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focus

'Bad faith' key to retrieving attorney fees for property insurance matters

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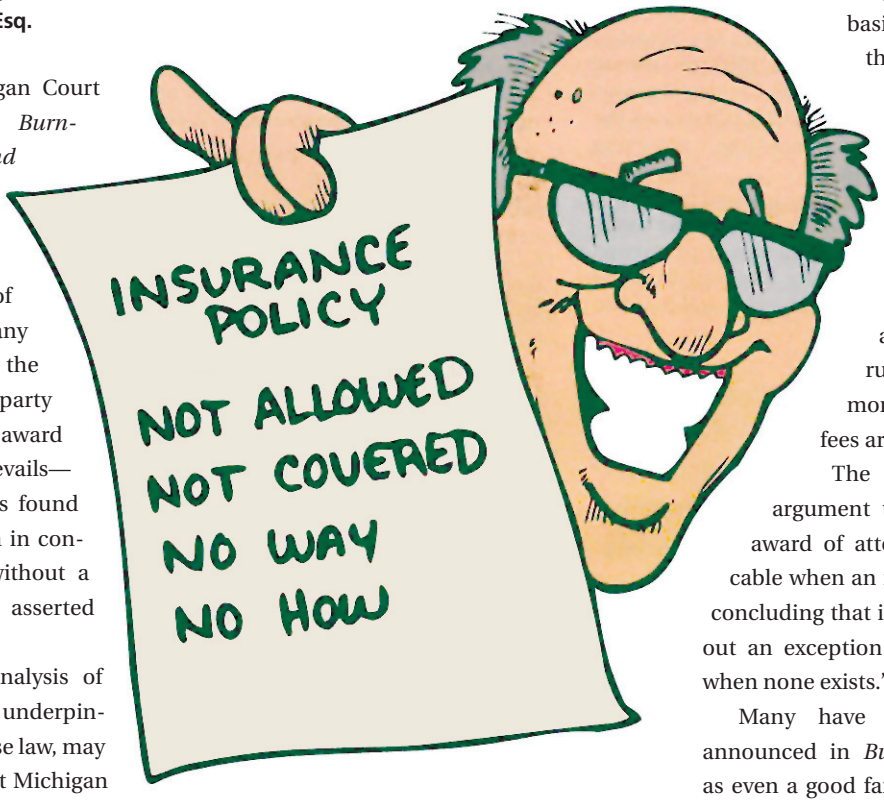

Following the Michigan Court of Appeals decision in *Burnside v. State Farm Fire and Casualty Co.*, 208 Mich App 422 (1995), lv. den. 450 Mich 893 (1995), the general understanding of most attorneys and many courts has been that the policyholder in a first-party suit is not entitled to an award of attorney fees if he prevails—even when the insurer is found to have denied the claim in conscious bad faith, and without a reasonable basis for its asserted defenses.

However, a closer analysis of *Burnside*, as well as its underpinnings and subsequent case law, may lead one to conclude that Michigan law, in fact, provides for an award of attorney fees when insurers have asserted defenses to a claim in "bad faith."

In most cases, an insurer's decision to deny a policyholder's property damage claim is based on a legitimate disagreement over facts or policy interpretation. Such denials are not in bad faith, and it is clear that, in Michigan, policyholders are not entitled to compensation for attorney fees incurred, even after prevailing at trial.

However, sometimes insurers deny a claim based upon what they know is a specious defense, in "bad faith," possibly accusing their own policyholder of arson or fraud or asserting a coverage defense, despite the knowing lack of any reasonable evidentiary or legal basis for the position.

In *Burnside,* the Court of Appeals held that, under Michigan law, policyholders are not entitled to be compensated for attorney fees incurred, even when insurers intentionally act in bad faith in denying their policyholders' claim. The basis of its holding was "that the recovery of attorney fees incurred as a result of an insurer's bad faith refusal to pay an insured's claim is governed by the American Rule," which holds that in the absence of an applicable statute, court rule or recognized common law exception, attorney fees are not recoverable.

The court then rejected the argument that the rule against an award of attorney fees was "inapplicable when an insurer acts in bad faith," concluding that it saw "no reason to carve out an exception [for a bad faith denial] when none exists."

Many have argued that the rule announced in *Burnside* is unduly harsh, as even a good faith, yet erroneous, denial can be economically devastating to a policyholder and, therefore, insurers should pay the policyholders' attorney fees and costs when the insurer clearly acted in bad faith resulting in a lawsuit when none should have been necessary.

However, the American Rule recognizes that all litigants, including insurance companies, have a right to assert a good faith claim or defense in court without the fear of paying not only for a judgment and their own litigation expenses, but also for

the opponent's legal fees and costs if a court disagrees with the losing party's position in the dispute.

So the question that must be answered is whether there is an exception to the "American Rule" for bad faith conduct, or, alternatively, whether the American Rule should be construed to protect insurers from paying its policyholders' attorney fees and costs when an insurer uses the court system and its known financial burden in a "bad faith" attempt to evade a known liability to its policyholders.

Sometimes insurers deny a claim based upon what they know is a specious defense, in "bad faith," possibly accusing their own policyholder of arson or fraud or asserting a coverage defense, despite the knowing lack of any reasonable evidentiary or legal basis for the position.

With respect to such bad faith claim denials, the vast majority of jurisdictions, including federal courts sitting in Michigan, have allowed for the recovery of attorney fees or punitive damages through various legal devices (e.g. causes of action under the tort of bad faith and under state statutes, as consequential damages in contract actions, or under the bad faith exception to the American Rule).

While the rule announced in *Burnside* has been cited by several panels of the Michigan Court of Appeals, a careful review of subsequent case law examining the "American Rule" reveals that the continued viability of the Court's holding in *Burnside* is questionable.

Indeed, just three years after *Burnside* was decided, the Michigan Supreme Court expressly addressed both the American Rule and its exceptions in *Nemeth v. Abonmarche*, 457 Mich 16 (1998), which involved a request that the Court recognize the "private attorney general" exception to the American Rule.

In *Nemeth*, the Court carefully defined the parameters of the American Rule under Michigan law by looking to the decision of the U.S. Supreme Court in *Alyeska Pipeline Service v. Wilderness Society* and other federal decisions. In doing so, *Nemeth* recognized just two well-established common-law exceptions to the American Rule that each party must pay its own attorney, one of which being the "bad faith exception."

While the Supreme Court's holding in *Nemeth* directly concerned the "private attorney general" exception to the American Rule, the Court examined which exceptions were "well established" so that the parameters of Michigan's common law (which depended upon which exceptions were well established in the federal courts) could be defined. This endeavor resulted in the Michigan Supreme Court's recognition of the bad faith exception to the American Rule.

Of course, *Burnside's* holding was based on the assumption that (contrary to *Nemeth*) there is no bad faith exception to the American Rule. Thus, there is a question regarding whether *Nemeth* abrogated *Burnside*, because the application of the Supreme Court's analysis in *Nemeth* certainly calls the legal underpinnings of the *Burnside* decision into question.

So, is the well-established, bad faith exception to the American Rule part of Michigan's common law, as the Michigan Supreme Court said in *Nemeth* (citing *Alyeska Pipeline*), or is the pre-*Nemeth* position taken by the Court of Appeals in *Burnside* an accurate reflection of the law?

Contrary to what many have assumed, the issue of payment of attorney fees when insurers deny claims in bad faith may still be unresolved in Michigan.

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