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Arizona Court of Appeals Reverses $1 Million Award of Punitive Damages in Insurance Bad Faith Case for Alleged "Institutional Bad Faith"

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In *Sobieski v. Am. Standard Ins. Co. of Wisconsin*, 2016 WL 5436588 (Ariz.App. Sept. 29, 2016),[1] despite upholding a bad faith judgment for an insurer conducting an unreasonable investigation and denying a claim, the Arizona Court of Appeals reversed a $1 million award of punitive damages. In so holding, the Court of Appeals continued Arizona's trend of reducing or reversing punitive damages in insurance bad faith cases and distinguished the alleged "institutional bad faith" of the Insurer in *Sobieski* from the insurer in *Nardelli v. Metropolitan Group Property & Casualty Insurance*.[2]

Facts & Procedural History

The *Sobieski* case arose from an uninsured motorist ("UM") claim. The Insured, while riding a motorcycle, was badly injured when he rear-ended an uninsured car after it slowed to make a turn and then stopped abruptly.[3] The Insured had $100,000 of UM coverage. The Insurer twice denied the claim because it concluded the Insured was at fault for the accident.[4] The Insureds[5] sued the Insurer for breach of contract. An arbitrator allocated 60 percent of fault to the Insured and found that the Insured incurred $950,000 of damages, so the Insured's total damages of $380,000 significantly exceeded the $100,000 UM limits.[6] The Insurer paid the policy limits.

The Insureds sued the Insurer again—this time for bad faith and punitive damages. Regarding bad faith, the Insureds alleged the Insurer unreasonably investigated and denied the UM claim.[7] Regarding punitive damages, the Insureds did not allege the Insurer intended to injure them by performing an unreasonable investigation, by unreasonable claims handling policies, or that the Insurer deliberately engaged in routine claims practices intended to benefit the Insurer at the expense of insureds.[8]

Rather, in *Sobieski,* the Insureds alleged the Insurer's bad faith "was driven by business policies that compelled the company's claims handlers to favor corporate profits at the expense of its insureds."[9] The Insureds likened the Insurer's conduct to the conduct of the insurer in *Nardelli*[10] and alleged five broad categories of evidence indicated claims adjusters denied the Insureds' claim because of "undue pressure" from the Insurer "to promote company profits at the expense of" insureds: (1) claims department business plans, (2) company-wide incentive-pay programs, (3) employee performance reviews and personnel files, (4) claims manager training materials, and (5) a mandate to claims employees to focus on comparative negligence in adjusting claims.[11] The jury awarded the Insureds $500,000 of compensatory damages and $1 million of punitive damages.[12] The trial court denied the Insurer's motions for judgment as a

matter of law and new trial.

Holding

The Court of Appeals held that a close review of the record revealed "no evidence" that the Insurer's "business plans, employee evaluations, compensation programs or training materials were designed or applied with the purpose of arbitrarily reducing or denying claims to further the [Insurer's] bottom line, or that those plans, materials or programs had any inappropriate effect whatsoever on how claims employees handled the [Insureds'] claim."[13] Accordingly, *Sobieski* reversed the $1 million award of punitive damages.[14]

Rationale

The Court of Appeals began its analysis by stating the legal principles guiding the imposition of punitive damages in Arizona.[15] Next, *Sobieski* analyzed the conduct warranting an award of punitive damages against the insurer in *Nardelli.*[16] Then, the Court of Appeals analyzed the five categories of evidence that allegedly caused undue pressure on claims adjusters to promote company profits at the expense of insureds.

