Colorado Bar Association

CLE in Colorado, Inc.

Construction Insurance Program

"Defending the Lawsuit to Maximize the Potential Recoveries that are Insured"

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L. Tyrone Holt, Esquire[1]

HOLT & STALDER LLC
1675 Broadway, Suite 1900
Denver, Colorado 80202
303.225.8500 (Main) – 303.225.4585 (Facsimile)
877.561.8319 (Toll Free)
www.holtstalder.com

[1] Matthew Osofsky, Esquire, co-authored this paper.

I. Due Diligence for the Lawyer Defending Construction Claims that Are or May Be Subject to Insurance Coverage

A. **Study** the Claims that Are Asserted?

1. Determine if Carrier(s) Are Already "On Notice" or Must Be Placed "On Notice".

2. Identify "insured", "potentially insured" and "likely" uninsured claims

3. Discuss Initial Findings with Your Client

4. Determine whether claims are to be asserted by you for indemnity or contribution against "others". See **Exhibit A** hereto for "typical" design professional indemnity agreement.

    a. Express indemnity
    b. Common law indemnity

B. What Insurance Is Available?

1. Identify All of Your Client's Applicable Policies – If not on "notice", put the carriers on "notice", i.e., advise them in writing and supply claim document.

2. Look at the applicable Contracts and Determine Your Client's Obligations to Carry Insurance. See **Exhibit B** hereto for a typical prime design professional's insurance contract provision. This may be useful for you in determining both what you should look for and what your client was contractually obligated to obtain.

3. Look for Other Parties Who May be Liable or Subject to An Indemnity Agreement.

C. Determine if other Counsel Should be Involved on Behalf of the Insured.

1. Uninsured Claims

2. Excess Liability Claims

D. Are there any "Reservations of Rights" or Declination of Coverage by any carriers.

E. What Is Your Role? Are you the only lawyer who will be representing your insured?

F. Make Sure that you know the "lay of the land" going into the defense situation and whether you have any particular areas of concern or sensitivity.

G. Spread the Risk Where Possible.

1. Should you join other parties or at least, put them "on Notice" of a potential claim.

2. When possible, use a continuous trigger theory of damages to spread liability among insurers.

a) In circumstances where property damage is continuous or repeated of a long period of time, multiple CGL policies may be triggered. *See Public Serv. Co. of Colo. v. Wallis & Cos.*, 986 P.2d 924, 935-36 (Colo. 1999).

b) When property damage occurs progressively over a period of time, multiple "occurrence" based policies may be triggered, so long as actual damage occurred within each given policy period. *American Employer's Ins. Co. v. Pinkard Const.*, 806 P.2d 954, 955-56 (Colo. Ct. App. 1990).

c) Environmental damages necessitating remediation were sustained over a period of several years. Damages were allocated among multiple insurers on a *pro rata* time on risk basis. *Public Serv. Co. of Colo. v. Wallis & Cos.*, 986 P.2d 924, 935-36 (Colo. 1999).

d) However, an occurrence-based policy is not triggered unless there is evidence of actual damage within the policy period. *Signature Dev. Cos., Inc. v. Royal Ins. Co. of Am.*, 230 F.3d 1215 (10th Cir. 2000) (applying Colorado law).

II. Insured and Uninsured Claims/Theories.

A. Commercial/Comprehensive General Liability Contracts. "The Donut" or coverage with a big hole in the middle.

1. CGL policies insure against "property damage" or bodily injury, and are generally triggered by an "occurrence" within the policy period.

2. An "occurrence" is generally defined as an "accident", including continuous or repeated exposure to substantially the same general harmful conditions.

a) CGL insurance is not a performance bond. Poor or faulty workmanship is generally not considered to be an "accident" (i.e. not covered).

i) The "poor workmanship" rule was anticipated by the federal courts before Colorado courts directly addressed the issue.

American Mfrs. Mut. Ins. Co. v. Seco/Warwick Corp., 266 F.Supp.2d 1259 (D.Colo. 2003); *DCB Constr. Co., Inc. v. Travelers Indem. Co. of Illinois*, 225 F.Supp.2d 1230 (D.Colo. 2002); *Bangert Bros. Constr. Co. v. Americas Ins. Co.*, 66 F.3d 338, 1995 WL 539479 (10th Cir. 1995)(unpublished), holding published on remand, 888 F.Supp. 1069 (D.Colo. 1995).

ii) Courts generally reason that the parties to a contract are the only ones in a position to evaluate and guard against damages incurred from the failure to perform contractual obligations by establishing a performance bond tailored to the contract. In this sense, contractual liabilities are *anticipated* risks. Risk sharing through insurance pertains to *unanticipated* risks, i.e. accidents. Public policy does not favor forcing insurers to cover contractual obligations that they are not in a position to evaluate. To do so would dramatically increase the costs of insurance. *See DCB Constr. Co.*, 225 F.Supp.2d at 1231.

