NEWSSTAND

Bad Faith: Choice of Law Matters

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Choice of law issues cannot be overlooked in insurance bad faith litigation, and often play a critical role in the outcome of such claims. In *Schwartz v. Twin City Fire Insurance Co., et al.*, 492 F.Supp.2d 308 (S.D.N.Y.2007), *aff'd. sub nom Schwartz v. Liberty Mutual Ins. Co.*, 539 F.3d 135 (2nd Cir.2008), the district court was faced with the issue of whether California law or New York law applied to the defendant Excess Insurers' cross-claims against the co-defendant Primary Insurer for bad faith failure to settle an underlying securities class action lawsuit.

At trial, the district court instructed the jury on the elements of bad faith that are common to California law and New York law, and then instructed the jury to decide (separately) whether the Excess Insurers proved that the Primary Insurer acted with "gross disregard" of the interests of the Excess Insurers, a showing that is required for recovery under New York law but not under the law of California. The jury returned an awarded totaling $5 million in favor of the Excess Insurers on their bad faith cross-claims, but found that the Primary Insurer did not act with "gross disregard." After post-trial briefing, the Primary Insurer snatched victory from the jaws of defeat, when the district court decided that the law of New York applied to the Excess Insurers' bad faith cross-claims and amended the judgment in a significant way by dismissing the bad faith cross-claims.

Background: The Securities Class Action

In 2003, Loral Space & Communications Ltd., a public company, filed for Chapter 11 protection as a result of its failed investment in a satellite telephone business known as Globalstar. The chief executive officer of Loral ("Schwartz") also served as chief executive of the Globalstar companies.

Schwartz became the sole defendant in a certified federal securities class action (the Securities Class Action) arising out of his service with Globalstar. In his capacity as an officer, he was insured under a primary layer of insurance with limits of $10 million, together with excess layers providing an additional $40 million in coverage.

At several points in pre-trial settlement discussions, class counsel expressed a willingness to resolve the case for $15 million. After evaluating the case, the Primary Insurer did not tender its limits of $10 million during the course of the action. With the primary layer unexhausted, the excess insurers were unwilling to contribute to a settlement.

With settlement not having been achieved, the second excess insurer, with limits of $5 million excess of $15 million, asserted that the Primary Insurer was acting in bad faith by not tendering its limits. The third excess insurer, with limits of $5 million excess of $20 million, took a similar position, but did not use the words "bad faith."

Over a weekend break in the trial, Schwartz concluded that the most prudent course of action was to settle the case. Class counsel, however, was no longer willing to accept $15 million in settlement, but stated that the case could be settled for $20 million. When the trial resumed, the parties announced that a $20 million settlement-in-principle had been reached. With no consent from any insurer having been received, Schwartz agreed to fund the settlement personally.

The Coverage Action

Within days of paying the $20 million settlement, Schwartz commenced a coverage action in the United States District Court for the Southern District of New York against the Primary and first three excess insurers to recover the $20 million settlement payment. The second and third excess insurers (the "Excess Insurers") asserted cross-claims against the Primary Insurer for bad faith failure to settle the Securities Class Action.

Prior to trial, the Primary and first excess insurer settled with Schwartz by paying their limits. Schwartz's claims against the Excess Insurers, and the Excess Insurers' cross-claims for bad faith against the Primary Insurer, proceeded to trial.

Following the presentation of evidence to the jury, the district court and the parties engaged in lengthy discussions concerning the jury charge and the special interrogatories to be included on the verdict sheet.[1] A question arose as to whether California law or New York law applied to the Excess Insurers' bad faith claim.

Instead of definitively ruling on the choice of law issue, the district court elected to charge the jury on the elements common to both California and New York bad faith claims.[2] Separately, the district court instructed the jury on New York's bad faith standard, requiring that the insurer be found to have acted in "gross disregard" of the rights of the Excess Insurers' interests. Accordingly, the district court charged the jury as follows:

In determining whether [the Primary Insurer] acted with gross disregard of [the Excess Insurers'] interests you should consider whether [the Primary Insurer] acted deliberately or recklessly in failing to place [the Excess Insurers'] interest on equal footing with its own. In determining whether [the Primary Insurer] acted with gross disregard by recklessly or deliberately failing to consider [the Excess Insurers'] interest in refusing to tender its policy or to approve a settlement at an earlier point in time, you may consider [Schwartz's] likelihood of success on the issue of liability, whether [the Primary Insurer] had investigated the circumstances of the allegations of securities fraud against [Schwartz] sufficiently to be able to evaluate the probability of a verdict against [Schwartz], the potential damages awarded to the [Securities Class Action] plaintiffs, the financial burden on each party if [the Primary Insurer] refused to settle, the information available to the insurer when the demand for settlement was made, and any other relevant proof tending to establish or negate the insurer's good faith in refusing to settle. If you conclude that [the Primary

Insurer] acted negligently but did not deliberately or recklessly fail to consider the excess insurer's interests, then you must find for [the Primary Insurer]. [3]

Since New York requires a finding of "gross disregard," included among the special interrogatories submitted to the jury was one requesting the jury to state whether each Excess Insurer had proved by a preponderance of the evidence that the Primary Insurer acted with "gross disregard" of the rights of the Excess Insurers.

