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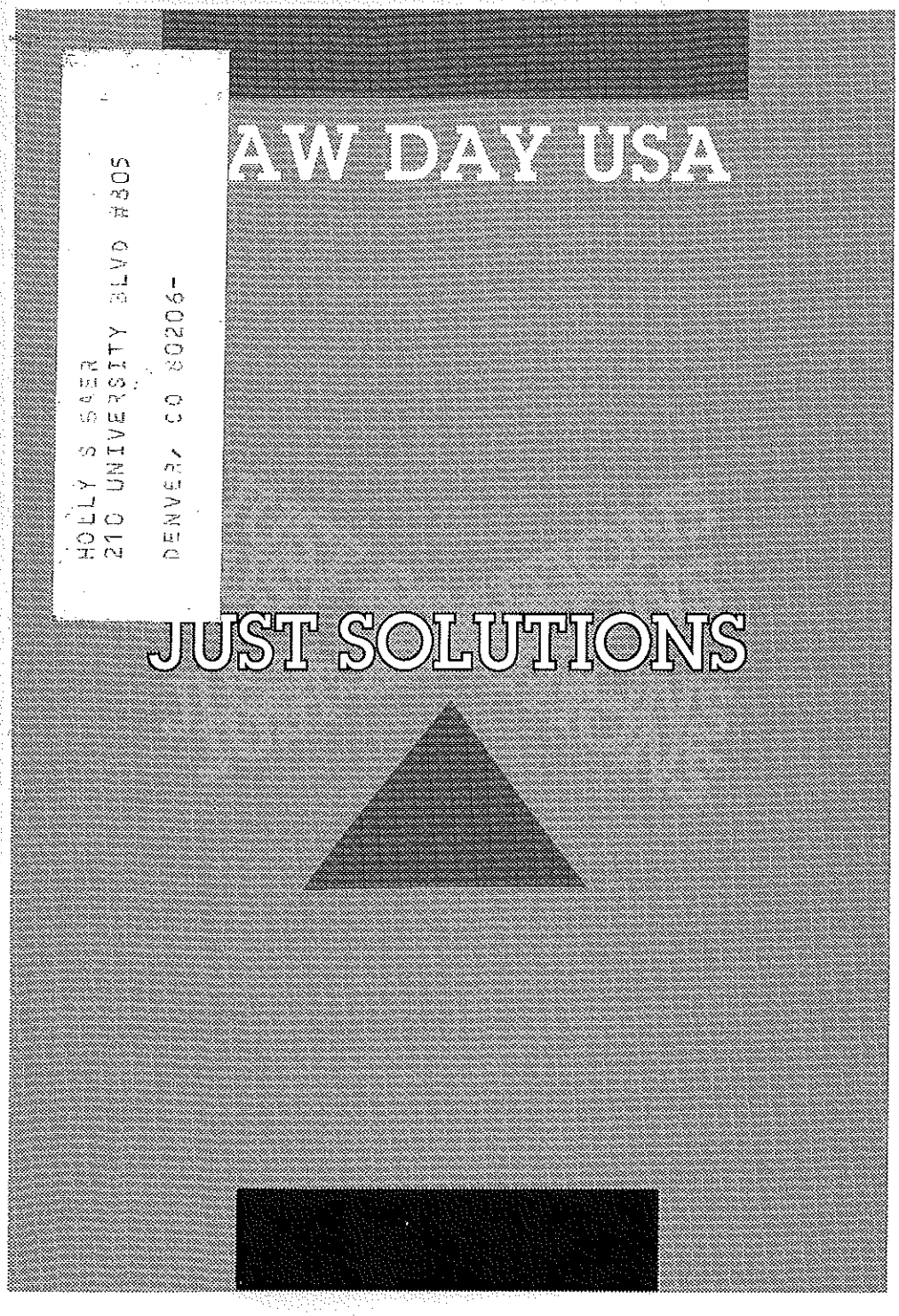

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The Insurer's Unreasonable Failure to Defend: Enough to Prove Bad Faith?

by Ronald M. Sandgrund

In the 1992 case of *Wheeler v. Reese*,[1] the Colorado Court of Appeals, purportedly following the Colorado Supreme Court's 1991 decision in *Farmers Group, Inc. v. Williams*,[2] held that the alleged bad faith of an insurer in refusing to defend its insured against an action for rescission was to be measured against the standard of "reasonableness under the circumstances." This article discusses (1) whether the court in *Wheeler* adopted the proper standard and (2) whether, instead, the "first-party" standard adopted by the Colorado Supreme Court in 1985 in *Traveler's Insurance Company v. Savio*[3]—that the insurer must not knowingly or recklessly disregard a valid claim—is the proper standard for proving bad faith where an insurer fails to defend.