iii) Colorado courts recently adopted the "poor workmanship" limitation on coverage for substantially the same reasons. *Union Ins. Co. v. Hottenstein*, 83 P.3d 1196 (Colo. 2003); *see also McGowan v. State farm Fire & Cas. Co.*, 2004 WL 856511 (Colo.App. 2004)(unpublished), *pet. for cert. pend.*

b) The parameters of the "poor workmanship" limitation are still somewhat vague. Frequently, "consequential damages" of a covered event may be covered under a CGL policy. However, the argument is frequently made that There is not enough case law at present to distinguish between accidents and unintentional poor or faulty work. The impact on construction defect cases is potentially huge, since most construction defects are, in some sense, caused by poor or faulty work.

i) Consequential damages of <u>poor workmanship</u> may not be covered. *Seco/Warwick*, 266 F.Supp.2d at 1266 ("An occurrence does not include the normal consequences of poor workmanship"), *citing Bangert Bros.*, 1995 WL 539479 at *2. For instance:

(1) Leaks and water intrusion damage may be the normal consequences of poor work, and therefore, the consequential damage as well as the replacement cost would not be covered.
(2) Negligent soil compaction may be the result of poor or faulty work, and therefore, the resulting damage from soil movement would not be covered.

ii) Accidents may be limited to narrow circumstances such as collisions caused by heavy equipment, digging through utility lines or damage caused by falling equipment.

c) The definition of "property damage" can also be a limitation on coverage. Policies often define "property damage", in part, as physical injury to tangible property. Diminished value is not a physical injury. *Hartford Accident & Indem. Co. v. Pacific Mut. Life Ins. Co.*, 861 F.2d 250 (10th Cir. 1998) (the addition of the word "physical" was inserted into the definition of property damage to exclude coverage for intangible injuries such as diminution in value). Diminished value is purely an economic loss, and economic losses are not covered "property damage" under a CGL policy. *Lamar Truck Plaza, Inc. v. Sentry Ins.*, 757 P.2d 1143 (Colo.App. 1988).

d) CGL coverage is also limited by typical exclusions, such as:

i) Expected or Intended Injury - "Bodily injury" or "property damage" expected or intended from the standpoint of the insured. This exclusion is very limited in Colorado and requires that the insured intended the damage or knew that damage would "flow directly and immediately from its intentional act." *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1088 (Colo.1991).

ii) Contractual Liability - "Bodily injury" or "property damage" for which the insured is obligated to pay damages by reason of the assumption of liability in a contract or agreement. Pure economic losses, such as diminution in value, are damages that lie in contract. *Town of Alma v. Azco Constr. Co., Inc.*, 10 P.3d 1256, 1261 (Colo. 2000)(economic loss rule).

iii) The application and viability of the economic loss rule in Colorado was just reemphasized by the Colorado Supreme Court in *BRW, Inc., v. Dufficy & Sons, Inc*., ___ P.3d ____, 2004 WL 2216522 (Colo. 2004). However, do not overlook the Supreme Court's comments regarding the so-called *Spearin Doctrine* and its potential implications for liability under express indemnity provision. In particular, please note the following statement by the Supreme Court:

"Moreover, as the Project's owner, the City impliedly warranted the adequacy of the plans and specifications. United States v. Spearin, 248 U.S. 132, 136, 54 Ct.Cl. 187,

39 S.Ct. 59, 63 L.Ed. 166 (1918) (explaining that the owner, not the contractor is responsible for the "consequences of defects in the plans and specifications".) This construction law remedy permits Dufficy to sue the City for economic loss due to faulty plans and specifications. Under Dufficy's contract with Anko, it was required to resolve all disputes regarding the contract, including the plans and specifications, pursuant to the City's administrative claims procedure. Thus, Dufficy bargained for this remedy, and the contracts' terms control. Terrones v. Tapia, 967 P.2d 216, 220 (Colo.App.1998) (barring owner's negligence claim against contractor under the economic loss rule even though parties did not have a direct two-party contract because source of contractor's duty was in contract); Scott Co. of Cal. v. MK-Ferguson Co., 832 P.2d 1000, 1005-06 (Colo.App.1991) (barring subcontractor's negligence and negligent misrepresentation claims against project owner under the economic loss rule even though the litigating parties had not contracted directly with each other)."

