



# Mediation of a bad-faith case

## *When the insurance company has “skin in the game”*

By ARNIE LEVINSON

The distinguishing characteristic between settlement of a personal-injury case and a bad-faith case is that, in a bad-faith case, the insurance company potentially has “skin in the game.” This often makes it particularly attuned to settlement of the case. Extra-contractual damages in the form of consequential damages (such as emotional distress damages) and punitive damages are potentially recoverable. To recover such tort damages, the insured has to show that the insurance company has acted unreasonably (*Egan v. Mutual of Omaha*, (1979) 24 Cal.3d 809, 818) and, for punitive damages, that it has acted maliciously, oppressively or fraudulently. (Cal. Civ. Code, § 3294).

This has two consequences. First, the claim is being made that the company’s personnel and/or its procedures are not only wrongful, but unreasonable and outrageous. It is an attack on the company, its personnel and its manner of operation. Alleging that the manner in which an insurer handles claims is, in reality, a despicable effort to deprive insureds of their benefits is sometimes not looked upon by an insurer dispassionately. Insurance companies are made up of people who sometimes take these allegations personally and who are sometimes highly offended by the allegations. Its adjusters are subjected to contentious depositions and the results of the cases can impact the adjusters’ very jobs and the manner in which the insurer conducts its business. There is a big difference between alleging that a defendant was negligent and alleging that the defendant is a large, unscrupulous and despicable insurance company which is out to deprive its insureds of benefits rightfully due.

Second, where punitive damages survive until trial, the case has the explosive possibility of a large judgment against the

insurance company. In addition to requiring the insurer to pay a large sum of money, it may require the insurer to spend even more money to change its practices or pay other claims it might have denied in the past. It also can hurt the insurer’s reputation and it can encourage other plaintiffs to seek larger settlements, pointing to the verdict in a particular case as an example of how a jury will adjudge its conduct.

On the other hand, a casualty case is more “business as usual” in the sense that the insurer handles these cases every day of the week, has a process in place to evaluate the cases, and has a reservoir of data to help evaluate each case. Moreover, it is not personalized, as a bad-faith case can be. It is the business the insurer is in. Adjuster depositions are not taken and they are not accused directly by the plaintiff in that action of improper conduct. The chances of a runaway verdict are not as likely in casualty cases as they are where punitive damages are at play. And, if there is such a verdict, it is more readily identifiable and expected.

As such, it is not uncommon for the insurer in a bad-faith case to send relatively high level employees or employees who are well-versed in the case to a mediation and to have others available to contact during the mediation. Higher level representatives are sent to casualty cases as well, but as a general rule of thumb insurers will often take a more active role in mediation of bad-faith claims where the target is their own conduct than it might in cases where only the conduct of its allegedly negligent insured is at issue.

### **Who will be attending the mediation for the insurer?**

Bad-faith cases usually involve a claim that the insurance company has not only denied a claim, but it has done so in bad faith. Indeed, the claims are often

accompanied by allegations of punitive damages, which assert that the person who denied the claim acted outrageously, maliciously and/or oppressively toward the plaintiff. It can then be a bit troublesome to the plaintiff when the representative of the insurer at mediation is the very same person who is being accused of acting so despicably. Most insurers have an entirely separate representative at the mediation, who, at least in theory, has the ability to make an objective assessment of the allegations and the conduct of the employee(s) who are accused of abusive conduct.

However, it is not uncommon for the insurance representative to be the same person who handled the claim. In these situations, plaintiff may not know if s/he can trust that this person is in a position to objectively assess the allegations against the insurer. It is worth talking to either defense counsel or the mediator in advance of the mediation to see who will be attending the mediation for the insurer. There is little a plaintiff can do to require the insurer to choose a different representative. The insurer has certainly made a conscious decision to select this representative. Nonetheless, this is an issue that inevitably will come up in the course of the mediation. At some point the mediator is going to have to address that issue when meeting with the insurer. If there is good basis for plaintiff’s allegations of unreasonable or malicious conduct, the mediator is going to have to handle those claims with special care.

This is not to say that it is always unwise or not constructive for an insurer to send persons to a mediation who were personally involved in claims. I have seen instances where such representatives were completely professional and competent and understood that the mediation was a business matter and not personal. And there are many insurance personnel who



have no issue with the idea that mistakes can and will be made. Their job is to resolve the case, if appropriate, in a fair manner, regardless of their prior involvement in the claim.

In my experience, concern about the fact that the mediation participant was also involved in the claim is greater early in the case than it is closer to trial. As the case gets close to trial and allegations of bad faith or punitive damages remain in the case, other eyes from the insurer almost always appear on the file. And, while the claims person who made the claims decision may still be at the mediation, that person's conduct has undoubtedly come under closer scrutiny by others at the insurer. Indeed, there may be a greater incentive for that person to accomplish a settlement in order to avoid a disaster at trial which can be attributed to that person.

