Florida law, at least not by any reference to existing bad faith principles. Tying Florida's Covenant jurisprudence into its bad faith jurisprudence resolves this tension. The Covenant arises at the time of contracting, or certainly no later than claim notification, and it imposes on the insurer a duty to make all discretionary decisions in good faith.<sup>195</sup> Its breach, then, could give rise to the tort of bad faith refusal to defend without regard to whether a "fiduciary" duty attaches upon assumption of the insured's defense. Naturally, the breach of fiduciary duties postdefense may give rise to "traditional" bad faith as has been the case since *Shaw*. Alternatively, even "traditional," postdefense bad faith could be seen as a breach of the Covenant in a situation where an insurer bears a heavy burden of good faith because of its power to control litigation and settlement. In other words, *all* breaches of the Covenant, with respect to defense or settlement, expose the insurer to potential bad faith liability depending upon the circumstances surrounding the particular breach. Seen this way, the traditional "fiduciary" duties attendant the assumption of an insured's defense are no different than the ever-present duties imposed by the Covenant, while the insurer's power to control litigation and settlement is but one circumstance tending to prove bad faith. Similarly, the breadth of an insurer's legal duty to defend its insured is a circumstance favoring a finding of bad faith for refusal to defend, which is merely a predefense breach of the Covenant. Approaching bad faith in this manner harmonizes pre- and postdefense bad faith jurisprudence while imposing upon insurers a single, definable duty to act in good faith from the inception of every claim. Indeed, the benefits of this approach go well beyond a desire to simplify and harmonize Florida's approach to all bad faith breaches.

First, a theory of bad faith refusal to defend predicated on breach of the Covenant will squarely address (and hopefully resolve) the question of whether bad faith arises in contract or in tort. Under the Covenant model, there would exist the three tiers of liable conduct: (1) good faith or negligent breach of the duty to defend that does not constitute breach of the Covenant and sounds only in contract; (2) a

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195. See discussion of the Covenant *supra* Part II.B.

breach of the duty to defend (not made in good faith) that accordingly gives rise to a tort claim for breach of the Covenant but which does not *necessarily* rise to the level of “bad faith” (a “mere” breach of the Covenant); and (3) an egregious breach of the Covenant that gives rise to a tort claim and will likely garner extreme tort damages (a “bad faith” breach of the Covenant).<sup>196</sup> Resolving this confusing issue might overcome Florida’s reluctance or inability to describe the most fundamental aspects of bad faith, particularly refusal to defend that might amount to bad faith. Of course, a more coherent approach would yield a more predictable and normatively beneficial doctrine.

The most obvious and important normative benefit concerns the behavior of insurers with respect to their defense obligations. This requires no academic discussion; simply imagine that you have been sued by a third party for damages that may or may not ultimately exceed your policy limits. What incentives would you prefer govern your insurer’s response to your demand for a contractual defense against the claim? Under the first option, your insurer’s wrongful refusal to defend, if actually litigated at some future date, will result at most in an obligation to pay the liability policy limits, the amount of an excess judgment, if any, and (arguably) your attorney’s fees. Under a second option, your insurer could face unpredictable and potentially staggering tort damages should it fail to honor its duty to defend. Which option might you personally choose? The answer is obvious and clearly illustrates the normative benefits of a well-defined and broadened tort remedy for refusal to defend.

In turn, it is difficult to imagine the insurer’s response to this logic. One might expect the argument that a broadening of tort remedies will result in more jury verdicts and increased costs that, predictably, would be passed on to the insured public. This claim rings hollow in the bad faith context, however. An insurer’s alleged breach, even if limited to contract remedies, will generate litigation. The only distinction is that a contract rather than a tort claim will be litigated. While tort claims admittedly expose a defendant to greater damages (which is, of course, the point), it is difficult to accept any suggestion by the insurance industry that it must pass on to its insureds the costs associated with its bad faith misconduct. Our jurisprudence should not ignore the normative benefits of broadened tort remedies in hopes of minimizing the costs that the tortfeasor itself might seek to pass along to those it has harmed.

A refusal-to-defend jurisprudence limited to foreseeable contract damages necessarily creates a situation in which the insurer can foresee, and therefore balance, the costs of defense against the costs of refusing to defend (discounted by the probability of subsequent

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196. See discussion *supra* Part II.C.

litigation by the insured and any savings the insurer realizes at the outset by avoiding the expense of defending its insured). Under such a construction, the insurer determines whether it will be exposed to a bad faith claim, and the exposure may be limited by breaching the contract. If the insurer breaches, it may file a declaratory action, thus subjecting its insured to a two-front war between the third-party case and the declaratory judgment action, both of which require out-of-pocket representation by virtue of the very breach at issue.<sup>197</sup> An insurer may well anticipate its ability to exhaust or coerce its insured under such circumstances. It thus has a range of incentives to roll the dice and refuse to defend its insured.<sup>198</sup> Rolling the proverbial dice is, after all, the very nature of the insurance business.

Moreover, a breach by the insurer upon the filing of a third-party claim differs from the traditional commercial contract. In the textbook commercial setting, the breaching party may have received payment for goods that it chose not to deliver in accordance with the parties' contract, but the benefits of such a breach would be easily disgorged. In the insurance context, however, an insured has necessarily performed his or her end of the bargain by dutifully paying premiums, often for years. Upon being sued by a third party, the insured looks to its insurer for the rendering of an esoteric duty at a peculiarly precarious time for the insured. An insurer could not conceivably satisfy its duty to the insured with delivery of a check for legal services because the duty to defend transcends the mere capital outlay in hiring a lawyer and litigating a civil action.<sup>199</sup> The California Supreme Court succinctly stated this policy rationale: "The availability of tort remedies in the limited context of an insurer's breach of the covenant [of good faith] advances the social policy of

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197. Florida courts encourage declaratory actions under such circumstances. *See, e.g.*, *State Farm Fire & Cas. Co. v. Higgins*, 788 So. 2d 992, 1004 (Fla. 4th DCA 2001); *Allstate Ins. Co. v. Conde*, 595 So. 2d 1005, 1006-07 (Fla. 5th DCA 1992). There are sound reasons for permitting this procedure, and even plaintiff's attorneys may benefit from its efficient and early determination of potential bad faith claims. But it is no less onerous to insureds and no less ripe for exploitation by an insurer who wishes to engage its insured in a war of attrition. The ideal solution might be for an insurer to defend under a reservation of rights.

