No. 11-1474

IN THE

Supreme Court of the United States

FARMERS INSURANCE COMPANY OF WASHINGTON AND FARMERS INSURANCE EXCHANGE,
Petitioners,

v.

EMILY L. MORATTI, a minor, by and through her Guardian Ad Litem GERALD R. TARUTIS,
Respondent.

On Petition for a Writ of Certiorari to the Washington Court of Appeals

AMICUS CURIAE BRIEF IN SUPPORT OF PETITION FOR A WRIT OF CERTIORARI

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INTEREST OF *AMICUS CURIAE* [1]

The Federation of Defense and Corporate Counsel (FDCC), formed as the Federation of Insurance Counsel in 1936, has an international membership of approximately 1,400 lawyers. FDCC members are

[1] No counsel for a party authored this brief in whole or in part. No person or entity other than *amici*, their counsel or their members made any monetary contribution toward preparation or submission of this brief. Letters indicating the parties' consent to the filing of this brief have been submitted to the Clerk. Counsel provided the required notice to the parties more than ten days before the filing deadline for this brief.

experienced attorneys in private practice, as well as general counsel and insurance claims executives from around the world. Membership is limited, available solely by nomination, and includes only those who have been judged by their peers to have achieved professional distinction and demonstrated leadership in their respective fields. The FDCC is committed to promoting knowledge, fellowship and professionalism of its members. Towards that end, the FDCC supports substantive law sections, established in fields of law and practice, material to the interests and professional activities of the membership, including *inter alia* an insurance coverage section consisting of more than 150 members. Through its amicus curiae efforts, the FDCC seeks to assist courts addressing issues of importance to its membership, such as the Constitutional questions presented by Washington's "covenant judgment" system which are at issue in this case.

This case, on a fundamental level, affects the rights and duties of all insurers that write policies in the State of Washington. It directly impacts an insurer's rights under the Due Process clause of the Fourteenth Amendment. The FDCC has a strong interest in preserving the rights of insurers (as well as other businesses), and therefore supports the position of Farmer's Insurance Company of Washington and Farmers Insurance Exchange in respect of the issues discussed below. Due to its geographic reach, the FDCC brings a unique perspective to the issues presented in this case, in additional to a legacy of experience in the fields of insurance coverage and bad faith litigation. In short, the FDCC's interest in this case is substantial; more importantly, its insight will be helpful to the Court.

ISSUE PRESENTED BY *AMICUS*

1. An insurer's right to due process is violated by the Washington Court's decision to give effect to presumptions that an insurer's bad faith harmed the policyholder and that the amount of damages to be awarded due to an insurer's bad faith is the amount of a covenant judgment, even if the amount exceeds the policy limits and even where the insurer has defended the policyholder.

SUMMARY OF ARGUMENT

Courts from all jurisdictions, including Washington, have expressed serious concern about the potential for abuse and collusion when a stipulated judgment (or "covenant judgment"), under which the insured has no personal liability, would bind the insurer. To prevent such abuse and preserve the integrity of the system, courts have imposed limitations on the circumstances under which an insurer can be bound by the terms of a settlement or judgment that is reached without its consent and is not based on an actual adjudication on the merits of the claim.

The primary and most effective way courts protect insurers is to require the insurer to pay covenant judgments only when the insurer has repudiated the contract and abandoned the insured by wrongfully denying coverage and refusing its duty to defend. Left to fend for himself, the insured is free to negotiate the best possible settlement consistent with its interests, including a covenant judgment that exceeds the policy limits.

This scheme honors the terms of the insurance contract, which give the insurer the right to defend and settle claims against the insured at its discretion,

and which obligate the policyholder to cooperate with the insurer in defending the suit and to refrain from assuming any obligation or incurring any expense without the insurer's consent.

Washington does not adopt this approach. Instead, under Washington law, even when an insurer is defending its insured, the insured may enter into a covenant judgment with a tort plaintiff to settle his claim with an agreement that the tort plaintiff will not execute on the full amount of the stipulated judgment in exchange for the defendant assigning his bad faith claim against the insurer to the tort plaintiff. Further, Washington law holds that a tort plaintiff suing on a bad faith claim assigned by the policyholder under a covenant judgment may rely on a presumption of harm, rather than prove the insurer caused actual harm to the policyholder. And, Washington law also provides a presumption that the amount of damages for the bad faith claim is the amount of the covenant judgment, even if the amount exceeds the policy limits. Under Washington's harm and damage presumptions, therefore, an insurer can be liable for the full covenant judgment even where there has been no showing of harm to the policyholder by the insurer's actions and even where the insurer was defending the insured against the tort plaintiff's claim.