2004 WL 2216522, at page 6

iv) Damage to "Your Work" or "Your Product". This exclusion significantly overlaps with the "poor workmanship" rule and reinforces the position of an insurer that consequential damage caused by an insured's work or product is not covered.

v) Impaired Property - Loss of use of tangible property, which has not been physically injured or destroyed, resulting from the failure of "your product" to meet the level of performance, quality, fitness or durability warranted or represented by you or on your behalf. This exclusion overlaps with the definition of "property damage" which does not include diminution of value.

3. Summary of insured and uninsured claims:

a) Insured:

(1) Property damage that occurs within a policy period and is caused by an accident;

(2) Bodily injury that occurs within a policy period and is caused by an accident.

b) Uninsured:

(1) Poor or faulty work;
(2) Contractual damages;
(3) Intended injuries;
(4) Intangible damage, i.e. diminished value;

B. Professional Liability Insurance.

Coverage is broader than CGL coverage in the sense that all negligent acts are generally covered. It is also more narrow in the sense that only one policy period can be implicated so one has to be timely.

1. Professional liability insurance contracts are generally "claims made" and "expense within limits" policies.

- "Claims Made" policies are triggered by the timing of the claim, not the timing of the act that resulted in the alleged liability.

- Costs of investigation and "defense" are paid out of the policy and reduce its practical "aggregate per claim limits"

2. Look for a definition of "Claim" in the policy.[2] A typical definition is attached hereto as Exhibit ____.

3. Look for the "Declarations Page" of the applicable policy. Specifically look for:

"Per Claim" Limits
"Aggregate Limits"
"Deductible Amount"
"Reporting" and "Extended Reporting Period", if any.
"Named Insured" and related Definitions

4. Look for the provisions regarding the carrier's right and duty to defend. A typical example is attached hereto as Exhibit ___.

5. Look at the rights, if any, of the insured with respect to settlement – is there a "consent to settlement" right. For example, look at Exhibit ___.

[2] You are required to identify any applicable or potentially applicable "insurance" coverage in your Rule 26, C.R.C.P., Disclosures, so you should be reviewing the policies as a part of your routine due diligence and case development.

6. On large claims, you must be alert to the conflict between extended and comprehensive litigation of claims, which exhausts the limits of the policy.

C. Performance Bonds[3]. [Payment and Performance Bonds Are Not Insurance]

1. A surety has the same duty to act reasonably as an insurer.

2. Performance bonds do not cover general liabilities in the manner of insurance. They cover specific items on specific projects.

3. The scope of indemnity under a performance bond is fact specific and depends on the language of the agreement.

D. Punitive Damages.

1. Punitive damages, as such, can never be covered by insurance as a matter of public policy.

> Public policy prohibits an insurance carrier from providing insurance coverage for punitive damages, because punitive damages are intended to punish the defendant for wrongful acts and to deter similar conduct in the future. *Bohrer v. Church Mut. Ins. Co.*, 12 P.3d 854 (Colo.App. 2000); *Lira*, 913 P.2d at 517.

2. Assertion of punitive damages and claims against individuals must be very carefully considered. They most often backfire and can result in unnecessary exhaustion of resources unless the claimant is sure that recovery, without insurance, is a likely possibility.

From the defense perspective, the implications of potential personal exposure, will often require the participation of "personal" or "monitoring counsel" for the insured. In my experience, vigorous defenses are the most likely result of personal, punitive and excess claims *unless they are very carefully focused and properly managed*.

E. Steps by Insured/Counsel for Insured to Maximize Insurance Coverage.

1. Attempt to Focus the Case on Covered Claims.

   a) Make sure that opposing counsel is aware of coverage issues. Opposing counsel should already be aware that an uncovered claim is not worth much. Disclose and produce insurance contracts as early as possible so that the opposing party can have an opportunity to tailor their case to covered claims.

[3] Payment and Performance surety bonds are outside the scope of this paper.

b) Attempt to eliminate uncovered claims on summary judgment.

c) Do not challenge assertions if doing so would remove coverage and leave the client liable for uncovered claims. For instance:

i) The contract may include a waiver of tort claims after an inspection, final payment or other event. The client's insurance, however, may not cover contractual liability. Moving for summary judgment as to the tort claims (leaving only contractual claims at issue) may eliminate coverage entirely and cause the insurer to withdraw the defense.

ii) The opposing party may allege that damages occurred in the policy period. A defense to causation or a defense based on the statute of limitations may require an argument that damages occurred outside the policy period. If the facts, which affect coverage, are not directly determinative of liability, counsel should consider whether there is a risk of losing the liability issue while establishing facts, which eliminate coverage.

iii) Vigorously defend against (or bargain to eliminate) allegations of intentional acts. Punitive damages are never covered. Moreover, compensatory damages caused by an "intentional act" (as defined by *Hecla*, 811 P.2d at 1088) may be excluded.

iv) Attempt to eliminate claims for violations of the Colorado Consumer Protection Act.