198. Other jurisdictions have recognized this phenomenon. *See, e.g.*, *Smith v. Am. Family Mut. Ins. Co.*, 294 N.W.2d 751, 759 (N.D. 1980) (recognizing that absent bad faith liability for refusal to defend insurance companies might "exert whatever coercion in whatever manner and under whatever circumstances as would serve their financial interest [leaving the insured] without a remedy for damages for the failure to defend beyond attorney's fees and legal costs"); *Farris v. U.S. Fid. Guar. Co.*, 587 P.2d 1015, 1028 (Or. 1978) (noting that absent bad faith refusal to defend, "a liability insurer intending to breach its contract in bad faith is encouraged to do so at the outset rather than risk the tort liability applicable to bad faith breaches *in performance*") (Lent, J., dissenting); *Warren v. Farmers Ins. Co.*, 838 P.2d 620, 623-24 (Or. Ct. App. 1992) ("[I]t is difficult to see why the insurer should be in a better position by refusing to defend and thereby breaching the insurance contract than it would have been had it undertaken the defense but done so negligently.").

199. Virtually all jurisdictions agree that an insurer may not satisfy its duty to defend merely by paying the policy benefit. *See discussion supra* Part III.A.

safeguarding an insured in an inferior bargaining position who contracts for calamity protection, not commercial advantage.”<sup>200</sup>

This approach also honors the contract as bargained for by insureds, respecting their purchase of “litigation insurance,”<sup>201</sup> and is in keeping with the nearly inescapable duty to defend that applies to indemnity contracts in Florida.<sup>202</sup> The culpability of an insurer’s behavior dictates the available remedies. A good faith breach of contract remains limited to contract remedies. A “mere” breach of the Covenant gives rise to potential tort damages. And a “bad faith” breach exposes the insurer to damages certainly unrecoverable as foreseeable contract damages.<sup>203</sup> These considerations reveal the ultimate commendation for bad faith liability predicated on the Covenant: its fairness. How might an attorney explain to Joe that his insurer acted in bad faith by dropping his defense midsuit while explaining to Jane that her insurer did not act in bad faith when it never assumed her defense in the first place? Though an explanation might be given, a justification would prove far more difficult.

### *E. The Nature of Bad Faith Refusal to Defend Predicated on Breach of the Covenant*

#### *1. Conduct Constituting Bad Faith*

If we accept the necessity of a model predicating bad faith refusal to defend on breach of the Covenant, the next step is to define what sort of bad faith we will have recognized. Under current bad faith jurisprudence, the trier of fact must determine whether a given breach of the contract rises to the level of bad faith.<sup>204</sup> A claim that an insurer wrongfully refused to defend its insured does not differ significantly in character from a claim for wrongful refusal to settle. Accordingly, the question of whether an insurer has breached the Covenant or whether that breach amounts to bad faith would “ordinarily [pose] a question for the trier of fact to be determined after considering the totality of the circumstances.”<sup>205</sup> The core question would be whether the insurance company failed to honor its contractual duty to defend “when, under all of the circumstances, it could

200. *Kransco v. Am. Empire Surplus Lines Ins. Co.*, 2 P.3d 1, 8 (Cal. 2000) (citation omitted).

201. See discussion *supra* Part III.A.

202. *Id.*

203. Damages are discussed *infra* Part III.F.

204. See *Liberty Mut. Ins. Co. v. Davis*, 412 F.2d 475, 481 (5th Cir. 1969) (“The question of failure to act with due regard for the interests of the insured is for the jury.”) (citing *Campbell v. Gov’t Employees Ins. Co.*, 306 So. 2d 525 (Fla. 1974)).

205. *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 62-63 (Fla. 1995) (rejecting the “fairly debatable” standard and adopting a “totality-of-the-circumstances” approach in first- and third-party bad faith claims).

and should have done so, had it acted fairly and honestly toward its insured and with due regard for his interests.”<sup>206</sup> According to the Florida Supreme Court decision in *Laforet*, the jury should take at least five factors into account:

- (1) whether the insurer was able to obtain a reservation of the right to deny coverage . . .
- (2) efforts or measures taken by the insurer to resolve the coverage dispute promptly or in such a way as to limit any potential prejudice to the insureds;
- (3) the substance of the coverage dispute or the weight of legal authority on the coverage issue;
- (4) the insurer’s diligence and thoroughness in investigating the facts specifically pertinent to coverage; and
- (5) efforts made by the insurer to settle the liability claim in the face of the coverage dispute.<sup>207</sup>

These factors are tailored to the refusal-to-settle context, but they provide a structure to determine whether an insurer acted with due regard for its insured’s interests in refusing to defend against a third-party liability claim. Additionally, the fact that the duty to defend is so broad should enter into the calculus of whether the insurer breached that duty in bad faith.

## 2. *Refusal to Defend: First- or Third-Party Claim?*

If one accepts the proposition that bad faith refusal to defend may and should be predicated upon breach of the Covenant, one must also attempt to characterize whether a resulting claim is in the nature of first- or third-party bad faith. I have suggested that a broad acceptance of bad faith predicated on breach of the Covenant would abolish most distinctions between first- and third-party bad faith.<sup>208</sup> This is so because exposure to excess damages would no longer serve as the litmus for bad-faith liability; instead, the severity of an insurer’s misconduct would determine whether it acted in bad faith. Naturally, an insured’s exposure to an excess judgment, for example, would prove more harmful if he or she has to pay that judgment, so that what is now deemed third-party bad faith might remain more egregious in certain ways than what is now deemed first-party bad faith. But these would become differences in character rather than kind. Unless Florida embraces breach of the Covenant in such a broad manner, and there is no indication that it might, the distinction be-

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206. FLA. STANDARD JURY INSTRUCTION MI 3.1; *see also* Gen. Star Indem. Co. v. Anheuser-Busch Cos., 741 So. 2d 1259, 1261 (Fla. 5th DCA 1999) (“The standard for evaluating bad faith claims against insurers for first party as well as third party claims under the common law as well as under the [unfair claim settlement] statute is whether the insurer acted fairly and honestly toward its insured with due regard for the insured’s interests.”).

207. *Laforet*, 658 So. 2d at 63 (approving of *Robinson v. State Farm Fire & Cas. Co.*, 583 So. 2d 1063, 1068 (Fla. 5th DCA 1991)).

208. *See* discussion *supra* notes 31-43.

tween first- and third-party claims will remain important. Of particular note is that first-party claims exist only by statute,<sup>209</sup> and failure to abide the statutory presuit procedures will destroy a cause of action for first-party bad faith.<sup>210</sup> It is necessary, then, to address at least briefly the nature of refusal to defend within the first- or third-party claim context.