### When should you mediate?

The question of whether to engage in early mediation or wait until closer to trial is a question to be addressed in any case. If, however, there are serious allegations of punitive damages, early mediation has less likelihood of achieving results. Many insurers welcome early mediation and do consider the costs of litigation when considering whether to settle early on in the case. It is, however, unusual for an insurer to agree to settle for an amount which is over and above the contract amount at an early mediation. In most instances, before an insurer is going to pay extra-contractual damages in settlement, it is going to need to be shown some strong evidence – including, in most instances, deposition testimony of its claims personnel.

In addition, most insurers are going to want to take a run at getting the punitive damages and perhaps the bad faith claims thrown out on a motion for summary adjudication, which is not going to be heard until around 30 days before trial. As a result, a productive mediation of a case involving serious claims of punitive damages may need to await at least

the insurer's filing of a summary adjudication motion and the plaintiff's opposition to that motion. The ruling on this motion is obviously going to have a dramatic impact on the trial. If the motion is granted, punitive damages are no longer in play. If the motion is denied, that does not mean, of course, that there will be a punitive damage verdict. It does mean, however, that there is a high likelihood that the issue of punitive damages is at least going to the jury – a significant fact which insurers need to consider in evaluating settlement.

### Successful mediation resulting in a high-low arbitration

As discussed in the first section above, bad-faith cases can have an explosive element. And sometimes this exposure can turn on a finite legal or factual issue – such as whether the claimant is actually an insured under the policy or whether a defense such as the statute of limitations or ERISA preemption applies. A claim could be made, for example, on a policy where the benefits are \$1 million, \$2 million, or \$5 million depending on one issue.

This can be the boulder in the middle of the road, which prevents a successful mediation. One way around this boulder is to settle the case with an agreement that this one issue will be submitted to a designated arbitrator and the parties agree to a high/low result based solely on the outcome of that finite issue. This has the advantage of assuring the plaintiff that s/he will not be shut out and assuring the insurer that a large, punitive-based verdict is off the table.

A word of caution is important here. It is critical that at least the following items are carefully determined and agreed to before the mediation is concluded.

(1) The issue to be arbitrated needs to be carefully written and agreed to by the parties. Once the mediation is over, it will be very difficult to change the issue. The issue must be so clear that the arbitrator need merely say "Yes" or "No" and

the high/low agreement kicks in automatically.

(2) It is best to limit this to a legal issue rather than a factual issue. A factual issue creates a myriad of potential problems to be determined by the mediator, such as the right to future discovery or what rules of evidence will be used in the arbitration.

(3) If the issue is limited to a legal one, the concern over what facts can be submitted to the arbitrator should not be a major concern. But it is helpful to agree that only certain facts (such as those in the claim file) can be submitted to the arbitrator. What neither party wants is the opposing party submitting unanticipated declaration(s) with the briefing or filing motions with the arbitrator which were not contemplated at the time of the agreement. Generally, if the legal issue is drafted with sufficient care, it is very likely that it will not matter what evidence is submitted by a party because the legal issue will not change.

(4) The arbitrator or method of selecting the arbitrator needs to be determined.

(5) Preferably, an exact briefing schedule should be set out. It is also helpful to agree on a time limit for argument (such as one hour) and what will appear in a joint pre-arbitration letter to the arbitrator.

(6) A date by which the arbitration decision must be made – such as 30 days.

(7) Any other rules that the parties believe are necessary should be specified at the mediation and included within the settlement documents.

### Due process exception to mediation privilege?

In California, the mediation privilege is sacrosanct and cannot be violated under any circumstances.

California Evidence Code § 1119(a) provides:

No evidence of anything said or any admission made for the purpose of, in the course of, or pursuant to, a mediation or a mediation consultation is



admissible or subject to discovery, and disclosure of the evidence shall not be compelled, in any arbitration, administrative adjudication, civil action, or other noncriminal proceeding in which, pursuant to law, testimony can be compelled to be given.

In order to encourage the candor necessary to a successful mediation, the Legislature has broadly provided for the confidentiality of things spoken or written in connection with a mediation proceeding. . . . [T]he Legislature's explicit command [is] that, unless . . . expressly waived, under statutory procedures, . . . things said or written "for the purpose of" and "pursuant to" a mediation shall be inadmissible in "any . . . civil action.

(*Cassel v. Superior Court* (2011) 51 Cal.4th 113, 118-119.)

Federal Judge Cormac Carney recently held in a bad-faith case that evidence of what transpired during mediation was admissible notwithstanding the mediation privilege.<sup>1</sup> He found in *Milhouse v. Travelers Insurance Company* (C.D. Cal. 2013) 682 F.Supp.2nd 1088 that there was a "due process" exception to the mediation privilege. This is a shocking holding, and the case is currently on appeal.

*Milhouse* arose out of a claim against Travelers Commercial Insurance Company, which issued a homeowners' policy to Dr. and Mrs. Milhouse. The Milhouse home was totally consumed in a fire and the Milhouses submitted a claim to Travelers for the loss of the home and their personal property. A jury eventually awarded the insureds nearly \$2 million in contract damages and consequential damages. However, it found that Travelers had not acted in bad faith and that its conduct did not warrant punitive damages. Both Travelers and the plaintiffs moved for a new trial.