The CCPA exists to deter bad faith conduct toward consumers. *Showpiece Homes, Corp. v. Assurance Co. of America*, 38 P.3d 47, 50-51 (Colo. 2001). The private enforcement mechanism of the CCPA facilitates the goal of deterrence. *Id.* CCPA damages should not be covered for the same public policy reason that punitive damages in general cannot be covered by insurance.

In my opinion and experience, CCPA claims can be very powerful when there is a factual and legal basis for their assertion. However, you do need to a colorable claim in order to be taken seriously. Note that if there are no resources to fund such a claim, it may not do anything except "burn" more money in the discovery process.

v) Where replacement costs overlap with diminution in value, maintain the assertion that the diminution in value claim is duplicative.

III. Settlement and Post Settlement Issues:

A. Protect the Client against Recovery of Expenditures by the Insurer – Defense Under a Reservation of Rights.

The insurer is required, under the duty to defend, to pay for the defense (at least initially) and to attempt to settle the case within policy limits. This does not mean that all defense or settlement expenditures are covered by the insurance contract.

1. The insurer's duty to pay for the defense of a suit against the insured is different from the duty to indemnify the insured. *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991) ("an insurer's duty to defend arises when the underlying complaint against the insurer alleges any facts that might fall within the coverage of the policy.")

2. Theoretically, the insurer can also settle a claim and then seek to recoup the portion of a settlement payment that was extended for damages, which are outside coverage. *See Safeco Ins. Co. of Am. V. Robertson*, 994 P.2d 488 (Colo.App. 1999).

3. If this appears to be a realistic possibility in your case, advise the client to seek independent counsel to advise them regarding the implications of a settlement in terms of the insurer's right to recover expenditures from the insured.

B. Early Use of Mediation, Settlement and Other Forms of ADR

It has been said that "every case has a settlement value". In order to properly defend the insured and maximize the insurance coverage, the "settlement value" of the case must be considered at every stage of the dispute by the defense counsel.

A realistic appraisal of the potential for a finding of liability on a claim-by-claim basis is essential. Additionally, a realistic and "unclouded" evaluation of the potential damages by claim is also necessary. If you defeat the claims that are covered by insurance but have a likelihood of losing one claim that is uninsured, a "global settlement" of all claims should be considered.

Mediation is a very useful tool through which lawyers and clients can achieve an early and reasonably accurate appraisal of the potential for both liability and damages.

C. Settlement Agreements: Subrogation Rights Against Third Parties

Look ahead to the client's position via the insurer when billing and structuring settlement.

1. To the extent possible, orient the defense around covered claims so that the client benefits from the overlap between preparation for the defense of covered and the preparation for the defense of uncovered claims.

2. Structure settlements in a manner that reasonably allocates payment to covered claims or does not specify the allocation of damages to claims. If the latter method is employed, emphasize covered damages through recitals or correspondence regarding settlement. However, keep in mind that, in the subrogation context, settlement agreements that attempt to circumvent the recovery rights of the insured have been invalidated.

3. Structure the settlement agreement to minimize or eliminate any regulatory or disciplinary proceedings that the insured may be exposed to later.

IV. THE ETHICAL AND PROFESSIONAL OBLIGATIONS OF THE INSURANCE COMPANY APPOINTED DEFENSE ATTORNEY.

A. The typical "Tripartite Relationship".

1. Review Formal Ethics Opinion 91, available at http://www.cobar.org/static/comms/ethics/fo/fo_91.htm. Attached hereto as Exhibit __.

2. Most insurance contracts provide that the "insurer retains an absolute right to control the defense of actions brought against the insured." *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1141 (Colo. 1984).

a) Although the insurance company controls the defense, the insurance company is not the defense attorney's client. *Rose Med. Center v. State Farm Mut. Auto. Ins. Co.*, 903 P.2d 15, 17 (Colo.App. 1994). References to "the client" below will always mean the insured, not the insurer.

b) The attorney-client relationship is with the insured. "Defense counsel owes the same unqualified loyalty as if he had been personally retained by the insured." Formal Ethics Opinion 91, *quoting* Mallen & Smith, *Legal Malpractice* (3d ed. 1989), 23.3 at 365-367. Therefore, defense counsel has a duty to maintain the client's confidential information and has a duty of loyalty to further the client's interests.

c) Defense counsel is not obligated to represent the insured in disputes with the insurer. Nonetheless, counsel must be aware of and consider the client's coverage interest.