The duty to defend under a liability policy runs between an insurer and its insured. Thus, the breach of this duty appears to give rise to a first-party claim. Supporting this notion, at least facially, is the fact that the first-party insured in a refusal-to-defend claim is asserting the breach of a duty owed directly to him or her under the contract. Moreover, an adversarial relationship exists between insurer and insured in the refusal-to-defend context.<sup>211</sup> And unlike the duty of indemnification, the duty to defend does not directly benefit an injured third party.<sup>212</sup>

But therein lies the distinction: in a true first-party claim there is no third party who might benefit or not by the insurer's acts. In first-party bad faith claims "the insured is the injured party and claimant, and no injured third party is involved . . ." <sup>213</sup> This comports with the commonsense notion that an insurer would never have a contractual duty to defend against a first-party claim—for example, an uninsured motorist or property claim—because there is no one from whom the insured requires protection. Instead, the first-party in-

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209. See *Laforet*, 658 So. 2d at 58-59 ("[N]o first-party action by an insured for bad faith [existed] in Florida at common law . . . Essentially, Florida courts [have] refused to recognize the tort of first-party bad faith . . .").

210. FLA. STAT. § 624.155(2)(a) (2000).

211. See *Baxter v. Royal Indem. Co.*, 285 So. 2d 652, 656 (Fla. 1st DCA 1973) (noting that in a first-party claim "the parties occupy a contractually adversary position toward each other").

212. See *Laforet*, 658 So. 2d at 58 ("Florida courts [have] allowed the injured third party to bring a bad faith action directly against the first party's insurer . . . because the injured third-party, as the beneficiary to the bad faith claim, was the real party in interest in a position similar to that of a 'judgment creditor.'") (citing *Thompson v. Commercial Union Ins. Co.*, 250 So. 2d 259, 264 (Fla. 1971)).

213. *Dunn v. Nat'l Sec. Fire & Cas. Co.*, 631 So. 2d 1103, 1107 (Fla. 5th DCA 1993); see also *Time Ins. Co. v. Burger*, 712 So. 2d 389, 391 (Fla. 1998) (characterizing third-party claims as those "in which an insured sues his liability insurance company for bad faith in failing to settle a claim which ultimately results in a third-party judgment against him in excess of the policy limits"); *Laforet*, 658 So. 2d at 59 ("Unlike third-party bad faith actions, in first-party bad faith actions the insured, particularly in uninsured motorist claims, is also the injured party who is to receive the benefits under the policy.") (citing *McLeod v. Cont'l Ins. Co.*, 591 So. 2d 621 (Fla. 1992)); *Greene v. Well Care HMO, Inc.*, 778 So. 2d 1037, 1042 (Fla. 4th DCA 2001) ("The distinction between the first party claims and third party claims was based upon obligations between the insured and insurer. In the duty to defend and settle, the insurer is acting on the insured's behalf and for his or her benefit.").

surer directly indemnifies the insured for losses the insured has suffered.<sup>214</sup>

Insofar as an adversarial relationship might distinguish first-from third-party claims,<sup>215</sup> it should be remembered that a traditional first-party claim is *inherently* adversarial. That is, the claim inescapably turns on a resolution of contractually adverse interests between a claimant and the insurer from whom redress is sought. In the refusal-to-defend context, however, the insurer and insured share theoretically aligned interests,<sup>216</sup> at least until the insurer breaches its duty to defend. If the relatively curtailed statutory remedy for first-party bad faith is characterized by an adversarial relationship between insurer and insured, then the insurer has an incentive to breach the contract, thereby creating an adversarial relationship, in order to limit its insured to statutory remedies. Indeed, the bad faith statute arguably affords no remedy at all for an insurer's bad faith breach of an insurer's duty to defend.<sup>217</sup> To the extent it does, the remedy is certainly more limited than that available in common law bad faith.<sup>218</sup> It would be puzzling at best if an insurer were permitted to avoid or diminish common law bad faith liability by breaching its contractual duties in bad faith, thus creating an adversarial relation-

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214. See, e.g., OSTRAGER & NEWMAN, *supra* note 147, at 654 ("First-party insurance reimburses the insured for losses which he incurs as a result of injury to himself or damage to property which he owns or leases.").

215. See *supra* note 211.

216. This is itself a bit of fiction as attested to by the number of bad faith cases litigated each year, but this is precisely the distinction relied upon by the *Baxter* court and others in distinguishing first-party from third-party claims.

217. Section 624.155, *Florida Statutes*, does not expressly identify refusal to defend as a basis for statutory bad faith liability. One might arguably bootstrap a refusal-to-defend claim under section 624.155(1)(b)(1), which permits a bad faith claim for an insurer's failure to settle. But failure to settle is not the precise misconduct at issue in a refusal-to-defend case. Theoretically, there would be no need for a refusal-to-defend claim were there a failure to settle or, more particularly, failure to settle should serve as a separate basis for liability rather than as a shoehorn for refusal to defend. Section 626.9541(1)(i)(3), *Florida Statutes*, permits a bad faith claim for conduct that is akin to and often present in the refusal-to-defend context, but it does not expressly identify breach of an insurer's duty to defend as a basis for bad faith liability.

218. If section 626.9541(1)(i)(3), *Florida Statutes*, were interpreted to permit a bad faith claim for an insurer's refusal to defend, the insured would be required not only to prove a violation of the statute in its case but that the insurer committed such breaches "with such frequency as to indicate a general business practice." *Id.* See *Shannon R. Ginn Constr. Co. v. Reliance Ins. Co.*, 51 F. Supp. 2d 1347, 1353 (S.D. Fla. 1999) ("To prevail, the plaintiff must establish that the insurer committed unfair acts 'with such frequency as to indicate a general business practice.'" (quoting FLA. STAT. § 626.9541(1)(i)(3)). Likewise, punitive damages are not available for statutory bad faith absent proof of a general business practice. FLA. STAT. § 624.155(4) (2000). One decision has held that four instances of demonstrable misconduct do not constitute a "general business practice." See *Howell-Demarest v. State Farm Mut. Auto. Ins. Co.*, 673 So. 2d 526, 529 (Fla. 4th DCA 1996) (noting that the plaintiff must "demonstrate that [the insurer] engaged in this practice far more frequently than that."). Of course, statutory claims are also subject to the notice and curing provisions that do not apply at common law. FLA. STAT. § 624.155(2)(b)-(f).

ship and circumscribing its insured's remedies by the very acts alleged to constitute bad faith.