These Washington presumptions violate the Due Process Clause. This is because the presumption that damages for bad faith are the amount of the covenant judgment is neither necessarily or universally true nor is it the only reasonable means of determining damages. *Vlandis v. Kline*, 412 U.S. 441, 452 (1973). Further, the presumption of harm to the policyholder violates due process because it is

"arbitrary" or "operates to deny a fair opportunity to repel it." *Western & A.R.R. v. Henderson*, 279 U.S. 639, 642 (1929). Even relatively modest, technical infractions where the insurer's conduct bears no causal relationship to any actual harm can lead to insurer liability for large stipulated judgments agreed to between the tort plaintiff and the insured.

Nor is the necessary due process afforded by the "reasonableness hearing" contemplated by RCW 4.22.060. That process determines only whether the stipulated settlement is a reasonable value of the tort plaintiff's damages in his claim against the insured. At no time does the court consider whether the covenant judgment is a fair assessment of harm from the insurer's conduct toward its policyholder.

The fallout from Washington's system extends far. Imposing awards outside the scope of insurance contracts and imposing damages without any relationship to harm disrupts the actuarial assessment of risk insurers rely on to provide coverage. And the costs of such awards ultimately are shouldered by other policyholders through increased premiums, by shareholders who receive diminished dividends, or by the market through decreased availability of coverage. Consequently, the due process issues are important ones. The use of presumptions to impose arbitrary liability and damages based on a stipulated judgment has substantial implications beyond this case for the insurance system and for the judicial system's due process guarantee.

ARGUMENT

I. WASHINGTON LAW UNFAIRLY FAVORS THE INTERESTS OF POLICYHOLDERS, AND ITS BAD FAITH LAWS REFLECT THAT BIAS.

Washington recognizes that "the business of insurance is one affected by the public interest, requiring that all persons be actuated by good faith, abstain from deception, and practice honesty and equity in all insurance matters." RCW 48.01.030. This declaration of public policy informs an insurer's broad duties under Washington law:

> The duty of good faith is not specific to either of the main benefits of an insurance contract [defense and indemnity] but permeates the insurance arrangement. The good faith duty between an insurer and an insured arises from a source akin to a fiduciary duty. . . . It implies a broad obligation of fair dealing . . . and a responsibility to give equal consideration to the insured's interests. Both Washington courts and the legislature have consistently imposed a duty of good faith on the insurance industry.

St. Paul Fire and Marine Ins. Co. v. Onvia, Inc., 165 Wash.2d 122, 129-130 (2008) [internal citations and quotation marks omitted].[2]

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[2] Washington courts have allowed an insurer to be held liable for bad faith even though it owes no duty to defend or indemnify under its policy. *See, e.g.*, *Safeco Ins. Co. of Am. v. Butler*, 118 Wash.2d 383 (1992) [insurer's delays constituted bad faith in third-party defense even though insured was not covered]; *Tank v. State Farm Fire & Cas. Co.*, 105 Wash.2d 381, 385-86, 715 P.2d 1133 (1986) [failure to defend constituted bad faith even though insured was not covered].

A. Washington Law Allows an Insured to Stipulate To a Judgment Against It Without the Insurer's Participation Or Consent.

Under Washington law, an insured may assign any claims against its insurer, including a bad faith claim, to the party claiming injury. *Safeco Ins. Co. of Am. v. Butler*, 118 Wash.2d 383, 387 (1992). The insured can do so without the insurer's knowledge or consent. *Butler, id*., 118 Wash.2d at 399.

Washington law also permits an insured to negotiate and settle claims directly with the injured party, without involving the insurer, and reach a stipulated judgment with a covenant not to execute. *Besel v. Viking Ins. Co. of Wis.*, 146 Wash.2d 730, 738 (2002). When coupled with an assignment, this procedure allows the insured to escape liability, regardless of its actions, and permits the injured party to seek recovery solely and directly from the insurer. This is the exact procedure employed by Lipscomb and Moratti here.

B. Harm Is Presumed And The Amount Of The Covenant Judgment Is Presumed To Be The Measure of Damages In Any Subsequent Bad Faith Case.