B. The Duty of Loyalty

1. Rule 1.7(b), Colorado Rules of Professional Conduct, states "A lawyer shall not represent a client if the representation [] may be materially limited by the lawyers responsibility to [] a third person …"

2. At the beginning of the relationship, make the nature and scope of the relationship clear to the client and carrier, preferably in writing.

3. Restrictions on defense costs.

   a) If the insurer declines to pay for work that counsel believes is reasonable and necessary the attorney must:
   b) Advise the client of the insurer's decision and why the action is reasonable and necessary;
   c) Advise the client that he or she will be billed instead of the insurer, if the client approves the work; and
   d) Advise the client to retain independent counsel in regard to the dispute with the insurer;
   e) Flat fee arrangements are permitted but must not limit the representation or interfere with the requirement that the lawyer maintain his or her independent judgment with regard to the representation. *See* Rules of Professional Conduct 1.7 & 5.4(c).

3. Disclosures to the insurer are not always permitted.

   a) An attorney cannot disclose to the carrier facts that would eliminate the insured's coverage. HOWEVER – The client must be advised that the failure to disclose information to the insurer may affect coverage under a policy's cooperation clause.

   b) If the insured does not consent to disclosure, counsel should advise the client to retain separate counsel to advise and/or represent them on the coverage issues.

   c) Practical reality: In cases involving Comprehensive/Commercial General Liability ("CGL") insurance, "poor workmanship" is not covered (See section "C" below, regarding "Insured and Uninsured Claims/Theories"). Most construction defect cases will include information that arguably implicates "poor workmanship". Therefore, the above describe tension regarding disclosures tends to be a continual problem for the client with CGL insurance. If the insurer is providing a defense pursuant to a reservation of rights, counsel should discuss with the client:

i) likely conflicts that may arise via the insurer and disclosures to the insurer that may affect coverage;

ii) the fact that a failure to disclose information to the insurer may be a breach of a cooperation clause in the insurance contract; and

iii) whether the client has independent counsel to advise them on coverage issues.

d) If the client authorizes disclosure of factual information to the insurer, which could potentially eliminate coverage, counsel should refrain from commenting on any such factual information when providing the information to the insurer.

4. On request of the insured, counsel should provide copies of all correspondence with the insurer.

C. Duty to Maintain the Confidentiality of Client's Information.

1. As discussed above, counsel cannot disclose information to the insurer in a manner that would violate the duty of loyalty. In addition, counsel must maintain the confidential relationship with the client.

a) Counsel cannot disclose information provided by the client within the attorney-client relationship to the insurer without the client's express or implied (see below) consent.

b) Insurance company representatives cannot attend client interviews without the client's informed consent.

c) The attorney cannot disclose to the insurer information regarding a client's attempt to defraud the insurance company. The attorney must withdraw, but also maintain the confidence. *See* Rules of Professional Conduct 1.16(a)(1).

2. Although information that is a matter of record may no longer be confidential, the duty of loyalty may prevent disclosure.

3. REMINDER - The client must be advised that the failure to disclose information to the insurer may affect coverage under a policy's cooperation clause.

4. Implied consent to disclose information to the insurer may be derived from the cooperation clause of the insurance contract as to information, which is not detrimental to coverage. Nonetheless, there may be a duty to advise the client

of the intent to disclose the information and the potential ramifications of the disclosure.

D. Duty to Advise Client Regarding Client's Legal Interests, within the Scope of Your Engagement.

1. Even though the insurer controls the defense, do not simply consult with the insurer on strategy. Counsel is required to keep the client informed of the status of the matter and the ramifications of actions and strategy. **Practice Note:** We send copies of all incoming and outgoing materials to the client. We also provide monthly "status/report" letters to the insured and the carrier.

2. Settlement negotiations.

a) The client may be restricted by the insurance contract from interfering with settlement negotiations. *See Farmers Group, Inc. v. Trimble*, 691 P.2d 1138 (Colo. 1984). Nonetheless, the client must be advised of all settlement offers so the client may:

i) Assert whatever rights (via the insurer) or reputation interests may exist.

ii) Make an independent decision regarding the offer (once again, the client should be advised of the potential ramifications to coverage and advised to retain independent counsel).

b) Certain insurance contracts give the insured the right to refuse or approve settlement. This is particularly found in professional liability policies where licensure and professional reputation issues are likely to exist.

c) Counsel must use his or her independent judgment in regard to recommending settlement.

A recommendation by counsel to settle a case at a certain sum or range may not be well received by the insurance company. If the insurer decides not to settle, the recommendation will likely be used as evidence of bad faith.

In the interest of the insured, however, counsel is "well advised" to document advice to settle. Formal Ethics Opinion 91.