Finally, a number of Florida decisions obliquely or implicitly accepted the notion of bad faith refusal to defend prior to the passage of section 624.155, *Florida Statutes*.<sup>219</sup> First-party bad faith did not exist prior to passage of the statute.<sup>220</sup> It follows a fortiori that any bad faith refusal to defend recognized (or not dismissed as a first-party claim) prior to passage of the statute tends to define refusal to defend as a third-party claim.

In short, there is little to characterize refusal to defend as a first-party claim. On the other hand, the duty arises solely in connection with a third-party claim. It involves an adversarial relationship only to the extent that the insurer has breached its duties and thus acted in bad faith. In addition, cases prior to passage of the bad faith act suggest the viability of bad faith refusal to defend. Insofar as the distinction between first- and third-party claims remains important under the model I have suggested, refusal to defend should be treated as a third-party bad faith claim.

### 3. *Discovery in the Bad Faith Refusal-to-Defend Claim*

Another issue of collateral interest is the nature of discovery in a refusal-to-defend bad faith action. To what extent should an insured or the insured's judgment creditor be permitted to discover the insurer's claim files relating to the underlying third-party claim and litigation? In the typical third-party bad faith scenario, the insured or judgment creditor is permitted to discover everything in the insurer's claim file up to the date of the underlying judgment.<sup>221</sup> The rationale, however, is that the insurer owed a fiduciary duty to its insured and was acting in its insured's interests in processing and litigating the underlying claim so that work-product immunity does not apply to the insurer's files.<sup>222</sup> This rule does not attach in first-party bad faith actions where the insurer and insured are in an adversarial posture from the inception of the claim.<sup>223</sup>

The better argument with respect to bad faith refusal to defend predicated on breach of the Covenant would be to permit discovery of

219. See cases cited *supra* Part III.C.

220. See *supra* note 209.

221. *Dunn v. Nat'l Sec. Fire & Cas. Co.*, 631 So. 2d 1103, 1109 (Fla. 5th DCA 1994) ("Discovery of the insurer's claim file . . . is allowed."); *Stone v. Travelers Ins. Co.*, 326 So. 2d 241, 243 (Fla. 3d DCA 1976) (stating that the "company's file . . . should be produced").

222. *Dunn*, 631 So. 2d at 1109 (permitting discovery over work product objections); *Stone*, 326 So. 2d at 243 ("In defending personal injury litigation, an insurance company participates not only on behalf of itself, but also on behalf of its insured.").

223. See *Manhattan Nat'l Life Ins. Co. v. Kujawa*, 522 So. 2d 1078, 1080 (Fla. 4th DCA 1988), *aff'd*, 541 So. 2d 1168, 1169 (Fla. 1989) (precluding discovery).

the insurer's files, at least until the time that coverage and defense were denied. To begin with, the insurer and insured are not in an adversarial relationship from the inception of the claim in a refusal-to-defend scenario, as is the case in the first-party claim. In fact, they are in precisely the same circumstances as every third-party claimant and insurer, at least until the insurer decides not to defend the insured. Until that time, the insurer is presumably acting in the best interests of its insured so that the logic and policy permitting discovery in third-party bad faith actions apply with full force in the refusal-to-defend context. To the extent the insurer's otherwise nondiscoverable materials demonstrate that the insurer was not acting in its insured's best interests, when by law it should have been doing so, it would make little sense to immunize the insurer's files from discovery in a subsequent bad faith action. Such a policy would reward the insurer's bad faith breach of its duty to defend by concealing the very proof of its misconduct. In other words, an insurer acting with due regard to its insured's interests during the initial claim process would eventually have to reveal its files under Florida's traditional approach to bad faith discovery. The insurer who fails to act with due regard to its insured's interests surely cannot argue that this distinction affords it immunity from discovery of the same materials.

Any materials generated by the insurer after its denial of the insured's defense might prove relevant to demonstrate the reasons the insurer refused to defend. Yet their discoverability is questionable and would necessarily depend upon the nature of the privilege or immunity asserted. Work-product immunity, for instance, might apply because subsequent litigation against the insurer is foreseeable even where the insurer rightfully declines to defend its insured.<sup>224</sup> Then again, it is hard to imagine any other source for claim documents so that if the insured can demonstrate a need for postdenial materials, the work-product immunity might be overcome.<sup>225</sup> Moreover, a policy denying subsequent bad faith discovery for materials generated after denial of the claim might encourage early breaches. This would effectively reward the most culpable breaches by rendering them the most difficult to prove. Naturally, work-product immunity and applicable discovery privileges can be addressed on a case-by-case basis with such considerations in mind.

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224. See, e.g., *Fed. Express Corp. v. Cantway*, 778 So. 2d 1052, 1053 (Fla. 4th DCA 2001) ("Materials prepared in anticipation of litigation are not subject to discovery except on a showing that the party seeking discovery 'has need of the materials in the preparation of the case and is unable without undue hardship to obtain the substantial equivalent of the materials by other means.'") (quoting FLA. R. CIV. P. 1.280(b)(3)).

225. See *id.*; see also *Auto Owners Ins. Co. v. Totaltape, Inc.*, 135 F.R.D. 199, 202 (M.D. Fla. 1990) (holding work-product protection of claims files waived where claims manager relied upon them to refresh recollection during deposition).

An additional consideration applies where the insured has won a declaration of the duty to defend prior to bringing its bad faith action. In such circumstances, Florida courts have directly held that an insurer's claim files are discoverable from the inception of the third-party claim.<sup>226</sup>

Absent peculiar circumstances tending to prove that an adversarial relationship existed from the very inception of the claim process, logic demands that we distinguish between predenial and postdenial discovery. Full discovery should be permitted for materials generated prior to a denial of coverage and defense because those circumstances are identical to the typical third-party claim. Materials generated after denial of coverage and defense might arguably enjoy greater protection because an adversarial relationship (created by the insurer) existed from that point forward. The matter is an interesting one that requires more attention than I can afford it in this Article.

#### 4. *Other Considerations*

A host of other considerations arise once one characterizes refusal to defend as a potential bad faith action. Most, however, are shared with bad faith generally, and it is beyond the scope of this Article to follow every potential lead. My purpose has been to demonstrate the need and the legal justification for bad faith predicated on refusal to defend. I hope that purpose has been accomplished by this point. But a list of potential collateral issues is desirable to round out this thesis.

