Courts Missing the Point on Pennsylvania Insurance Bad Faith

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In August 2007, the 3rd U.S. Circuit Court of Appeals handed down a decision that further clouds the already murky waters of insurance bad faith law in Pennsylvania. In *Gallatin Fuels Inc. v. Westchester Fire Ins. Co.*, the court upheld an insured's statutory bad faith claim under 42 Pa. Cons. Stat. Ann. Section 8371 (West 2007) even though there was no insurance policy in force as of the date of loss. While the court chose not to designate the opinion for publication in the *Federal Reporter*, it has received recognition on a national level, thus warranting a discussion of its merits.

Though the court purportedly intended to carve out a special exception to the fundamental requirement that a statutory bad faith action arise under an insurance policy, the decision may end up creating a slippery slope of future bad faith actions arising irrespective of an insuring agreement between the parties.

Gallatin sold a coal mine to Mon View Mining Corporation. The terms of the sale required Mon View to insure the mining equipment and name Gallatin as a loss payee. Mon View obtained insurance from Westchester Fire and financed the premiums. Mon View's agreement with the finance company permitted the policy to be cancelled upon any default, subject to a 15-day notice period. Due to Mon View's failure to reimburse the premiums, the finance company sent notices of cancellation to Westchester, Mon View, and Mon View's insurance broker, but not to Gallatin. The policy was cancelled on March 28, 2002.

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On April 8, 2002, due to Mon View's failure to pay the electric bill, power to the mine was shut off, causing damage to various pieces of equipment. Without any knowledge that the policy had been cancelled, Gallatin submitted a claim to Westchester for the damaged equipment. Westchester, apparently also unaware that the policy had been cancelled, proceeded to investigate the claim. When Gallatin submitted a proof of loss requesting policy limits for the damages incurred, Westchester rejected it on the grounds that no loss had occurred and that the claimed amount was not supported by documentation. It was not until Oct. 25, 2002, that Westchester informed Gallatin that the policy had been cancelled prior to the loss.

Gallatin filed suit against Westchester in the Western District of Pennsylvania for breach of contract and statutory bad faith. A jury verdict was returned against Westchester for $1.325 million in compensatory damages and $20 million in punitive damages under the bad faith statute. The district court later reduced the punitive damage award to $4.5 million.

Over the nearly 18 years since the statute was enacted, the inclusion of a bad faith cause of action in litigation against an insurer has become more and more commonplace. The Gallatin opinion could signal the beginning of a new line of bad faith actions yet to be confronted in the commonwealth.

On appeal, the 3rd Circuit partially overturned the verdict and held that the policy was cancelled prior to the loss thus precluding coverage. Despite this finding, the court went on to uphold the bad faith verdict entered against Westchester. While recognizing that a finding of no coverage would preclude a finding of bad faith in most cases, the court declined to apply the rule in this instance.

In issuing its ruling, the court analyzed other cases discussing the issue, including its own decision in *Frog Switch & Manufacturing Co. v. Travelers Ins. Co.* In *Frog Switch*, the 3rd Circuit held that where the insurer was correct as a matter of law in denying coverage, no claim for bad faith could exist. In an attempt to justify the obvious discrepancy between its two rulings, the *Gallatin* court distinguished *Frog Switch* by stating, "a finding that the insured [sic] did not ultimately have a duty to cover the plaintiff's claim does not *per se* make the insured's [sic] actions reasonable."

In *Gallatin*, the bad faith claim rested on

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Westchester's behavior beyond the denial of coverage. Comparing the case to *Frog Switch*, where the insurer consistently relied on the same coverage defense throughout its investigation, the court emphasized Westchester's failure to raise the policy cancellation defense until six months after the claim was made.

This reasoning is in direct conflict with the principles set forth by the Eastern District of Pennsylvania in *Williams v. Hartford Cas. Ins. Co.* In *Williams*, the Court held that if there is a reasonable basis for the insurer's actions in its handling of a claim, even if it did not rely on that basis, there can be no bad faith as a matter of law. Thus in *Gallatin*, the cancellation of the policy prior to the loss should have precluded any bad faith cause of action regardless of Westchester's delay in discovering it and notifying Gallatin.

Though Pennsylvania's bad faith statute has been criticized for failing to define bad faith, it does begin with the words, "In an action arising under an insurance policy ... ." Inexplicably, the 3rd Circuit ignored the statute's explicit precondition of a valid insurance policy. Supreme Court Chief Justice Ralph J. Cappy aptly noted in his dissent in *Hollock v. Erie Insurance Exchange*, "a bad faith lawsuit is established when the insured proves a breach of the duty of good faith in fair dealing that the insurer owes the insured when processing or settling a claim under a policy of insurance. The relationship between the parties is defined by the insurance policy. Once that policy has been terminated, the claim paid, or the claim denied the relationship is over." Recently, in *Toy v. Metropolitan Life Ins. Co.*, Cappy wrote that the term bad faith refers to actions by an insurer in furtherance of its contractual obligations, including the duty of good faith and fair dealing implied in the insuring contract. It is thus axiomatic that without an insurance policy there can be no bad faith.

Although the *Gallatin* court couched its decision as being "one of the exceedingly rare cases in which an insurer can be liable for bad faith even after the insured cancels the policy," the decision is falsely premised on the belief that a bad faith claim can survive in the absence of an insurance policy. Looking through the words of the *Gallatin* holding, one can only assume that the court was searching for some basis to reprimand the insurer for its conduct. Irrespective of the insurer's actions, the Pennsylvania bad faith statute was not an appropriate vehicle for inflicting this punishment.

The opinion's multiple references to the case being atypical seem to acknowledge a lack of conviction in the reasoning behind the holding. By ignoring the clear parameters of the statutory language set forth by the Pennsylvania Legislature, this decision may create dangerous, albeit unintended, consequences for future litigants. Conceivably, the ruling could empower some creative parties to conjure arguments of quasi-insurance agreements solely to fuel a bad faith action.

Unfortunately, *Gallatin* has joined a growing list of judicial opinions that fail to recognize the limits of the remedies provided by Pennsylvania's bad faith statute. Over the nearly 18 years since the statute was enacted, the inclusion of a bad faith cause of action in litigation against an insurer has become more and more commonplace. The *Gallatin* opinion could signal the beginning of a new line of bad faith actions yet to be confronted in the commonwealth.

One can only hope that the 3rd Circuit's caveat in its ruling will encourage other courts to treat the case as an anomaly. If not, the potential exists for future holdings, inconsistent with the statute and established case law, to broaden bad faith as a theory of recovery beyond the intentions of the legislature. Since the courts are reluctant or possibly unable to do so, it may fall to the Pennsylvania Legislature to clearly delineate the boundaries of this potentially formidable cause of action. •

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