December 2014

Clarifying Bad-Faith Jurisprudence in Virginia, Federal Court Recognizes Bad-Faith Claim Against First-Party Insurer

In *Great Am. Ins. Co. v. GRM Mgmt., LLC*, Case No. 3:14CV295, 2014 U.S. Dist. LEXIS 164147 (E.D. Va. Nov. 24, 2014), a federal district court denied an insurer's motion to dismiss a bad-faith claim arising out of the insurer's denial of its policyholder's claim for property damage and loss of business income following the theft of rooftop air conditioning units from the policyholder's hotel. The ruling is significant because it illustrates that Virginia law supports first-party bad-faith claims against insurers.

Background

Great American Insurance Company ("GAIC") issued a "business insurance policy" to GRM Management, LLC, and SN Holdings, LLC, (collectively, the "policyholders"), covering property at and belonging to the Richmond Magnuson Grand Hotel and Convention Center (the "hotel").

The policyholders reported a loss to GAIC after the hotel's HVAC roof units were stolen, resulting in damage to other hotel property and a loss of business income. GAIC investigated the claim, and during the investigation issued five reservation-of-rights letters discussing various policy exclusions, including an employee theft exclusion, that GAIC contended applied to bar coverage for the claim.

The same day GAIC sent its fifth reservation-of-rights letter, it filed suit seeking a declaration of no coverage under the policy. The policyholders asserted counterclaims alleging breach of contract and breach of GAIC's duty of good faith and fair dealing. GAIC moved to dismiss the counterclaims and for judgment on the pleadings.

Arguments and Holdings

The court determined as a threshold matter that the policyholders made out a prima facie claim for breach of contract, even though GAIC had not formally denied coverage for the claim, because the policyholders alleged that GAIC had not paid the claims for property damage, missing property and loss of business income. By the same token, however, because GAIC had not yet denied coverage, the court could not sustain the policyholders' claim for anticipatory breach.

Nevertheless, the court sustained the policyholders' bad-faith claim. The court found that good faith is implied in insurance contracts, as in other contracts, notwithstanding the "oft-cited" Supreme Court of Virginia opinion in *Ward's Equip., Inc. v. New Holland N. Am., Inc.*, 493 S.E.2d 516 (Va. 1997), in which the court held that "when parties to a contract create valid and binding rights, an implied covenant of good faith and fair dealing is inapplicable to those rights." GAIC relied heavily on this aspect of *Ward's* to support its argument that Virginia expressly disallows bad-faith claims in the first-party context. But, the *GRM* court explained that subsequent federal opinions make clear that the holding in *Ward's* means only that an implied duty cannot override express contractual terms where the plain language and implied duty seem to conflict.

Moreover, the court found that the Fourth Circuit and the Eastern District of Virginia recognize an "implied duty of good faith and fair dealing governing first-party relationships in Virginia." While noting that Virginia bad-faith law is "not exceptionally clear," the *GRM* court also explained that no Virginia state court has expressly rejected the implied good-faith duty in the first-party insurance context. Because federal courts have recognized the possibility of bad-faith claims in the first-party context, and because no Virginia court has repudiated that possibility, the *GRM* court upheld the policyholder's bad-faith claim.

Implications

The *GRM* opinion clarifies an important and previously uncertain area of Virginia insurance law, confirming that a policyholder may indeed assert bad-faith claims against insurers who wrongfully deny coverage for first-party claims, at least in federal courts. While Virginia state courts have recognized the possibility for bad-faith damages in the third-party context, they have not ruled on (and therefore have not eliminated) bad-faith claims in the first-party context.

Bad-faith claims serve a vital role in the fair and timely adjustment and payment of first-party claims, just as they work as a check on insurer misconduct when insurers wrongfully refuse to defend and indemnify third-party claims. Without an avenue for extra-contractual recovery, property insurers have no incentive to pay a claim, since the most they could be liable for if sued for breach of contract would be the amount they should have paid in the first place. Therefore, just as it does in the third-party context, a viable claim of first-party bad faith will serve to prevent insurers from gambling with the outcome of a claim by increasing the stakes should the denial be deemed unjustified, thereby forcing insurers to think twice before shirking their contractual obligations.

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