One issue certain to arise is whether an excess judgment would be an essential element in a refusal-to-defend bad faith claim. The Florida Supreme Court has deemed an excess judgment a predicate to statutory third-party bad faith liability.<sup>227</sup> It reasoned that the bad faith statute creates a duty intended to protect the insured and that absent an excess judgment, the third-party cannot prove that the insurer breached its fiduciary duties.<sup>228</sup>

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226. *Fortune Ins. Co. v. Greene*, 775 So. 2d 338, 339 (Fla. 2d DCA 2000) (deeming work-product discoverable because “[w]hen coverage is established through a declaratory judgment action, the insurer’s fiduciary relationship with the insured dates back to the time the claim is made”) (citing *Gen. Acc. Fire & Life Ins. Corp. v. Boudreau*, 658 So. 2d 1006 (Fla. 5th DCA 1994)). These holdings conflict with *Shaw*’s general principle that the fiduciary duty arises upon assumption of an insured’s defense but are consonant with the duties an insurer owes its insured under the Covenant.

227. *State Farm Fire & Cas. Co. v. Zebrowski*, 706 So. 2d 275, 277 (Fla. 1997) (stating that “in the absence of an excess judgment,” the third-party’s claim cannot stand); see also *Cunningham v. Standard Guar. Ins. Co.*, 630 So. 2d 179, 181 (Fla. 1994) (characterizing excess judgment as “an element of a bad faith-claim”); *Kelly v. Williams*, 411 So. 2d 902, 904 (Fla. 5th DCA 1982) (“[A] cause of action for bad faith arises when the insured is *legally obligated* to pay a judgment that is in excess of his policy limits.”).

228. *Zebrowski*, 706 So. 2d at 277 (“[I]n the absence of an excess judgment, a third-party plaintiff cannot demonstrate that the insurer breached a duty toward its insured.”);

Although there may well be an excess judgment following an insurer's refusal to defend (as occurred in *Thomas v. Western World Insurance Co.*<sup>229</sup>), it does not necessarily occur. On one hand, the rationale set out above could be applied to refusal-to-defend cases where there is a judgment for less than the limits of the policy that is ultimately satisfied by the insurer. Yet the insured whose insurer refuses to settle does not suffer the expense and anguish of litigation that burdens the victim of a wrongful refusal to defend. Indeed, it is undoubtedly true in at least some cases that the insured is forced to judgment or settlement for the very reason that the insurer breached its duty to defend in bad faith. If bad faith refusal to defend is predicated on the insurer's breach of the Covenant, then the breach and its result are identical to an excess judgment scenario except for the presence of the excess judgment. In other words, the conduct that amounts to bad faith and theoretically should warrant bad faith remedies is present regardless of whether the insured faces the additional burden of an excess judgment. The excess judgment, in fact, is a wholly separate matter that does not itself indicate the presence of bad faith because an excess can occur where the insurer rightfully refused to defend. In these circumstances, the insured has faced consequences of the insurer's breach that are not present in the refusal-to-settle context, and the excess judgment serves merely as a measure of monetary losses rather than a predicate to bad faith liability. The harm to the insured does not lie *only* in the excess judgment. Indeed, the harm is done at the very inception of litigation, and its consequences include all of the events leading up to the excess judgment. It makes little sense to demand an excess judgment as proof of bad faith where the harm lies in the nature and severity of the insurer's breach, a matter that could in theory be demonstrated even before judgment in the underlying action. Without engaging in an exhaustive analysis, then, the existence of an excess judgment should prove irrelevant to whether a cause of action exists for bad faith refusal to defend predicated on breach of the Covenant, though the excess judgment is clearly some measure of damages.

A tangentially related issue is whether the injured third party might bring a bad faith refusal-to-defend action directly against the insured defendant's liability insurer. Since *Thompson v. Commercial Union Insurance Co. of New York*,<sup>230</sup> Florida has permitted a judgment creditor to bring a bad faith claim directly against the

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*see also* *McLeod v. Cont'l Ins. Co.*, 591 So. 2d 621, 624-25 (Fla. 1992) ("Third-party actions do not allow for the recovery of the excess judgment in cases in which the insured is not damaged by the excess liability.") (citing *Fid. & Cas. Co. v. Cope*, 462 So. 2d 459, 461 (Fla. 1985)).

229. 343 So. 2d 1298, 1300-01 (Fla. 2d DCA 1977).

230. 250 So. 2d 259 (Fla. 1971).

nonsettling insurer. In permitting this procedure, however, the *Thompson* court reasoned that the injured judgment creditor is a third-party beneficiary under the liability policy because its indemnification provisions were intended to benefit injured third persons.<sup>231</sup> But the defense provisions in a liability policy are intended to do just the opposite—to guard against and potentially avoid the injured third party’s claim. In this sense, a judgment creditor in a refusal-to-defend case has a weak third-party beneficiary argument except to the extent the refusal to defend might have resulted in a failure to settle and, hence, to indemnify. However, the *Thompson* court also relied on the fact that the injured third party is a “real party in interest” to the contract (albeit in part because of the third party’s third-party beneficiary status).<sup>232</sup> Such considerations are beyond the scope of this Article, but they merit consideration should Florida adopt a model of bad faith refusal to defend similar to that proposed here.

Of course, an exhaustive list of collateral considerations would correlate to the virtually endless factual scenarios that might arise in bad faith refusal to defend, and many are common to bad faith generally. For instance, when a bad faith refusal-to-defend cause of action accrues and when it might be brought are complex considerations common to other bad faith cases. Another massive undertaking would be to address the procedural complexities that arise in bad faith generally, with particular attention to bad faith refusal to defend. These depend in large part upon whether bad faith is characterized as an action in tort or in contract.<sup>233</sup> Comparative bad faith is one example among many of the novel substantive and procedural bridges to be crossed in bad faith.<sup>234</sup> Other defenses might be common to contract and tort, such as the duty to mitigate losses; yet they will take on a different flavor in the context of bad faith refusal to defend.<sup>235</sup> Again, these are matters beyond the scope of this Article, but they warrant at least passing mention. If nothing else, such matters

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231. *Id.* at 261-64.

232. *See id.* at 262.

233. Ironing out the wrinkles in the hybridized “ConTort” bad faith area is one potential benefit of squarely identifying bad faith as a tort cause of action.

234. *See, e.g.*, *Nationwide Prop. & Cas. Ins. Co. v. King*, 568 So. 2d 990, 990-91 (Fla. 4th DCA 1990) (striking defense of comparative bad faith and declining “to create a new affirmative defense”); *see also* *Kransco v. Am. Empire Surplus Lines Ins. Co.*, 2 P.3d 1, 5-8 (Cal. 2000) (analyzing and rejecting comparative bad faith under California law, which is quite similar to the inchoate model I have proposed).