While the temptation exists to phrase recommendations in a manner that protects the insurer, the duty of loyalty requires counsel to focus on protecting the interests of the client.

Defense Counsel should keep in mind that:

i) The aggravation of pending litigation and discovery are burdensome to the client. Settlement may be in the client's best interest even if the insurer will be required to pay a judgment in excess of policy limits.

ii) An insured can bring suit for bad faith and assert emotional distress damages even when the insured pays a judgment in full or eventually settles the case (see section "B" regarding bad faith below).

iii) Counsel's ongoing relationship with the insurer (when counsel is retained on multiple cases) may give the appearance of a conflict with the lawyer's duty of unqualified loyalty to the client, particularly, when counsel is in-house or part of a "captive" firm that works exclusively for the insurer.

iv) The ongoing relationship must be disclosed and the client must waive the conflict, unless counsel reasonably believes that representation will not be affected. *See* Rule of Professional Conduct 1.7(b).

d) Counsel may want to consider advising the client of the ongoing relationship with the insurer at the beginning of the representation to avoid any misunderstanding.

e) Counsel should absolutely avoid any representation, which could mislead the client as to counsel's relationship with the insurer.

f) The client may demand that counsel recommend a policy limit settlement to the insurer. Counsel may advise the client that such a demand is not warranted, but should also advise the client to seek independent counsel on the issue.

3. Advising the client regarding coverage issues.

a) Clients should be advised of their right to retain independent counsel whenever there are significant issues of uninsured exposure, such as damages sought in excess of policy limits or uncovered claims.

(In some cases, coverage issues may be significant enough that defense counsel should recommend to the client that he or she retain independent counsel.

b) The client must be advised that the issue of who pays for independent counsel should be discussed with independent counsel. The insurer is generally not required to pay for independent counsel and the client should be advised of the insurer's position in this regard, if known.

c) Multiple covered and non-covered claims:

i) "The duty to the client is always the primary concern." Formal Ethics Opinion 91.

ii) Counsel cannot conduct the defense in a manner that will take the insured out of coverage. (See preceding discussion on "Insured and Uninsured Claims/Theories").

iii) Counsel cannot seek dismissal of covered claims and leave only uncovered claims at issue. For instance, the insurance contract may exclude contractual liabilities. If the case involves both contract and tort claims, counsel cannot seek dismissal of the tort claims and allow the case to go forward only on the uncovered contract claims.

iv) Counsel cannot resist an amendment to the pleadings, which increase exposure within liability limits but improves the client's chance for coverage.

d) The client must be advised of the strategic options and their coverage implications. YOU SHOULD TAKE REASONABLE PRECAUTIONS TO DETERMINE IF THE INSURED IS FULLY INFORMED OF THE OPTIONS.

4. Counterclaims.

(a) The scope of insurance company retained defense counsel's representation may not include the assertion of counterclaims or cross-claims. The client should be advised of such claims and advised to retain independent counsel to assert such claims.

(b) Even when the scope of representation allows retained defense counsel to pursue such claims, an insurer/insured conflict may arise. For example, the insurer may want to settle the case globally and the insured may want to pursue counter/cross-claims.

(i) Retained defense counsel should advise the client to seek independent counsel.

(ii) The insured's contractual obligation to cooperate in the defense may not require the insured to surrender counter/cross-claims.

Special Note

The duty to advise the client of conflicts via the insurer can arise at any point in the representation, and the client should be so advised at the earliest possible time.

IV. BAD FAITH REFUSAL OF INSURER TO SETTLE THE CLAIM.

A. The tort of bad faith.

All contracts are supplemented at law by an implied covenant of good faith and fair dealing. *Amoco Oil Co. v. Ervin*, 908 P.2d 493, 498 (Colo. 1995). However, an insurer's breach of the duty to act in good faith is a tort rather than simply a breach of contract. *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1141 (Colo. 1984). This distinction allows a litigant who proves bad faith conduct to recover more than the benefit of the contract. *Id.*

Bad faith cases are very dependent upon the facts. Remember, that as defense counsel, you may in part "create the "facts" upon which a subsequent "bad faith" claim is premised.