In ruling on the new trial motions, Judge Carney reduced the \$2 million to approximately \$1 million and otherwise denied all motions. In their motion for new trial, the plaintiffs argued that the

Court had improperly admitted evidence of what transpired during mediation sessions in attempts to settle the matter.

In particular, testimony was presented that at the mediation the Milhouses made a \$7 million demand of payment and that they asked for nearly a million dollars of attorneys fees when their attorney had only worked on the case for a few weeks. (982 F.Supp. at 1104.)

The Milhouses claimed that this evidence was improper, highly prejudicial and warranted a new trial on the bad-faith issues.

The Court first held that the Milhouses waived the privilege by failing to properly object during trial. The Court also raised the possibility that F.R.C.P. 408, which permits evidence of settlement negotiations to be admitted when offered to prove a matter other than liability might trump California's mediation privilege. (982 F.Supp. at 1104, n. 10.) The Court found that it did not need to address the issue, given plaintiffs' waiver.

The Court then set out an alternative ground for permitting evidence of communications which took place during the mediation. It held that "[d]ue process demanded that the Court allow the jury to hear the testimony regarding the parties' mediation statements." (*Id.* at 1106.) The crux of the Court's ruling was that the plaintiffs continually argued to the jury that Travelers had acted in bad faith because it made no attempt to settle the plaintiffs' claims when, in fact, the parties had gone to mediation and Travelers had made efforts to settle the case at mediation.<sup>2</sup> Indeed, the Court found that during mediation, "[i]t was not Travelers who acted unreasonably in settling the claim. Sadly, it was the Milhouses. They demanded way too much money to settle their claims." (*Id.* at 1107-08.)

The Court explained, [f]or the Milhouses, the case was about a despicable insurance company that had a policy of not fairly and reasonably cooperating with its insureds to settle their claims after a tragic loss. . . .

Travelers needed to present the parties' mediation statements to provide a complete defense of its actions and to avoid paying millions of dollars in bad faith and punitive damages for wrongfully refusing to settle the Milhouses' claim. (*Id.* at 1107.)

The Court recounted the fact that, when the parties approached mediation, they were approximately \$500,000 apart on the claim and that Travelers had offered to meet them halfway. However, the Milhouses demanded \$7 million, including nearly \$1 million in attorneys' fees despite the fact that the attorneys had only been involved for about six weeks. In the Court's mind, it was required to permit Travelers to admit this evidence in order to fairly rebut Plaintiffs' claims. "To exclude this evidence would have been to deny Travelers of its due process right to present a defense." (*Id.* at 1108.)

It is doubtful that this holding is supportable on appeal. As noted above, the California Supreme Court has strongly endorsed the unqualified mediation privilege and there are no exceptions in the statute.

Another obvious concern is that the Court offers no definition of "due process," thereby leaving a potentially gaping hole in the mediation privilege. How could parties ever effectively mediate if there was the possibility that an undefined due process exception could expose all of the statements made at mediation? This is exactly why the statute insulating the mediation privilege was passed. Indeed, in *Cassel*, the plaintiff was suing his former attorney for legal malpractice arising out of his recommendation of settlement at a mediation. If there were any case where a party needed access to the events which transpired during the mediation in order to prove their case, this is it. Still, the California Supreme Court held that these communications were inadmissible.

Another consequence is the potential for very difficult issues at trial. In *Milhouse* what happened at mediation was generally undisputed. But that is unlikely to be



universally true. Rather, it is more likely that the parties will dispute what happened, thereby requiring trial counsel and possibly the mediator to take the stand during trial – all of which raise all sorts of conflict and other confusing issues at trial for counsel and the court.

Moreover, there are other ways to resolve this “due process” issue – such as by documentation of settlement discussions outside the mediation and by limiting what can be argued at trial. To create a huge undefined “due process” hole in the privilege is in direct contravention of the statute, which the California Supreme Court so strongly endorsed and creates an exception so vague as to defy definitional limits. Indeed, the Court had no need even to discuss the issue in light of the waiver by the plaintiff of the privilege claims. In my informal discussions with attorneys and other mediators, there is a strong sense that the opinion will not survive appeal.

**Conclusion**

There are certain aspects of bad-faith claims that distinguish them from mediation of casualty and other types of claims. Most importantly, alleging that an insurer has engaged in despicable conduct provokes a much different defense and approach to settlement than do claims where the insurer is defending a third party alleged to have acted negligently. It is also worth keeping an eye out for an appellate decision in the *Milhouse* case, although, in all likelihood, the appellate court will confirm that the mediation privilege is sacrosanct and not subject to a general “due process” exception.

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**Endnotes**

<sup>1</sup> Judge Carney recently issued another notable opinion in which he held that the death penalty as administered in California was unconstitutional. *Jones v. Chappel*, \_\_\_\_ F. Supp.2d \_\_\_\_, 2014 WL 3567365.

<sup>2</sup> It is not clear from the opinion whether the mediation occurred prior to or during the litigation. In speaking with one of the counsel to the case, I learned that there were, in fact, multiple mediations. It is not clear from the opinion whether the evidence submitted was from one or more of these mediations.