235. *See, e.g.*, *U.S. Auto. Ass’n v. Hartford Ins. Co.*, 468 So. 2d 545, 547 (Fla. 5th DCA 1985) (holding that an insurer may not challenge the reasonableness of an insured’s third-party settlement following a refusal to defend). *But see* *Steil v. Fla. Physicians Ins. Reciprocal*, 448 So. 2d 589, 592 (Fla. 2d DCA 1984) (characterizing “consent judgment with a covenant not to execute” as “suspect” and holding that it may not be enforced against the insurer if “unreasonable in amount or tainted by bad faith”).

illustrate that the hybridization of contract and tort through bad faith will present interesting questions, the answers to which prove necessary to the long-term health of the law. To the extent that the questions bear upon bad faith refusal to defend, I cannot help but reiterate the egregious nature of this tort, the abandonment of an insured at the time of greatest need—indeed, at the very moment for which years of insurance premiums have been paid. When this occurs for mercenary reasons that breach the Covenant and run counter to the very purpose of purchasing insurance coverage, an insurer should receive the severest reproach that might be constitutionally fashioned within our civil law.

*F. The Nature of Bad Faith Refusal to Defend Predicated  
on Breach of the Covenant: Damages*

*1. Generally*

Even if Florida were to accept a cause of action for bad faith refusal to defend predicated on breach of the Covenant, the question remains what difference this might make with respect to remedies. The *Thomas* court recognized that the plaintiffs might recover the excess judgment as well as their attorney's fees and costs as elements of foreseeable losses in a strict contract action.<sup>236</sup> The *Robinson* court observed that there would seemingly be "little difference in the exposure of the insurer under a bad faith or contractual theory."<sup>237</sup> This may or may not be the case. It is neither possible nor necessary to exhaustively analyze the potential remedial aspects of bad faith refusal to defend in this Article. Whether characterizing wrongful refusal to defend as bad faith might necessarily garner more damages is somewhat beside the point for two reasons. First, even if bad faith and contractual remedies might be coextensive at this point in time, that is not to say that this will always prove true. Bad faith is a nascent and quickly evolving area of law. A refusal-to-defend claim sounding in bad faith might well garner damages distinct from contractual remedies two or ten or twenty years in the future. That potentiality will never be realized unless the true nature of the cause of action is recognized now.

Second, refusal to defend remains an anomaly under Florida's current bad faith jurisprudence. Regardless of whether refusal to defend might ever serve as a basis for distinct damages, it is an end unto itself that we harmonize the presently dissonant chords sounding in our bad faith jurisprudence. The common law is tangential in

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236. *Thomas v. W. World Ins. Co.*, 343 So. 2d 1298, 1303 (Fla. 2d DCA 1977).

237. *Robinson v. State Farm Fire & Cas. Co.*, 583 So. 2d 1063, 1069 n.23 (Fla. 5th DCA 1991) (citing *Butchikas v. Travelers Indem. Co.*, 343 So. 2d 816 (Fla. 1976)).

nature, the seemingly slightest or most insignificant anomalies may over the course of time yield bizarre and irreconcilable results. Indeed, this is the precise manner in which refusal to defend has, over time, been relegated to the pale of bad faith jurisprudence rendering it a peculiar and intimidating presence. A cause of action for refusal to defend premised on breach of the Covenant is at odds with the traditional approach to Florida bad faith even while our courts could uneventfully incorporate it into existing bad faith jurisprudence without fear of substantial contradiction. Put plainly, Florida has embraced a myopic version of bad faith premised on failure to settle, and it should correct this vision for the sake of correction regardless of whether litigants might enjoy certain remedial advantages as a result.

And the argument remains that damages under bad faith refusal to defend could indeed differ from those available in contract. Punitive and noneconomic damages are particularly obvious examples. To that end, a brief look at potential damages is appropriate despite both the limited relevance of damages and the fact that articles concerning bad faith remedies could sustain an entire law review issue in their own right.

## 2. Punitive Damages

The successful common law third-party bad faith litigant today might expect to recover the amount of the excess judgment, attorney's fees and costs in bringing the bad faith case, loss of any property levied upon as a result of the underlying judgment, prejudgment interest, and foreseeable contract damages.<sup>238</sup> Each might be recovered in a strict contract action for refusal to defend. The potential distinction between refusal to defend in bad faith and refusal to defend in contract lies in the recovery of extracontractual damages including punitive and noneconomic losses.<sup>239</sup>

Both remedies are stifled under the Florida Supreme Court's decision in *Butchikas v. Travelers Indemnity Co.*,<sup>240</sup> which held that punitive damages would be available only in cases involving "deliberate,

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238. See generally James F. McKenzie, *Unfair Claims Practices & Bad Faith*, in FLORIDA AUTOMOBILE INSURANCE LAW §§ 7.35-.37 (Fla. Bar 2000); see also *Dunn v. Nat'l Sec. Fire & Cas. Co.*, 631 So. 2d 1103, 1106-08 (Fla. 5th DCA 1993) (explaining that direct consequential damages and other losses beyond the excess judgment may be recoverable in appropriate cases).

239. See, e.g., *Ferguson Transp., Inc. v. N. Am. Van Lines, Inc.*, 687 So. 2d 821, 822 (Fla. 1996) ("The general rule is that punitive damages are not recoverable for breach of contract, irrespective of the motive of defendant.")

240. 343 So. 2d 816 (Fla. 1976).

overt and dishonest dealing”<sup>241</sup> and that damages for mental anguish could not be recovered given Florida’s impact doctrine.<sup>242</sup> One could quite literally devote an article to the problems inherent in the *Butchikas* court’s reasoning and treatment of the case before it. I am satisfied to list several.

First, *Butchikas* theoretically should not apply to the “tort of bad faith”<sup>243</sup> because the *Butchikas* court limited its holding to cases arising in contract. Interestingly, the *Robinson* court believed that the *Butchikas* decision “did not expressly classify an ‘excess case’ as either tort or contract.”<sup>244</sup> To the contrary, in the course of limiting punitive and noneconomic damages in the “excess case” before it, the *Butchikas* court stated that its holding did not affect the availability of noneconomic or punitive damages “in a non-contract lawsuit.”<sup>245</sup> The court clearly deemed the case before it one in contract or this observation would have been unnecessary. Elsewhere, the court distinguished an authority on grounds that the case “involved a tort action rather than a contract action.”<sup>246</sup> These statements are cryptic when considered in light of the court’s apparent uncertainty about whether to characterize the case as one in bad faith (or perhaps its unwillingness to do so),<sup>247</sup> though they leave no question that the *Butchikas* court addressed the case before it as one in contract. It is no wonder, then, that punitive and noneconomic damages were limited. But this is hardly the extent of the errors in *Butchikas*.