First, regarding the business plans, *Sobieski* held the plans "contain no support for the assertion that the [Insurer] sought to turn its claim department into a 'profit-center' at the expense of its insureds" for the following reasons: (a) the "plans set no arbitrary goals for claims payouts"; (b) the plans "did not direct adjusters to keep company profits in mind when settling claims"; (c) "a company keeping statistics on resolution of claims and looking to their bottom line are reasonable internal procedures; particularly [if an insured] has offered no evidence that this behavior ever resulted in the denial of a legitimate (or illegitimate) claim"; (e) "an insurer does not open itself to punitive damages simply by taking steps to monitor profitability"; (f) there was no evidence that "company officers directed adjusters to reduce claims payouts to enhance the company's bottom line"; and (f) on the contrary, the plans emphasized customer (insured) service and satisfaction and an Insurer philosophy to "pay what we owe."[17]

Second, regarding compensation policies, the Court of Appeals held that, unlike *Nardelli*: (a) there was no evidence that "any specific severity[18] goal was imposed on the claims office that handled the [Insureds'] claim"; (b) there was no evidence that "compensation paid to claims employees was linked to their success in limiting claims payouts"; and (c) the Insurer's "incentive plan was a company-wide profit sharing program in which all employees could be rewarded in accordance with the company's overall performance," including non-claims related activity such as return on Insurer investments.[19]

Third, regarding claims employee personnel files, *Sobieski* held "employee personnel files in the record offer no support for the argument that [Insurer] management encouraged claims workers to arbitrarily or unreasonably deny claims," because: (a) there was no evidence of "documented demands managers placed on claims workers…to handle claims with a 'laser-like focus' on meeting company profit goals"; (b) there was no evidence or inference that the pertinent claims manager "encouraged his employees to deliberately short-change insureds to improve company profits or his standing within the company"; and (c) again, the personnel files included praise for the pertinent adjuster's customer (insured) service.[20]

Fourth, regarding training materials for claims managers, the Court of Appeals noted that the materials' answer to the question, "How can a manager control severity?" belied the contention that the Insurer "trained its managers to control severity by short-changing claimants."[21]

Fifth, regarding corporate documents urging claims employees to apply comparative fault, *Sobieski* noted: (a) "there is nothing wrong in the abstract with an insurer seeking to lay off an appropriate share of the liability on a third party's insurer when the third party is at fault"; and (b) there was no evidence that "an improper [Insurer] focus on comparative fault drove [the Insurer] to deny the [Insureds] claim."[22] Rather, the Insureds argued that the Insurer committed bad faith by *failing* to apply comparative fault.[23]

Analysis

There are at least two significant take-ways from *Sobieski.* First, *Sobieski's* reversal of the $1 million award of punitive damages continues Arizona's trend of reducing or reversing punitive damages awards in bad faith cases. Four years ago in *Nardelli,*[24] the Court of Appeals upheld a trial court's reduction of a $55 million punitive damages award in an insurance bad faith case to only $620,000, *and* further reduced the punitive damages award to only $155,000—a 1:1 ratio with compensatory damages. Two years ago in *Arellano v. Primerica Life Insurance Company,*[25] the Court of Appeals again reduced a punitive damages award in an insurance bad faith case of approximately $1.1 million to only $328,000—a 4:1 ratio with compensatory damages.

Second, insurers should note the distinctions that the Court of Appeals drew between the insurer's conduct in *Nardelli* and the Insurer's conduct in *Sobieski* to help insulate themselves from bad faith claims and punitive damage awards based on "institutional bad faith." At the risk of stating the obvious, Insurers should *not*: (a) "set arbitrary goals for claims payouts";[26] (b) "direct adjusters to keep company profits in mind when settling claims"[27] or "reduce claims payouts to enhance the company's bottom line";[28] (c) set "any specific severity goals";[29] (d) link "compensation paid to claims employees…to their success in limiting claims payouts";[30] (e) document employee personnel files to include manager demands or encouragement to handle claims or deliberately short-change insureds with a focus on meeting company profit goals, improving company profits, or improving the manager's standing within the company";[31] or (f) "train its managers to control severity by short-changing claimants."[32] Equally at the risk of stating the obvious, insurers *should*: (a) emphasize customer (insured) service and satisfaction in business plans;[33] (b) emphasize a philosophy to "pay what we owe" in business plans;[34] (c) make incentive pay plans available to all employees—not just claims employees—linked to overall company performance, including non-claims related activity;[35] and (d) document personnel files with praise and an emphasis on customer (insured) service.[36]

