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NEWSLETTER

# Second Circuit Affirms Verdict Finding Breach of Covenant of Good Faith and Fair Dealing and Trial Court's Decision to Vacate Bad Faith Award

September 2008

The United States Court of Appeals for the Second Circuit Court has affirmed a trial court's decision to dismiss a bad faith claim against the primary insurer brought by excess insurers, holding that, under New York law, the jury's finding that the primary insurer did not act in "gross disregard" of the rights of the excess insurers precluded a finding of bad faith. *Schwartz v. Liberty Mutual Ins. Co.*, 2008 WL 3850768 (2d Cir. Aug. 19, 2008). The court also affirmed the jury's verdict finding that the insurers breached the covenant of good faith and fair dealing for failure to approve a securities settlement of $20 million and affirmed the trial court's award of prejudgment interest running from the date the insured paid the settlement.

The insured was the CEO of a satellite telephone business. In 2001, the company revealed that its satellite technology could not perform as promised. A securities class action was then filed against the insured, his employer and a related investor. After the entity defendants filed for bankruptcy, the case proceeded solely against the former CEO, who was covered by a $50 million tower of D&O insurance, with a $10 primary policy followed by successive $5 million excess policies.

Prior to trial, the parties engaged in settlement negotiations. The plaintiffs demanded $15 million for settlement, while the primary insurer would not offer more than $5 million, despite the insured's protestations that he faced potentially hundreds of millions of dollars in liability if plaintiffs prevailed at trial. During trial, the judge indicated that a plaintiffs' verdict could be eight or nine figures. In response, the primary insurer offered $3 million for settlement. The plaintiffs again refused the offer. During subsequent settlement discussions, the plaintiffs' settlement demand rose to $20 million. Despite protests from the insured and the excess insurers, the primary insurer refused to provide its policy limits in furtherance of settlement. Thereafter, the insured settled the case with the plaintiff for $20 million. The insured provided the insurers with notice of, and requested approval for, the settlement at 10:00 pm on a Sunday night, requiring approval by 9:00 am Monday morning. The insured ultimately paid the settlement by writing a personal check for $20 million. The insurers later refused to approve the settlement, and coverage litigation ensued.

The coverage litigation proceeded to trial, with the insured seeking recovery for the amount he paid in settlement, plus defense costs, and the excess insurers pursuing bad faith refusal to settle claims against the primary insurer. The jury awarded the insured the full amounts sought and awarded bad faith damages against the primary insurer. In a special verdict, however, the jury found that the primary insurer did not act with "gross disregard" for the rights of the excess insurers. After the jury's verdict, the trial court awarded the insured prejudgment interest measured from the time he made the settlement payment. The court also concluded that New York law applied to the question of bad faith damages. Because New York law requires a finding of "gross disregard" in order to award bad faith damages, the court struck the bad faith damages from the judgment. On appeal, the insurers objected to the jury's finding that the settlement was covered by the policies and the judge's decision to grant prejudgment interest from the time of the settlement payment. The excess insurers also appealed the trial court's determination that New York law applied to their bad faith cross-claims against the primary insurer.

The appellate court first concluded that the jury did not err in finding that the insurers violated their duty of good faith and fair dealing in refusing to approve the settlement. The court recited the extensive evidence demonstrating the insurers' participation in the settlement process, the frequent warnings that an excess verdict was possible and the trial developments that favored the plaintiffs. The court concluded that the jury reasonably determined that: 1. the insurers had an adequate opportunity to consider the settlement offer; 2. $20 million was a reasonable settlement amount; and 3. the insurers withheld their consent.

Next, the court considered the insurers' argument that the policies required the insured to obtain consent prior to settling the case and, because the insurers did not provide consent, the settlement therefore should not be covered by the policies. Again, the court affirmed the jury's verdict, noting that the insurers were apprised of the status of the case and the prospects for settlement. The court also noted that the allegations of bad faith militated in favor of the conclusion that the insurers' consent was not required.

The court then turned to the insurers' argument that the eleven hour window to consider the $20 million settlement was not reasonable to permit meaningful consideration of the settlement. The court, however, rejected this argument, opining that the insurers had been involved for months in the settlement process and should not have been surprised by the parties' settlement positions.

Turning to the issue of prejudgment interest, the excess insurers argued that the amount should be calculated only from the time that the primary insurer paid its policy limits, rather than the time at which the insured wrote the personal check in satisfaction of the settlement agreement. Relying on California law, the excess insurers argued that the insured's right to damages did not "vest" until payment had been made by the primary insurer. The court, however, rejected this argument, finding that the relevant California statute required the taxing of prejudgment interest once the damages became fixed and known.

Finally, the court turned to the issue of bad faith damages against the primary insurer. The court affirmed the trial court's holding that New York choice of law rules applied. Because New York was the location of the subject matter of the bad faith claims, the court also affirmed the trial court's decision to apply New York substantive law. Indicating that New York law requires a finding that the primary insurer "grossly disregarded" the excess insurer's interests in order to award bad faith damages, the Second Circuit determined that because the jury found that the primary insurer did not act with gross disregard for the interests of the excess insurers, the trial court's decision to strike the bad faith damages from the judgment was correct.