Standard of Conduct—Third-Party Claims

The 1984 case of *Farmers Group, Inc. v. Trimble*[4] involved a claim by an insured against his liability insurer arising from the insurer's investigation into and defense of a third-party tort claim. In recognizing liability in tort for the breach of an insurer's implied duty of good faith and fair dealing, the Colorado Supreme Court in *Trimble* relied on the special nature of the insurance contract and the relationship which exists between the insurer and the insured.

Contrary to an ordinary commercial contract, by obtaining insurance an insured seeks to obtain some measure of financial security and protection against calamity, rather than to secure commercial advantage. By refusing to pay valid claims without justification, the insurer defeats the expectations of the insured and the purpose of the insurance contract. For this reason, the court in *Trimble* held that it is necessary to impose a legal duty on the insurer to deal with its insured in good faith. The court noted that particularly when handling claims of third parties that are brought against the insured, an insurance company stands in a position similar to that of the fiduciary.[5]

By virtue of the insurer's liability insurance policy, which authorizes the insurer to investigate and settle any claims arising under the policy and provides the insurer with the right and duty to defend any action brought against the insured for claims covered by the policies, the *Trimble* court said that the insurer "retains the absolute right to control the defense of actions brought against the insured, and the insured is therefore precluded from interfering with the investigation and negotiation for settlement." The insured who purchases a liability policy thus barters to the insurer the exclusive right to settle or compromise the claim and to conduct the defense and agrees that he or she will not interfere except at his or her own cost and expense.

Trimble held that the standard of conduct of an insurer toward its insured in a third-party context must be characterized by general principles of negligence and that the question of whether an insurer has breached its duties of good faith and fair dealing with its insured is one of reasonableness under the circumstances. The court noted that while the conduct forming the basis of the claim will necessarily be an "intentional act" by virtue of the necessity of a conscious decision on the part of the insurer to refuse to pay a claim, the standard applicable to establish the tort of bad faith remains one of reasonableness under the circumstances.

Standard of Conduct—First-Party Claims

In *Savio*, the Colorado Supreme Court addressed the question of what standard of conduct applies where an insurer is presented with a direct claim by its insured for benefits under the policy, in this case a workers' compensation policy. *Savio* held that in this first-party context, an insured must not only prove that the insurer acted unreasonably under the circumstances, but that the insured must further establish the insurer's knowledge or reckless disregard of a valid claim.

The court noted that the basic rationale for imposing tort liability for bad faith conduct by an insurer in the third-party context—financial inequity—applied equally to the first-party context. Once a calamity has befallen an employee covered by workers' compensation or an insured covered under a private insurance contract, the injured party is particularly vulnerable because of the injury or loss. If a claim for bad faith were not cognizable, insurers, backed by sufficient financial resources, would be encouraged to delay payment of claims with an eye toward settling for a lesser amount than

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that due under the policy. However, in imposing an additional element of proof in a first-party bad faith claim, the *Savio* court offered two rationales.

First, in a first-party direct coverage case, the insured has not ceded any right to represent his or her interest to the insurer. Rather, the insured can directly influence the insurer's claim evaluation process and may file a civil action to compel performance by the insurer or to seek damages for failure of the insurer to perform.

Second, the insurer must be accorded wide latitude in its ability to investigate claims and to resist false or unfounded claims to obtain funds not available under the contract of insurance. Thus, this element of "adversity" between the insured and insurer in the context of a first-party claim is significantly different from the relationship which characterizes a third-party claim.[6]

Duty to Defend as a First-Party Benefit

In *Trimble*, the insurance company conducted a pre-suit investigation into the facts but did not inform its insured of the results of the investigation. The insurance company also rejected a pre-suit settlement offer and did not inform its insured of this settlement offer. Ultimately, the insurer assumed control of the defense and settlement of the case but did so under a reservation of its rights under the policy. As such, the record supports the conclusion that the insured had "ceded" his right to represent his own interests to the insurer.