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[1] The Arizona and Pacific Reporter citations are not yet available.
[2] 230 Ariz. 592, 277 P.3d 789 (App. 2012).
[3] *See Sobieski,* 2016 WL 5436588 at *1, ¶ 2.
[4] *Id.* at *1, 2, ¶¶ 3-6.
[5] Both the insured motorcyclist and his wife sued the Insurer.
[6] *Id.* at *2, ¶ 7.
[7] *Id.* at *3, ¶ 11. Although not the focus of this article, the Court of Appeals held the Insureds presented sufficient evidence from which the jury could conclude the Insurer's investigation of the claim was unreasonable because: (1) the Insurer knew there were five witnesses to the accident, but spoke only to the Insured and the Uninsured Motorist; (2) the Insurer reached a first conclusion regarding liability before it received the Accident Report; (3) the Insurer had reason to question the Uninsured Motorist's account of the Accident; (4) after the Insurer re-opened the claim because of statements from witnesses casting additional doubt on the Uninsured Motorist's account of the accident, the Insurer performed no additional investigation before it reached a second conclusion regarding liability and it denied the claim a second time; (5) the Insurer's decision to not interview other witnesses because it thought the witnesses would be biased in favor of the Insured, was undermined by the fact that the Uninsured Motorist's account of the Accident was clearly biased in favor of the Insurer; and (6) despite knowing the Insured's damages were significant, so even a slight amount of comparative fault applied to the Uninsured Motorist could result in at least some recovery to the Insured, the Insurer failed to investigate and apply comparative fault. *Id.* at *3, ¶¶ 12-15.
[8] *Id.* at *5, ¶ 19.
[9] *Id.* at *5, ¶ 19.
[10] 230 Ariz. 592, 277 P.3d 789. To see a previous article regarding the "low to moderate" reprehensible conduct warranting punitive damages in *Nardelli,* but the Court of Appeals nevertheless upholding a $54 million reduction of the punitive damages award, click here: http://www.jaburgwilk.com/news-publications/arizona-upholds-54-million-reduction-of-punitive-damages-in-insurance-bad-faith-case . In *Nardelli,* the Arizona Court of Appeals found the following facts presented clear and convincing evidence that the Insurer acted with an "evil mind" when it decided to repair rather than total an insured's theft-recovered vehicle: (1) the insurer "instituted an aggressive company-wide profit goal for 2002"; (2) the insurer "assigned the claims department a significant role in achieving that goal"; (3) the insurer "aggressively communicated this goal to the claims department (including the office and employees handling [the Insureds'] claims)"; (4) the insurer "tied the benefits of claims offices and individuals to, among other things, the average amount paid on claims"; (5) the insurer's efforts to reach its profit goal influenced how its employees handled claims; and (6) the insurer did nothing to ensure its focus on meeting its profit goal did not affect how its employees handled, evaluated and assessed claims." *Id.* at 605, 277 P.3d at 802.
[11] *Sobieski,* 2016 WL 5436588 at *6, ¶ 24.
[12] *Id.* at *2, ¶ 7.
[13] *Id.* at *11, ¶ 45.
[14] *Id.* at *11, ¶ 49.
[15] "A breach of the duty of good faith and fair dealing is not sufficient, by itself, to support a claim for punitive damages." *Id.* at *4, ¶17. "There must be circumstances of aggravation or outrage, such as spite or 'malice,' or a fraudulent or evil motive on the part of the defendant, or a *conscious and deliberate disregard* of the interests of others. We restrict punitive damages to those cases in which the defendant's wrongful conduct was guided by evil motives. Thus, to obtain punitive damages, plaintiff must prove that defendant's evil hand was guided by an evil mind. The evil mind which will justify the imposition of punitive damages may be manifested in either of two ways. It may be found where defendant intended to injure the plaintiff. It may also be found where, although not intending to cause injury, defendant consciously pursued a course of conduct knowing that it created a substantial risk of significant harm to others. Such damages are recoverable in bad faith tort actions when, *and only when*, the facts establish that defendant's conduct was aggravated, outrageous, malicious or fraudulent. When defendant's motives are shown to be so improper, *or* its conduct so oppressive, outrageous or intolerable that such an "evil mind" may be inferred, punitive damages may be awarded." *Id.* (italics in original) (citing *Rawlings v. Apodaca,* 151 Ariz. 149, 162–63, 726 P.2d 565, 578–79 (1986) (citations omitted)). Furthermore, "a plaintiff suing for punitive damages must prove the defendant's 'evil mind' by clear and convincing evidence." *Sobieski,* 2016 WL 5436588 at *4 ¶17 (citing *Linthicum v. Nationwide Life Ins.*, 150 Ariz. 326, 332, 723 P.2d 675, 681 (1986)). "Punitive damages are appropriate only in the most egregious of cases, upon proof of both the defendant's reprehensible conduct and evil mind." *Sobieski,* 2016 WL 5436588 at *4 ¶18 (citing *SWC Baseline & Crismon Inv'rs, L.L.C. v. Augusta Ranch Ltd.*