B. An Insurer's Duties Concerning Settlement.

1. An insurer must act reasonably in its efforts and decisions whether to settle a case on behalf of the insured.

a) "The standard of conduct of an insurer in relation to its insured in a third-party context must be characterized by general principles of negligence." *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1142 (Colo. 1984).

b) A one point the Colorado Supreme Court hinted at a higher scienter requirement stating that the insurer must act unreasonably, and must act with knowledge or reckless disregard of the fact that the conduct was unreasonable to be in bad faith. *Travelers Ins. Co. v. Savio*, 706 P.2d 1258, 1272 (Colo. 1985). However, in at least one author's experience, this latter requirement is frequently downplayed by a trial court. Gregory R. Giometti, *Colorado Law of Insurance Bad Faith* at 30 (CLE in CO, Inc. 1995).

c) These respective standards of care were codified by the Colorado legislature in 1987 in the Colorado Fair Claims Practices Act. C.R.S. § 10-3-1113. However, the Fair Claims Practices Act is

strictly a regulatory act, and does not provide for a private cause of action. *Schnacker v. State Farm Mutual Automobile Ins. Co.*, 843 P.2d 102, 104 (Colo. App. 1992).

d) The Colorado Supreme Court recently clarified that the scienter requirement only applies the first-party claim context (a claim by the insured to pay for injuries to the insured). *Goodson v. American Standard Ins. Co. of Wis.*, 89 P.3d 409, 415 (Colo. 2004). Thus, to establish bad faith regarding the decision to settle a third-party claim on behalf of the insured, "the insured must show that a reasonable insurer under the circumstances would have paid or otherwise settled the third-party claim." *Goodson*, 89 P.3d at 415.

e) "The reasonableness of the insurer's conduct must be determined objectively, based on proof of industry standards", and generally through the testimony of expert witnesses. *Goodson*, 89 P.3d at 415.

2. An insurer may consider its own interests but must show at least "equal consideration" of the benefit to the insured in its decision whether to settle. *See United States Fid. & Guar. Co. v. Lembke*, 328 F.2d 569 (10th Cir. 1964)(applying Colorado law).

The reasoning of the equal consideration rule is as follows. "The insured's interest will almost always favor settlement, even up to policy limits, since the insured has nothing to gain and much to lose by litigating rather than settling. Conversely, if the claimant's settlement demand is close to the policy limits, the insurer will be inclined to go to trial, since doing so will not expose it to liability greater than the cost to settle the case. The 'equal consideration' requirement prohibits the insurer from taking a gamble that only its insured stands to lose. In order to avoid such a result, an insurer that breaches its duty to consider settlement offers in good faith may be held liable for the entire judgment obtained against the insured, regardless of policy limitations." *Magnum Foods, Inc. v. Continental Cas. Co.*, 36 F.3d 1491, 1504 (10th Cir.1994).

3. Limits on the duty to act for the benefit of the insured.

a) The insurer is not required to consider the insured's exposure to punitive damages in settlement negotiations. *Lira v. Shelter Ins. Co.*, 913 P.2d 514, 516 (Colo. 1996) ("An insurer … has no duty to settle the compensatory part of an action in order to minimize the insured's exposure to punitive damages").

b) It is unresolved, though, whether the insurer must consider the insured's exposure to compensatory damages that are outside coverage in its decision whether to settle a case.

i) The logic of *Lira* seems to imply that the insurer is not required to consider exposure to uncovered damages. The court stated that "[i]f the insurer has no contractual duty to indemnify the insured for punitive damages, the insurer has no tort duty to settle in good faith with regard to punitive damages." 913 P.2d at 517.

ii) However, the *Lira* court also noted the particular public policy concerns associated with punitive damages. It stated that "[t]o allow the petitioner in this case to recover compensatory damages which derive from his own wrongful conduct undercuts the public policy of this state against the insurability of punitive damages." *Id.*

iii) The fact that the insurer controls the defense and has a quasi-fiduciary duty to the insured, suggest that the insurer has a duty to consider the insured's exposure to uncovered claim, especially considering the fact that the insurer has an alternative remedy. The insurer can seek to recover the uncovered portion of a settlement payment from the insured in a declaratory judgment action. *See Safeco Ins. Co. of Am. v. Robertson*, 994 P.2d 488 (Colo.App. 1999).

C. Breach of the Duty to Settle in Good Faith.

1. The insurer must act reasonably in considering settlement offers but it may also have a duty to initiate settlement negotiations and this duty may even arise before a suit is filed.

a) Offer made by opponent

i) An insurer must exercise the degree of care and diligence that a reasonably prudent person would employ in like circumstances. *Aetna Casualty & Surety Co. v. Kornbluth*, 471 P.2d 609, 611 (Colo. 1970).

ii) This standard applies to a decision whether to settle a claim, and to decisions to deny or delay payment of a claim. *Trimble*, 691 P.2d at 1141-42.

b) Duty to initiate settlement negotiations in the course of litigation.

i) Colorado courts have not directly considered whether the insurer must initiate settlement negotiations in appropriate circumstances.