Presumptions have been called "the slipperiest member of the family of legal terms." 2 John W. Strong, McCormick on Evidence § 342 (5th. Ed. 1999) They are a legal fiction that allows the existence of one fact (the presumed fact), for which there may be no direct evidence, upon presentation of other facts (the basic fact). *Morales v. Nationwide Insurance Company*, 237 F. Supp. 147, 156 (D. Puerto Rico 2002). Importantly, the Washington presumptions

operate not merely as burden-shifting presumptions, that fade away once contrary evidence is presented, but as conclusive, "game over" presumptions.

An action for bad faith handling of an insurance claim sounds in tort. *Butler, supra*, 118 Wash.2d at 389. "Claims of insurer bad faith are analyzed applying the same principles as any other tort: duty, breach of that duty, and damages proximately caused by any breach of duty." *Smith v. Safeco Ins. Co.*, 150 Wash.2d 478, 485 (2003). To establish bad faith, an insured is required to show the breach was unreasonable, frivolous, or unfounded. *Kirk v. Mt. Airy Ins. Co.*, 134 Wash.2d 558, 560 (1998).

Under Washington law, however, an insured's (or assignee's) ordinary burden to prove damages proximately caused by the insurer's alleged bad faith conduct is replaced by two presumptions. First, if the insured/assignee can establish insurer acted in bad faith, there is a presumption of harm. *Butler, supra*, 118 Wash.2d at 389. While this presumption theoretically is rebuttable, the Washington Supreme Court has acknowledged numerous times that rebutting this presumption carries "an almost impossible burden." *Mut. of Enumclaw Ins. Co. v. Dan Paulson Const., Inc.*, 161 Wash.2d 903, 921 (2007). Because there is no meaningful opportunity to rebut the presumption of harm, it violates the Due Process Clause of the Fourteenth Amendment

Second, in the event of a covenant judgment, the amount of that judgment is the presumptive measure of damages caused by the insurer's bad faith, as long as the settlement between the insured and the tort plaintiff was reasonable and free from collusion or fraud. *Besel, supra*, 146 Wash.2d at 738. Absent a showing of unreasonableness or collusion, the insurer

will be liable for the stipulated amount, even beyond its policy limits.[3] This is arbitrary and unfair because the stipulated covenant judgment amount is awarded as bad faith damages without any opportunity for the insurer to show that the harm it caused, if any at all, was less than the amount of the covenant judgment.

C. A Stipulated Settlement Is Reviewed Only Through A Reasonableness Hearing, Which Does Not Consider An Insurer's Bad Faith.

A reasonableness hearing is a proceeding in equity held to determine if a settlement between a plaintiff and defendant is reasonable. RCW 4.22.060 (1); *Schmidt v. Cornerstone Investments, Inc.*, 115 Wash.2d 148, 159-161 (1990).[4] The reasonableness determination is made by the trial court, without a jury.

To determine a tort settlement's reasonableness in the context of a consent judgment, the court considers the following factors:

> (1) The releasing person's damages; (2) The merits of the releasing person's liability theory; (3) The merits of the released person's defense theory; (4) The released person's relative faults; (5) The

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[3] Another consequence of a bad faith determination under Washington law bears mention: an insurer found liable for bad faith is estopped from denying coverage. *Mut. of Enunclaw Ins. Co. v. Don Paulson Const., Inc.*, *supra* 161 Wash. 2d at 294. This principal is (appropriately) described by Washington courts as "coverage by estoppel."

[4] The hearing requires just five day's notice to all parties and the court. RCW 4.22.060(1).

> risks and expense of continued litigation; (6) The released person's ability to pay; (7) Any evidence of bad faith, collusion or fraud; (8) The extent of the releasing person's investigation and preparation of the case; and (9) The interests of the parties not being released.

Chaussee v. Maryland Cas. Co., 60 Wash. App. 504, 512 (1991). No one factor controls and the trial court has discretion to weigh each case individually. *Chaussee, id.*, 60 Wash. App. at 512.[5]

Importantly, a reasonableness hearing considers only the appropriateness of the settlement of the tort claim. It does not determine whether the insurer acted in bad faith, whether the policyholder suffered any harm from the insurer's bad faith, or whether the amount of a reasonable stipulated settlement fairly reflects the damages actually or proximately caused by the insurer's conduct. Yet in a later suit to recover the stipulated judgment from the insurer, if bad faith of any kind is shown, then the fact and amount of damages are presumed. The stipulated amount of the tort settlement arbitrarily and irrationally is imposed on the insurer without regard to what actual harm, if any, its conduct caused.