The plaintiffs in *Butchikas* sought punitive damages under the authority of the earlier supreme court decision of *Campbell v. Government Employees Insurance Co.*<sup>248</sup> The *Campbell* court allowed an award of punitive damages against the insurer because the case “involved the elements of concealment and misrepresentations—a con-

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241. *Id.* at 818 (“We . . . view this class of case as less egregious than those involving deliberate, overt and dishonest dealing. In this class of case the insured can be made whole by a compensatory damage award and a recovery of attorney’s fees.”).

242. *Id.* at 819 (“The rule in Florida has been that, absent a physical injury, a plaintiff can recover damages for mental anguish only where it is shown the defendant acted with such malice that punitive damages would be justified.”) (citing *Crane v. Loftin*, 70 So. 2d 574 (Fla. 1954)).

Also worth noting is section 627.737(4), *Florida Statutes* (2000), which purports to abolish punitive damages in this context: “In any action brought against an automobile liability insurer for damages in excess of its policy limits, no claim for punitive damages shall be allowed.” According to McKenzie, *supra* note 238, at § 7.38, the constitutionality of this statute has not been addressed.

243. See *State Farm Mut. Auto. Ins. Co. v. Laforet*, 658 So. 2d 55, 58 (Fla. 1995) (referring to “the tort of bad faith”).

244. *Robinson v. State Farm Fire & Cas. Co.*, 583 So. 2d 1063, 1069 n.23 (Fla. 5th DCA 1991).

245. *Butchikas*, 343 So. 2d at 819 n.9.

246. *Id.* at 817 n.2.

247. The *Butchikas* decision never uses the term “bad faith” and refers to an insurer’s failure to “honor” its “responsibility” to its insured “no matter how labeled.” *Id.* at 818.

248. 306 So. 2d 525 (Fla. 1974); see *Butchikas*, 343 So. 2d at 816.

tinued course of dishonest dealing on the part of insurer toward insured.”<sup>249</sup> While admittedly the insurer’s conduct in *Butchikas* did not involve overt concealment and misrepresentation, the *Butchikas* court did not merely distinguish *Campbell* on these grounds. Rather, it characterized *Campbell* as limiting recovery of punitive damages to those cases involving overt concealment and misrepresentation.<sup>250</sup> Courts since *Butchikas* have limited punitive damages in bad faith cases in reliance upon this illogic.<sup>251</sup> Although the *Butchikas* rationale was ultimately based on public policy, the method by which it reached its conclusion is hardly sound. Imagine that you have brought a claim of civil battery for having been punched in the nose. Imagine next that the court denies your recovery by citing an earlier battery case that permitted damages for a battery involving a gun, reasoning that only shootings merit damages in civil battery. As absurd as this reasoning would be, it is directly analogous to the outcome in *Butchikas*, which held that because the *Campbell* decision permitted punitive damages based upon proof of concealment and misrepresentation, all litigants who fail to prove concealment and misrepresentation are not entitled to punitive damages. Nor did the *Butchikas* decision offer any convincing public policy for its logically specious limitation on punitive damages. It stated: “The social policy for punitive damages, as articulated by Mr. Justice Ervin in *Campbell*, is a sound one, but its application here is misplaced. A potential award in excess of policy limits plus attorney’s fees should be stimulus enough for an insurer . . . to communicate with its insured . . . .”<sup>252</sup> But this claim is belied by the very facts before the *Butchikas* court in which “the company wholly ignored their insured from the beginning to the end of the proceedings.”<sup>253</sup>

In short, *Butchikas* refused to discuss “bad faith” as such and handed down a decision governing extracontractual damages in what

249. 306 So. 2d at 532.

250. *Butchikas*, 343 So. 2d at 818 (“The social policy for punitive damages, as articulated by Mr. Justice Ervin in *Campbell*, is a sound one, but its application here is misplaced. A potential award in excess of policy limits plus attorney’s fees should be stimulus enough for an insurer . . . to communicate with its insured . . . .”).

251. See, e.g., *Dunn v. Nat’l Sec. Fire & Cas. Co.*, 631 So. 2d 1103, 1108 (Fla. 5th DCA 1993) (“In general, [to recover punitive damages], dishonesty, misrepresentations, and fraudulent conduct must be alleged and established.”) (citing *Butchikas*, 343 So. 2d 816); *Shuster v. S. Broward Hosp. Dist. Physicians’ Prof’l Liab. Ins. Trust*, 570 So. 2d 1362, 1367 (Fla. 4th DCA 1990) (“[I]n *Butchikas* . . . the [s]upreme [c]ourt held that punitive damages and damages for mental anguish . . . were not available [in excess judgment cases] absent a claim of active concealment or deliberate misrepresentation which would amount to an independent tort.”); *Indus. Fire & Cas. Ins. Co. v. Romer*, 432 So. 2d 66, 69 (Fla. 4th DCA 1983) (stating that under *Butchikas*, punitive damages would be available “if the plaintiff/insured in a third party bad faith case proved that the company engaged in deliberate, overt and dishonest dealing . . . .”).

252. *Butchikas*, 343 So. 2d at 818.

253. *Id.*

the court obviously considered a contract case. The ostensible logic and policy supporting the opinion lack coherence, yet it remains a limiting principle in Florida bad faith law.<sup>254</sup> Even with these limitations, however, the fact remains that should Florida characterize refusal to defend as a tortious breach of the Covenant, *Butchikas* will likely apply. Thus, although *Butchikas* represents a marginal departure from what might be expected in the way of punitive damages in strict contract, it is a potential departure nevertheless, and offers a reason to right the approach Florida has taken with respect to refusal to defend.

### 3. Noneconomic Losses

*Butchikas* proves even more troublesome if viewed exclusively through the lens of noneconomic losses suffered by virtue of an insurer's bad faith refusal to defend. The *Butchikas* court stated its conviction that "the insured can be made whole by a compensatory damage award and a recovery of attorney's fees."<sup>255</sup> Yet, as discussed above, the insured whose insurer refuses to defend stands in far more precarious posture than the insured whose insurer refuses to settle. While both are abandoned by the insurer, the insured who suffers a bad faith refusal to settle faces only the potential for a personal judgment in excess of the policy limits that in all likelihood will be negotiated in the context of a subsequent third-party bad faith action by the judgment creditor. When an insurer refuses to defend, however, the insured is cut loose to drift in an ocean of tort law without guidance or representation. Many insureds lack the sophistication or resources to obtain private counsel. Moreover, insurers debating their duty to defend or indemnify are encouraged to file declaratory judgment actions in Florida,<sup>256</sup> thus subjecting the insured not only to the underlying legal action, but to litigation instigated by the very party the insured counted on in the eventuality at hand.