However, does the lawyer defending the insured have a duty to advise the insured that an early settlement would be in his/her best interests?

ii) Majority view among other jurisdictions is that an insurer may have a duty to initiate settlement negotiations, particularly in cases where there is a substantial likelihood of liability in excess of policy limits. *See* Cindie Keegan McMahon, J.D., *Duty of Liability Insurer to Initiate Settlement Negotiations*, 51 A.L.R.5th 701 (2004).

iii) Texas is the only state which does not hold out some possibility that an insurer can be in bad faith for failing to solicit settlement offers.

> *American Physicians Ins. Exch. v. Garcia* 876 SW.2d 842 (Tex. 1994) held that the insurer's duty to exercise due care in settling claims against the insured does not require the insurer to make or solicit settlement offers, because such a requirement would force the insurer to bid against itself and would necessarily discourage early settlements.

iv) The equal consideration rule is compatible with Kansas' approach.

> The court in *Coleman v Holecek* 542 F.2d 532, (10th Cir. 1976)(applying Kansas law), ruled that the duty to settle arises whenever the insurer would initiate settlement negotiations on its own behalf were its potential liability equal to the insured's.

v) Duty to initiate settlement negotiations prior to litigation.

There is a split of authorities as to whether the duty to settle in good faith can arise before a suit is filed.

> The court in *Smith v. Blackwell*, 791 P.2d 1343 (Kan. App. 1989) recognized that a liability insurer has a duty to attempt to negotiate a settlement regardless of whether the claimant has actually commenced an action against the insured.

Blackwell is consistent with the statement in *Trimble*, 691 P.2d at 1141-42, that the duty of an insurer to act reasonably and in good faith applies to a decision whether to settle a claim and to the decision to deny or delay payment of a claim.

D. Damages Which Can Be Asserted for a Failure to Settle in Good Faith.

1. In general.

   a) The insured "is entitled to recover damages based upon traditional tort principles of compensation for resultant injuries actually suffered ... rather than upon concepts derived from contract law." *Farmers Group, Inc. v. Trimble*, 658 P.2d 1370, 1375 (Colo.App.1982), *aff'd* 691 P.2d at 1142.

   b) An actual judgment in excess of the policy limits is not a necessary prerequisite to a claim of bad faith breach of an insurance contract. *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138 (Colo. 1984).

2. Policy limits.

   a) Compensatory damages in a bad faith action include damages in excess of the policy limits in the underlying action. *Ballow v. PHICO Ins. Co.*, 878 P.2d 672, 677 (Colo.1994).

   b) It is unclear whether policy limits are considered waived because bad faith is a tort claim, not a breach of contract claim. Thus the policy provisions are not a direct limitation on damages.

3. Emotional distress of Insured

   a) The insurer may become liable to the insured in tort for compensatory damages, such as for an award for emotional distress. *Ballow v. PHICO Ins. Co.*, 878 P.2d 672, 677 (Colo.1994).

   b) The insured can recover damages for emotional distress without proving substantial property or economic loss. *Goodson v. American Standard Ins. Co. of Wisconsin*, 89 P.3d 409 (Colo. 2004)

   c) Fact that insurer finally pays in full does not erase the distress caused by insurer's bad faith conduct. *Goodson*, 89 P.3d at 417-17.

3. Attorneys' fees.

a) Attorneys' fees incurred as in pursuit of benefits are recoverable, but not those fees that are incurred in pursuing the bad faith action itself. *Martin v. Principal Casualty Ins. Co.*, 835 P.2d 505 (Colo. App. 1991), *rev'd on other grounds* 855 P.2d 1377 (1993).

b) Attorneys' fees expended in recovery of bad faith damages are not recoverable absent a contractual provision. *Bernhard v. Farmers Ins. Exch.*, 915 P.2d 1285 (Colo. 1996).

4. Punitive damages

"To recover punitive damages, the insured must show that the insurer's breach was accompanied by circumstances of fraud, malice, or willful and wanton conduct." *Goodson v. American Standard Ins. Co. of Wisconsin*, 89 P.3d 409, 415 (Colo. 2004).

E. Coverage defenses may still apply.

1. As noted above, bad faith damages lie in tort and therefore are not directly dependent on contractual provisions.

a) However, if the insured was not entitled to indemnification for all or some of the damages, then any money expended by the insurer to settle the uncovered claims could be recovered from the insured. *See Safeco Ins. Co. of Am. V. Robertson*, 994 P.2d 488 (Colo.App. 1999).

b) Therefore, the insurer that unreasonably fails to settle a case within policy limits, may still be entitled to assert coverage defenses. *See generally Lira v. Shelter Ins. Co.*, 913 P.2d 514 (Colo. 1996).