However, a question arises as to what standard should apply where an insurance company investigates a third-party claim, determines that it is not obligated to defend that claim and never assumes the defense of the claim nor any responsibility for settlement negotiations relating to that claim. Does the rationale for imposing liability under the third-party standard in Colorado apply to such a failure to defend? Under the facts of *Wheeler*, the Colorado Court of Appeals' answer to this question was "yes."

The *Wheeler* Decision

In *Wheeler*, the Colorado Court of Appeals held that a title insurer's alleged bad faith refusal to defend a third-party action for rescission was to be measured against the standard of reasonableness under the circumstances, expressly relying on *Williams*.[7] In *Wheeler*, the insurer, Transamerica, flatly refused to defend the underlying claim of rescission against its insured. The insured filed a third-party complaint against the insurer for breach of its duty to defend and for bad faith.

> "The insurer must be accorded wide latitude in its ability to investigate claims and to resist false or unfounded claims."

The trial court found for the insurer on the insured's third-party claims for breach of its duty to defend and bad faith. The Colorado Court of Appeals reversed, holding that the insurer had an obligation to defend the insured against the underlying rescission claim, relying on the broad "duty to defend" adopted in *Hecla Mining Co. v. New Hampshire Insurance Company*.[8]

Turning to the question of whether the trial court erred in applying the standard it used in finding that the insurer did not act in bad faith in refusing to defend the insured, the Court of Appeals held that the trial court applied the incorrect standard but affirmed the result it reached. The court acknowledged that two standards exist for measuring the conduct of an insurer in relation to its insured, depending on the context of the claim. In the context of a third-party claim against the insured, the court stated that the standard for bad faith must be characterized by general rules of negligence, relying on *Trimble*. (This holding could be regarded as *dicta* because the same result would have been reached by the Court of Appeals applying either the first- or third-party standard, since the court held that the insurer's decision not to defend did not lack a reasonable basis.)

The *Wheeler* panel reasoned that if the allegations of bad faith arise in a situation in which the insured "claims benefits that he is entitled to under the terms of the insurance contract for himself"—a so-called first-party claim—the insured must establish not only that the insurer acted unreasonably, but also that the insurer knew or recklessly disregarded the fact that it was acting unreasonably, citing *Savio*. The court held that because "Transamerica's alleged bad faith refusal to defend occurred in the context of third-party Wheeler's action for rescission against Barker, the correct standard is reasonableness under the circumstances." The Colorado Supreme Court denied *certiorari* in August 1992 with regard to the question of what "bad faith" standard should properly apply to an insurer's refusal to defend.

The decision in *Wheeler* noted that the standard of conduct applicable to first-party claims applies where an insured claims benefits that he or she is entitled to under the terms of the insurance contract. However, the court ignored the fact that in the case before it the insured *was seeking* benefits to which he was entitled under the terms of the insurance contract—the provision of a legal defense against the claims of a third-party at the expense of his insurer. Instead, the *Wheeler* court appears to have accorded greater weight to the "label" it attached to the context in which the claim arose (a third-party claim for rescission asserted against the insured) than on whether the allegedly wrongful act arose from the insured ceding certain of his rights to the insurer.[9]

In *Trimble*, it was the ceding of the insured's interests to the insurer and the insurer exercising its absolute right of control over the defense of the action against its insured that gave rise to liability. In *Wheeler*, no such right of control was ever ceded to nor exercised by the insurer, as the insured at all times controlled the defense and settlement of the claims asserted against him.

Selecting the Proper Standard

Critical in determining whether a first- or third-party standard applies are: the "ceding" of the insured's control over his or her fate (that is, the control of his or her legal defense); control over the evaluation and acceptance of a settlement offer; and control over the investigation of the facts so as to make an intelligent and informed decision regarding the handling of the third party's claim. Where this ceding of interest does not occur—for example, in a first-party fire loss claim—the imposition of a higher standard of care as espoused in *Trimble* is less justifiable.[10] With regard to a first-party claim, it is reasonable to grant greater leeway to the insurer to investigate the claim, to demand information from the insured and to treat the insured in some respects as an adverse party so as to discover the true facts of the claim.