Also distinguishing the refusal-to-defend insured from the refusal-to-settle insured is a point raised by the *Butchikas* court itself. Namely, the court keenly observed that any mental anguish suffered by an insured in the refusal-to-settle context is ultimately a result of the insured's choice to purchase relatively insufficient coverage.<sup>257</sup> Putting aside those insureds who simply cannot afford extravagant

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254. See, e.g., *Dunn*, 631 So. 2d at 1108 (citing *Butchikas* as governing the proof necessary to recover punitive damages in common law bad faith).

255. *Butchikas*, 343 So. 2d at 818.

256. See, e.g., *State Farm Fire & Cas. Co. v. Higgins*, 778 So. 2d 1002, 1003-04 (Fla. 4th DCA 2001); *Allstate Ins. Co. v. Conde*, 595 So. 2d 1005, 1006 (Fla. 5th DCA 1992).

257. *Butchikas*, 343 So. 2d at 819 ("[I]n 'excess' cases the fact and degree of financial exposure are brought about by the insured's decision to risk the financial and emotional consequences which naturally flow from the insufficiency of coverage.").

coverages, the simple fact remains that the amount of coverage purchased is irrelevant in a refusal-to-defend case. While it might ultimately bear on the amount of any excess judgment entered against the insured, it has no bearing on the propriety of the insurer's refusal to defend or the mental anguish of an insured facing a lawsuit by the injured party and potentially facing a second lawsuit by the very insurer it paid to protect it under such circumstances.

Finally, the *Butchikas* court denied recovery of mental anguish damages because “[t]he rule in Florida ha[d] been that, absent a physical injury, a plaintiff [could] recover damages for mental anguish only where it [was] shown the defendant acted with such malice that punitive damages would be justified.”<sup>258</sup> The so-called “impact rule” has come under assault since *Butchikas*, however. In fact, a case pending before the Florida Supreme Court at the time of this writing could ultimately curtail or even prove fatal to the doctrine.<sup>259</sup>

Of course, if Florida embraces refusal to defend as a breach of the Covenant sounding in tort, noneconomic losses might arguably prove more appropriate as a traditional tort remedy. Regardless of how this question might be resolved at present, noneconomic losses remain a potential recovery in bad faith refusal to defend that would not typically exist in contract.<sup>260</sup> The potentiality alone serves as reason to place refusal to defend in its proper context so that whatever eventuality arises, Florida's bad faith framework will be poised to integrate it in a consistent and harmonious fashion.

#### IV. CONCLUSION

Florida has developed a restrictive view of bad faith. In searching out bad faith conduct, Florida courts first ask whether an insurer assumed its insured's defense because under Florida's narrow view of bad faith, this event triggers the insurer's fiduciary obligations, the breach of which might give rise to a claim in bad faith.

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<sup>258.</sup> *Id.*

<sup>259.</sup> See *Gracey v. Eaker*, 747 So. 2d 475, 477-78 (Fla. 5th DCA 1999) (certifying as a question of great public importance whether the an exception to the impact rule should apply for infliction of emotional injuries in violation of a statutory duty of confidentiality), *rev. granted*, 760 So. 2d 946 (Fla. 2000). Other bad faith cases addressing recovery of mental anguish damages depend upon the impact rule and might thus be affected as well. See, e.g., *Time Ins. Co. v. Burger*, 712 So. 2d 389, 393 (Fla. 1998) (carving out limited exception for recovery of noneconomic losses in bad faith); *Otero v. Midland Life Ins. Co.*, 753 So. 2d 579, 580 (Fla. 3d DCA 2000) (reversing substantial jury award for emotional distress in bad faith claim).

<sup>260.</sup> Damages for mental anguish are not available even for “willful and flagrant” breach of contract. See *Floyd v. Video Barn, Inc.*, 538 So. 2d 1322, 1325 (Fla. 1st DCA 1989). Of course, this rationale applies not only to mental anguish, but loss of enjoyment of life, emotional distress, and any other noneconomic damages that might legitimately be pled in response to an insurer's refusal to defend.

This myopic view led the Third District Court of Appeal to reject bad faith as a prerequisite for recovery in the refusal-to-defend context because, it said, the bad faith concept “presupposes [the] exercise [of] skill, judgment and fidelity on [the insured’s] behalf.”<sup>261</sup> It does indeed. But so, too, does the Covenant demand the exercise of skill, judgment, and fidelity on the insured’s behalf *before* a defense of the insured has been assumed. Indeed, skill, judgment, and fidelity must inform the decision of whether to defend an insured in the first place. It follows that its breach should constitute bad faith where the attendant facts and circumstances warrant such a finding. Apparently unaware of this potentiality, the *Thomas* court deemed wrongful refusal to defend an act of “no faith” rather than one of “bad faith.” Yet an act of “no faith” under the Covenant is itself an act of bad faith by omission.

The apparent incongruity is only that: apparent. By reconciling Florida’s bad faith jurisprudence with its Covenant jurisprudence, refusal to defend may be brought into the fold without contradiction. I have proposed a structure in which three possibilities exist. An insurer may wrongfully refuse to defend in good faith; it may refuse to defend in breach of the Covenant and thus give rise to tort damages (a “mere” breach); or it may refuse to defend in such a way or on such grounds as to breach the Covenant and give rise to extraordinary tort damages (a “bad faith” breach). Under our existing common law bad faith structure, the particulars are for jurors to decide in light of the surrounding circumstances. This is as it should be.

Though my suggested framework is hardly the only manner in which refusal to defend might be reconciled with existing bad faith principles, I hope it is, if nothing else, a starting point for a serious reexamination of this illusory contradiction. I have no doubt that should there be a serious reexamination of our refusal-to-defend jurisprudence, experienced and authoritative voices on all sides of the debate would contribute in ways I have not considered. At a minimum, I hope to have raised a flag of distress that might at least spark concern over where we are heading in light of where we have been. In the end, my goal would be achieved were there some affirmative response to what I hope by now is a demonstrated need. Unless such a response is forthcoming, the refusal-to-defend doctrine will persist as a forbidding mirage of apparent contradiction. Both the health of the law and the rights of our litigants demand otherwise.

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261. *Thomas v. W. World Ins. Co.*, 343 So. 2d 1298, 1304 (Fla. 2d DCA 1977).