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[5] Unlike a trial on the merits, a reasonableness hearing does not determine the relative fault of the settling insured. *Mutual of Enumclaw Ins. Co. v. T & G Const., Inc.*, 143 Wash.App. 667, 676-677 (2008) [although relative fault of a party is one factor to consider, "the purpose of the reasonableness hearing is not to establish the defendant's actual liability"]; *Price v. Kitsap Transit*, 125 Wash. 2d 456, 467-68 (1994) ["Thus, the amount determined to be 'reasonable' does not even purport to represent the amount of damages for which a settling defendant is at fault, and we cannot draw any such inference."]

II. GIVING EFFECT TO A COVENANT JUDGMENT WHEN THE INSURER HAS DEFENDED UNCONDITIONALLY WOULD BE UNFAIRLY PUNITIVE TO THE INSURER.

A. Liability Policies Commonly Confer On The Insurer The Duty To Defend Its Insured And The Right To Control The Defense It Provides.

A general liability policy form, like that issued by the Insurance Services Office ("ISO"), insures ". . . all sums an 'insured' legally must pay as damages because of 'bodily injury' or 'property damage' to which this insurance applies. . . ." The policy confers upon the insurer the "right and duty" to defend any insured against a suit asking for such damages, and to investigate and settle any claim or suit the insurer considers appropriate.[6] [IRMI at IV.T.203.]

In conjunction with this contractual right to control the settlement and defense of any claim or suit against its insured, the typical policy expressly prohibits the insured from assuming any obligation or expense without the insurer's consent:

> 2. Duties In The Event Of Occurrence, Offense, Claim Or Suit

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[6] The policy form citations in this section are to a 2003 Commercial General Liability coverage form, No.. CG 00 01 1204, issued by the Insurance Services Office (ISO). This is a form widely used throughout the industry. This form is contained in its entirety in a manual published by IRMI, entitled International Risk Management Institute, Inc., *Commercial Liability Insurance* (2012), Vol.1, pp. IV.T.203-217.

c. You and any other involved insured must:

(3) Cooperate with us in the investigation or settlement of the claim or defense against the "suit;"

d. No insured will, except at that insured's own cost, voluntarily make a payment, assume any obligation, or incur any expense, other than from first aid, without our consent. [IRMI at IV.T.212.]

The policy also establishes conditions precedent that limit an insured's ability to make a claim against the insurer for payment under the policy:

3. Legal Action Against Us

No person or organization has a right under this Coverage Part:

b. To sue us on this Coverage part unless all of its terms have been fully complied with.

A person or organization may sue us to recover on an agreed settlement or on a final judgment against an insured; but we will not be liable for damages that are not payable under the terms of this Coverage Part or that are in excess of the applicable limit of insurance. An agreed settlement means a settlement and release of liability signed by us, the insured and the claimant or the claimant's legal representative. [IRMI at IV.T.212-213.]

This type of clause is commonly referred to as the "no action" clause. *See, e.g., Rose v. Royal Ins. Co. of America*, 2 Cal. App. 4th 709 (1991).

In light of these policy provisions, there are very few circumstances under which an insured may be

released from its contractual duties, permitted to settle with the injured party without the insurer's consent, and allowed to seek reimbursement of that settlement as damages from its insurer.

B. A Stipulated Judgment Should Not Bind An Insurer When The Insurer Has Not Wrongfully Denied Coverage And Refused To Defend.

The majority rule in states that have considered this issue is that the defendant's liability insurer will be liable for the amount of a stipulated covenant judgment only if the insurer breaches its contractual obligation to defend the insured. *Old Republic Ins. Co. v. Ross*, 180 P.3d 427 (Colo. 2008), citing as examples *Hamilton v. Maryland Cas. Co.*, 27 Cal.4th 718, (2002) [California] ["The denial of coverage and a defense entitles the policyholder to make a reasonable, noncollusive settlement without the insurer's consent and to seek reimbursement for the settlement amount in an action for breach of the covenant of good faith and fair dealing."]; *Black v. Goodwin, Loomis & Britton, Inc.*, 239 Conn. 144 (1996) [Connecticut] ["An insurer who chooses not to provide its insured with a defense and who is subsequently found to have breached its duty to do so must bear the consequences of its decision, including the payment of any reasonable settlement agreed to by the plaintiffs and the insured."]; *S. Guar. Ins. Co. v. Dowse*, 278 Ga. 674 (2004) [Georgia] ["An insurer that denies coverage and refuses to defend an action against its insured . . . becomes bound to pay the amount of any settlement within a policy's limits made in good faith. . . ."]; *Guillen v. Potomac Ins. Co. of Ill.*, 203 Ill.2d 141 (2003) [Illinois] [same holding]; *Red Giant Oil Co. v. Lawlor*, 528 N.W.2d 524, 532-33