Rather than analyzing a claim on the basis of whether it is a first- or third-party claim and then, based on this characterization, mechanically imposing a standard of conduct, one should analyze the wrongful claims handling decisions at issue and determine, on a claim-by-claim basis, whether the rationale for imposing the *Savio* standard or the rationale for imposing the *Trimble* standard applies to each decision. Using this analysis, some traditional third-party claims may be subject to the first-party standard and vice versa. In addition, the applicable standard of conduct may change where, for example, the insurer initially denies a defense then later assumes the defense under a reservation of rights.

Such a shifting standard of care is consistent with the *Savio* rationale. The *Savio* court refused to hamstring an insurer's right to investigate vigorously and, if appropriate, reject a noncompensable first-party claim. However, the Colorado Supreme Court has not yet addressed the question of whether there is a good and sufficient reason why similar leeway should not be granted a liability insurer when evaluating its duty to defend a third-party claim.

When a liability claim is presented, an insurer must review the facts, often available only from the insured, in an effort to evaluate coverage under its policy (and its duty to settle such a claim if there is coverage). Arguably, under these circumstances, a third-party insured could be as equally motivated as a first-party insured to mislead its insurer or distort the facts,[11] especially where the third-party insured is seeking the benefit of substantial defense costs from its insurer and faces the substantial risk of a judgment for which it seeks indemnity under its policy. Just as the *Savio* court noted that a first-party insured can directly influence the insurer's claim evaluation process and may file a civil action to compel performance by the insurer or seek damages for the failure of the insurer to perform its duties in the workers' compensation context, a third-party insured may similarly do so in the liability insurance context.

Recent Colorado decisions, such as *Wheeler*, suggest that a consistent analysis of which standard should be applied is needed.[12]

Other Jurisdictions

While a few courts have grappled with the question of what bad faith standard applies to an insurer who fails to defend, none of these decisions provides much guidance to the resolution of this question under Colorado law.[13] Two cases have wrestled with the interesting question of what standard applies to an insurer that fails to settle while defending under a reservation of rights. Both decisions offer some guidance to Colorado courts.

In *North Iowa State Bank v. Allied Mutual Insurance Company*,[14] a bank was sued by several borrowers for an alleged wrongful attachment and sale of their swine herd. The borrowers sued on six theories. The bank's insurer, Allied, agreed to provide an attorney to assist in defending only one of the six claims, and the bank sued the insurer for bad faith. The trial court held that the insurer's decision not to defend the bank and assume coverage, although mistaken in part, was a fairly debatable issue and did not support a finding that the insurer acted in bad faith or was stubbornly litigious.

On appeal, the bank urged that the trial court erred in determining that the insurer could not be guilty of bad faith by applying a fairly debatable standard—the standard required of a casualty insurer when handling a first-party claim of its insured in Iowa. The bank contended that the trial court should have applied the same standard of conduct required of a liability insurer in representing its insured against a third-party claim. Like Colorado, Iowa applies different standards for tort recovery in bad faith actions against an insurer, depending on the nature of the claim.

The Iowa Supreme Court in *Allied Mutual* said that in a first-party claim, the insurer occupies the same arm's-length position in relation to an insured that it occupies when the insurer challenges an insured's coverage of casualty losses. The court held that the trial court correctly applied the fairly debatable standard in what it said was properly characterized as a first-party dispute concerning the insurer's duty to defend.

In the Arizona case of *Clearwater v. State Farm Mutual Insurance Company*,[15] suit was brought against insurer State Farm's insured for wrongful death arising from a traffic accident. The insurer defended the claim. During the course of the litigation, the insurer refused three offers of settlement within the policy limits. The insured was not notified of these offers because of State Farm's internal policy not to inform insureds of settlement offers greater than the policy limit. An excess verdict was returned. The in-

surer paid the policy limit, and its insured assigned her bad faith claims to the decedent's parents in return for a covenant not to execute the judgment against the insured personally.