After the seven day trial, the jury returned a verdict in favor of Schwartz against the Excess Insurers. The jury also returned verdicts in favor of each of the Excess Insurers against the Primary Insurer on their bad faith cross-claims and awarded them $3 million and $2 million, respectively. However, in response to the special interrogatory, the jury found that the Primary Insurer had not acted with "gross disregard." The district court initially entered judgment in favor of the Excess Insurers, but then considered the choice of law issue.

If California law applied to the Excess Insurers' cross-claims, the Primary Insurer would be liable for damages to the Excess Insurers for bad faith. However, if New York law applied, because the jury found by way of the special interrogatory that the Primary Insurer did not act with "gross disregard" of the rights of the Excess Insurers, the Primary Insurer would prevail against the Excess Insurers. The district court's choice of law analysis would determine the outcome.

Post-Trial Motions and Decision

The Primary and Excess Insurers filed post-trial motions directed at the bad faith claims. The threshold issue, of course, was which state law applied, California or New York. Since a federal court sitting in diversity must apply the choice of law rules of the forum state, the district court applied New York's choice of law principles.

In conducting its analysis, the district court concluded that the substantive law of California and New York were in conflict on the issue. Next, the district court determined that under New York law, a bad faith claim for unreasonable failure to settle sounds in contract and as a result, New York courts apply the contractual "grouping of contacts" analysis to determine which state's substantive law should govern. The district court found that the "grouping of the contacts" analysis favored the application of New York law to the bad faith claim, and stated:

New York was the place of "performance" of the contract as it is the place where the events which constitute the basis of the underlying lawsuit occurred as well as where that suit was filed and defended. Additionally, New York is where the claim was handled and where all settlement discussions occurred, including the eventual settlement. Further, New York is the site of any alleged breach of the covenant of good faith and fair dealing since any wrongful conduct, including an unreasonable refusal to settle, occurred in New York. Additionally, New York has a substantial public policy interest in application of its bad faith law. [4]

On appeal, this finding was echoed by the Second Circuit, which found:

"the location of the subject matter" of the bad-faith cross-claims points strongly toward New York. The [Securities Class Action] was filed, tried and ultimately settled in New York. Prior to settlement, the parties participated in a mediation session and a settlement conference in New York. (The other two mediation sessions occurred in Washington, DC.) The underlying class action was tried in New York, and [the Primary Insurers'] alleged misconduct was the refusal in New York to settle that New York litigation. None of these events took place in California. [5]

The district court also found that New York's compelling interest in the application of its bad faith law to this claim, coupled with the state's contacts with the Securities Class Action, its defense, evaluation and settlement, all led to the conclusion that New York law governed the Excess Insurers' bad faith claim.

While the district court applied New York law to the Excess Insurers' bad faith claim, it also concluded that California, and not New York law, governed the interpretation and meaning of the relevant insurance policies, which were formed before any claim arose. Since the conduct of the Primary and Excess Insurers in the handling of the claim occurred in New York, the district court found it appropriate that New York govern only the aspects of the bad faith claim.

Having determined that New York law applied to the Excess Insurers' bad faith claims, the focus turned to the special interrogatories presented to the jury. The first interrogatory asked whether the Excess Insurers had demonstrated that the Primary Insurer had acted in bad faith, as defined in the district court's instructions, which encompassed the elements common to both California and New York law. The jury concluded that there was bad faith, but the jury's work did not end there. The jury was then required to determine whether the Primary Insurer acted with "gross disregard" for the Excess Insurers' interests. The Excess Insurers' interests were set forth in the district court's instructions to the jury, which were framed in accordance with New York law.

Because the jury did not find that the Primary Insurer acted with "gross disregard," and because the district court found that New York law applied to the Excess Insurers' bad faith cross-claims, the district court amended the judgment and directed the entry of judgment in favor of the Primary Insurer, dismissing the bad faith cross-claims.

Conclusion

With so few bad faith cases going to trial, let alone to verdict, the Schwartz case provides valuable insight into the advocacy process that can be employed during trial that could help preserve a winning argument on an unresolved choice of law issue. Taking the time to draft jury instructions carefully and proposing the use of special interrogatories to highlight the differences in the bad faith standards between states' laws could mean the difference between judgment or dismissal. In bad faith litigation, the choice of law issues cannot be overlooked.

Endnotes

1. Trial Tr. 1159-209, January 18, 2007

2. Trial Tr. 1356-62, January 18, 2007; see also Schwartz 492 F.Supp. 2d at 326 n.9.
3. Trial Tr. 1361-62, January 18, 2007
4. *Schwartz*, 492 F.Supp. 2d at 327 (internal citations omitted).
5. *Schwartz v. Liberty Mutual Ins. Co.*, 539 F.3d 135, 152 (2nd Cir. 2008).