(1995) [Iowa] [same holding]; *Griggs v. Bertram*, 88 N.J. 347, 443 A.2d 163, 175 (1982) [New Jersey] [same holding].[7]

Courts reason that an insured should be allowed to assume control over a settlement in these circumstances because an insurer has wrongfully denied coverage, repudiated the contract and abandoned the insured, leaving it to defend the case unassisted. "[I]f the insurer wrongfully refuses to defend, leaving the insured to his own resources to provide a defense, then the insurer forfeits the right to control settlement . . ." *Safeco Ins. Co. of America v. Superior Court*, 71 Cal. App. 4th 782, 787 (1999); Justin A. Harris, Note, *Judicial Approaches to Stipulated Judgments, Assignments of Rights, and Covenants Not to Execute in Insurance Litigation*, 47 *Drake L.Rev.* 853, 855, 874 (1999) [stating "where the provider has agreed to defend the insured, assignments of claims, following a stipulated judgment and a covenant not to execute, are fraught with an unjustified risk of fraud and collusion. . . . An adequate balance may be drawn under an approach that permits insureds to settle with a plaintiff and assign his claims against his provider to the plaintiff, in exchange for a covenant not to execute, only when the insured is truly abandoned by the provider."].

By contrast, when an insurer provides its policyholder with a defense, so that the insured is not abandoned and left to his own devices, the insured

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[7] *In accord*, 14 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance 3d* § 202:7, at 202-32 (1999) [The "insurer's unjustified refusal to defend relieves the insured from his or her contract obligations not to settle and the insured is at liberty to make a reasonable settlement or compromise without losing his or her right to recover on the policy."]

should not be permitted to wrest control of the defense and settle with the claimant on its own. *Hamilton v. Maryland Cas. Co*., 27 Cal. 4th 718, 726 (2002). The reason for allowing the insurer to retain control of settlement is clear: when an insurer honors its defense obligation under the policy, it acquires the right to control settlement without interference by the insured. *Buss v. Superior Court*, 16 Cal. 4th 35, 41 and fn.2, 42 and fn.3, 45-46 and fn.9 (1997); *Farmers Group, Inc. v. Trimble*, 691 P.2d 1138, 1141 (Colo. 1984).

In the case now before the Court, Farmers conceded coverage and defended the insured unconditionally. Complaint at ¶67; App. 3a. Never did it abandon its insured. Farmers therefore was entitled to retain its contractual right to control the defense and settlement of the claim.

C. In Some States A Stipulated Judgment May Be Binding On An Insurer That Failed To Settle, But Never Under These Circumstances.

In spite of the majority rule cited above, there is some disagreement about the impact of an insurer's failure to settle on a stipulated judgment.

California, for example, gives no effect to a stipulated judgment, even if reached after the insurer refused an opportunity to settle within policy limits, as long as the insurer provided a defense. In *Hamilton v. Maryland Cas. Co.*, 27 Cal. 4th 718 (2002), the insurer agreed to defend its insured in a personal injury action. After the insurer refused a settlement demand within its $1 million policy limit, the claimant and insured, without the insurer's participation or consent, agreed on a settlement in

the form of a $3 million stipulated judgment, and an accompanying covenant not to execute against the insured. The trial court approved the settlement as made in good faith pursuant to Calif. Code of Civil Procedure §877.6. In a subsequent action to collect the stipulated judgment based on the insurer's alleged refusal to settle, the Supreme Court unanimously held that a defending insurer is not bound by a stipulated judgment that it did not participate in or agree to, even where the settlement was approved by the court under §877.6:

> [W]here the insurer has accepted defense of the action, no trial has been held to determine the insured's liability, and a covenant not to execute excuses the insured from bearing any actual liability from the stipulated judgment, the entry of a stipulated judgment is insufficient to show, even rebuttably, that the insured has been injured to *any* extent by the failure to settle, much less in the amount of the stipulated judgment. In these circumstances, **the judgment provides no reliable basis to establish damages resulting from a refusal to settle.**

Hamilton, id, 27 Cal. 4th at 726 (our emphasis).