The Arizona Supreme Court in *Clearwater* noted that:

> Bad faith actions against insurers are generally classified as either first- or third-party claims. These classifications are based on the type of insurance coverage provided by the policy in question. The first-party coverage arises when the insurer contracts to pay benefits directly to the insured. Examples of first-party coverage include health and accident, life, disability, homeowner's, fire, title, and property damage insurance. In contrast, a third-party coverage arises when the insurer contracts to indemnify the insured against liability to third-parties. [*Citations omitted.*] The type of claim is not determined by the identity of the party bringing the bad faith action against the insured. For example, a third-party action might be brought by the *insured* in the event that he is subjected to excess liability by reason of the insurer's bad faith refusal to settle. In that event, the standards applicable to third-party claims would govern the action, although it was brought by the insured, rather than a third-party assignee.[16]

The insurer in *Clearwater* requested a fairly debatable instruction based on case law involving first-party coverage, in which insureds brought actions against their own insurers alleging bad faith refusal to pay valid claims. The court noted that both first- and third-party bad faith claims derive from the same duty—the duty of good faith and fair dealing. However, the court noted, in a third-party claim the "insurer takes on the additional responsibility of defending the claim, and typically has exclusive authority to accept or reject offers of settlement." Citing to the New Hampshire case of *Lawton v. Great Southwest Fire Insurance Company*,[17] the *Clearwater* court noted the dilemma presented by the absolute control of trial and settlement vested in the insurer by the insurance contract in the third-party context. (One conclusion might be that this dilemma is absent from a third-party claim where the insured has not yet assumed absolute control of trial and settlement by accepting the defense of the action and acknowledging coverage.)

The *Clearwater* court held that although the fairly debatable standard sufficiently protects both parties' interest in first-party actions, it inadequately protects the insured's interest in third-party actions. Consequently, the court upheld the trial court's instruction that the insurer could be liable for bad faith if it fails to give equal consideration to the interests of its insured as it gives to its own interests and that rejection of a first-party fairly debatable instruction was proper.[18]

Conclusion

Application of the *Savio* or *Trimble* standard should not automatically be based on whether the insurance claim at issue arises under first-party or third-party coverage. Instead, the applicable standard must devolve from a thorough and reasoned evaluation of the relationship of the insured and insurer, the context in which their dispute arose and the respective obligations, rights and duties of the insured and insurer under the circumstances.

It is essential to then analyze, on a claim-by-claim basis, whether the insured has ceded some right to its insurer such that the insured may reasonably rely on the insurer's judgment in the handling of this aspect of the insured's affairs. Where the insured's rights have been ceded to the insurer, a more exacting standard of conduct should properly be imposed on the insurer than where such rights have not been relinquished.