P'ship, 228 Ariz. 271, 289, ¶ 74, 265 P.3d 1070, 1088 (App. 2011)). The Arizona "supreme court has made clear that an insurer does not open itself to punitive damages simply by considering its own interests in denying a claim." *Sobieski,* 2016 WL 5436588 at *4 ¶18 (citing *Gurule v. Ill. Mut. Life & Cas. Co.*, 152 Ariz. 600, 607, 734 P.2d 85, 92 (1987) ("Self-interest is not, however, evidence of an 'evil mind.'")). "Because punitive damages may be awarded only when they will serve to punish a defendant that acted with an evil mind, the defendant's motives are determinative." *Sobieski,* 2016 WL 5436588 at *4 ¶18 (citing *Bradshaw v. State Farm Mutual Automobile Insurance*, 157 Ariz. 411, 422, 758 P.2d 1313, 1324 (1988)).

[16] *Sobieski,* 2016 WL 5436588 at *5-6, ¶¶ 20-23. *See* note 10, *supra.*

[17] *Id.* at *6-7, ¶¶ 25-31.

[18] *Sobieski* explained "severity" as "amounts paid out on claims." *Id.* at *8, ¶ 35.

[19] *Id.* at *7, ¶¶ 32, 33.

[20] *Id.* at *8, ¶¶ 34-38 (internal citations omitted).

[21] *Id.* at *10, ¶ 39. The answer focused upon encouraging adjusters to exercise their curiosity by conducting "great investigations" so that a "file supports the information that's in it." *Id.*

[22] *Id.* at *10, ¶¶ 40-42.

[23] *Id.*

[24] 230 Ariz. 592, 277 P.3d 789. Again, to see a previous article regarding *Nardelli* upholding a $54 million reduction of the punitive damages award, click here: http://www.jaburgwilk.com/news-publications/arizona-upholds-54-million-reduction-of-punitive-damages-in-insurance-bad-faith-case .

[25] 235 Ariz. 371, 332 P.3d 597 (App. 2014). To see a previous article regarding *Arellano* upholding a $700,000 reduction of punitive damages, click here: http://www.jaburgwilk.com//news-publications/az-reduces-punitive-damages-in-insurance-bad-faith-case-again .

[26] *Sobieski,* 2016 WL 5436588 at *6, ¶ 25.

[27] *Id.* at *6, ¶ 27.

[28] *Id.*

[29] *Id.* at *7, ¶¶ 32, 33.

[30] *Id.* at *7, ¶ 32.

[31] *Id.* at *8, ¶¶ 34-38.

[32] *Id.* at *10 ¶ 39.

[33] *Id.* at *6, 7, ¶¶ 28, 29.

[34] *Id.* at *7, ¶¶ 29, 30.

[35] *Id.* at *7, ¶¶ 32, 33.

[36] *Id.* at *8, ¶¶ 34, 37 (internal citations omitted).