NOTES

1. 835 P.2d 572 (Colo.App. 1992).
2. 805 P.2d 419 (Colo. 1991).
3. 706 P.2d 1258 (Colo. 1985).
4. 691 P.2d 1138 (Colo. 1984).
5. Recently, the Colorado Court of Appeals held that the relationship between insured and insurer is not a true fiduciary relationship and that a cause of action for breach of fiduciary duty will not lie. *Bailey v. Allstate Ins. Co.*, 844 P.2d 1336, 1339-40 (Colo. App. 1992).
6. *Compare Bucholtz v. Safeco Ins. Co. of America*, 773 P.2d 590, 593 (Colo.App. 1989) (delays and disagreements between insured and insurer during arbitration of underinsured motorist claim measured against first-party bad faith standard; evidence held insufficient to constitute bad faith).
7. *See* note 1, *supra*.
8. 811 P.2d 1083 (Colo. 1991).
9. The Colorado Supreme Court has tried to avoid results that defeat the insured's "legitimate expectation of a defense." *Cf. Hartford Ins. Co. v. District Court*, 625 P.2d 1013, 1017 (Colo. 1981).
10. A reasonable argument can be made that the specter of financial ruin resulting from an insurer's wrongful refusal to settle a third-party claim can be greatly lessened due to the possibility that the insured can convince the third-party claimant to take an indirect "assignment" of the insured's rights under his or her liability insurance policy (including any bad faith claims) in exchange for a deferred release of the insured's personal liability. *See Bashor v. Northland Ins. Co.*, 494 P.2d 1292 (Colo. 1972), where such a procedure was approved by the Colorado Supreme Court. A first-party insured, however, can strike a deal with no one but its own insurer in trying to seek remuneration for a loss, and if the insurance company refuses to honor its commitment under its insurance contract in the case of a significant loss, it is possible the insured will be subject to financial ruin. Thus, the risk of financial disaster to the insured, alone, does not provide a compelling distinction for the imposition of different standards of conduct on a property insurer *versus* a liability insurer.
11. While often the only "facts" relevant to the duty to defend will be the allegations of the complaint, facts extrinsic to the complaint are frequently implicated in evaluating coverage and the duty to defend. For example, the resolution of questions concerning whether the person demanding a defense is an "insured," timeliness of notice, fraud in the inducement, loss in progress and scienter may turn on matters not at issue in or relevant to proof of the claims alleged in the complaint. *Hecla*, *supra*, note 8, did not address any of these issues, and recent leading cases from other jurisdictions make it clear that the Colorado Supreme Court still needs to provide insurers and insureds guidance in this regard. *Compare Montrose Chem. Corp. of California v. The Superior Court of Los Angeles County*, 861 P.2d 1153 (Cal. 1993) (facts extrinsic to complaint may be considered in evaluating duty to defend).
12. *Compare Ballow, D.P.M. v. PHICO*, 23 Colo.Law. 250 (Jan. 1994) (S.Ct. No. 92SC530, *annc'd* 11/15/93) (applying first-party bad faith standard to insurer's refusal to renew third-party liability policies); *with Surdyka v. Dewitt*, 784 P.2d 819, 822 (Colo.App. 1989) (applying third-party standard to insurer's failure to defend and denial of coverage on tender of claim).
13. *See Marcus v. Saint Paul Fire and Marine Insurance Co.*, 543 F.Supp. 253 (N.D.Ala. 1982) (central inquiry was whether malpractice insurer who refused to acknowledge coverage and denied a defense had, as a matter of law, a lawful basis for such refusal, *i.e.*, a legitimate or arguable reason for denying the insured benefits under the policy, applying Alabama law); *Black v. Firemans Fund Amer. Ins. Co.*, 767 P.2d 824 (Id.App. 1989) (court applied what in Colorado would be charac-

terized as the first-party standard to a third-party claim premised on the insurance company's failure to defend); *Mowry v. Badger State Mut. Cas. Co.*, 385 N.W.2d 171 (Wis. 1986) (holding that an insurer's failure to settle involves more than a mere finding of negligence; it is not bad faith for an insurer to refuse to settle an injured's claim within the policy limits when the question of policy coverage is fairly debatable and when the grounds for the refusal, if determined in the insurer's favor, would wholly defeat the indemnity responsibility of the insurer to its insured).

14. 471 N.W.2d 824 (Iowa 1991).

15. 792 P.2d 719 (Ariz. 1990).

16. *Id.* at 721.

17. 392 A.2d 576, 580-81 (N.H. 1978).

18. *Savio, supra*, note 3 at 1275, quoting with approval the fairly debatable standard articulated in the seminal Wisconsin case of *Anderson v. Continental Ins. Co.*, 271 N.W.2d 368, 377 (Wis. 1978). The Colorado Court of Appeals has since distanced itself from this standard in *Brewer v. American and Foreign Ins. Co.*, 837 P.2d 236, 238 (Colo.App. 1992).

National Symposium On Elder Law: May 18-22 in Seattle

The National Academy of Elder Law Attorneys, Inc. ("NAELA") will hold its Sixth Annual Symposium on Elder Law on May 18-22 in Seattle, Washington. The symposium features sessions on the following topics: "A Look at National Health Care Policy"; "Where AARP Stands and Where They Hope to Go Regarding Health Care"; "Retirement Benefits and Trust Planning"; "Obtaining Medicare Coverage for Home Health Care/Nursing Home Care"; and "The Constitutionality of State Prohibition of Assisted Suicide." In addition, May 18 is designated as an "Introduction to Elder Law."

For additional information, call the NAELA at (602) 881-4005.