Some states nevertheless have demonstrated a willingness to depart from the majority rule and impose liability for stipulated judgments based on an insurer's refusal to settle, but they typically have done so only when: 1) the matter involved questionable coverage and the insurer reserved its right to deny coverage for any judgment obtained; and 2) the insurer refused a fair and reasonable demand to

settle within policy limits.[8] *See, e.g., Kelly v. Iowa Mut. Ins. Co.*, 620 N.W.2d 637, 645 (Iowa 2000) [". . . when an insurer provides a defense under a reservation of rights and rejects a fair and reasonable settlement demand that a reasonable and prudent insurer would pay, the insured is free to consummate the settlement on terms that protect the insured from personal exposure."]; *Associated Wholesale Grocers, Inc. v. Americold Corp.*, 261 Kan. 806 (1997) [stipulated judgment enforceable in case of wrongful coverage denial and refusal to settle within policy limits]; *Gainsco Ins. Co. v. Amoco Prod. Co.*, 53 P.3d 1051, 1079 (Wyo.2002) [stipulated judgment enforceable where insurer defends under reservation of rights and declines an offer to settle within policy limits].

To our knowledge, none of these states has imposed liability for a stipulated judgment on an insurer where, as here, the insurer defended its insured without reservation, and never received (and rejected) an actual demand to settle the case within its policy limits.

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[8] A few courts have held that a stipulated judgment can be imposed on an insurer that provides a defense to the insured but reserves its right to deny liability for any ultimate judgment. *See, e.g., Cay Divers, Inc. v. Raven*, 812 F.2d 866, 870-871 (3d Cir. 1987); *Ins. Co. of North America v. Spangler*, 881 F.Supp. 539, 545 (D.Wyo. 1995). These cases have been highly criticized, since an insurer does not breach the policy simply because it defends under a reservation of rights. 14 Lee R. Russ & Thomas F. Segalla, *Couch on Insurance 3d* §202:38, at 202-95 to 202-96 (1999). It therefore is wrong to "permit an insured to breach his duties under the policy, even though there has not been a breach of the contract by the insurance company." *Kelly v. Iowa Mut. Ins. Co.*, 620 N.W.2d 637, 642 (Iowa 2000).

D. Washington Fails To Impose The Limitations On The Effect Of A Covenant Judgment Needed To Protect The Insurer's Due Process Rights.

Unlike other jurisdictions, Washington fails to distinguish an insurer's repudiatory conduct, like a wrongful failure to defend, from other types of "bad faith" behavior when determining the effect of a stipulated judgment.

In *Safeco Ins. Co. of America v. Butler*, 118 Wash.2d 383 (1992), for instance, Safeco defended its insured (Butler) under a reservation of rights, and sought a declaratory judgment that its homeowner's policy did not provide coverage for Butler's actions. The insured ultimately stipulated to an excess judgment of $3 million, accompanied by a covenant not to execute. The Washington Supreme Court applied its presumptions of harm and damages (making Safeco responsible for the amount of the covenant judgment) based on Safeco's: 1) delay in notifying the insured of its reservation of rights; 2) delay in investigating; and 3) commingling of defense and coverage files.

Ten years later, the Washington Supreme Court decided *Besel*. The insurer urged that *Butler's* presumptions of harm and damages should not apply because *Butler* involved a defense tendered under a reservation of rights, which was not at issue in *Besel*. The *Besel* court concluded the nature of the insurer's defense was irrelevant:

> This is a distinction without a difference. **The principles in *Butler* do not depend on how an insurer acted in bad faith. Rather, the principles apply whenever an insurer acts in bad faith,** whether by poorly defending a

> claim under a reservation of rights, *Butler*, 118 Wash.2d at 390-92, 823 P.2d 499; refusing to defend a claim, *Kirk v. Mt. Airy Insurance Co*., 134 Wash.2d 558, 565, 951 P.2d 1124 (1998); or failing to properly investigate a claim; *Coventry Associates v. American States Insurance Co.*, 136 Wash.2d 269, 961 P.2d 933 (1998).

Besel v. Viking Ins. Co., supra, 146 Wash.2d at 737 (our emphasis).

Bad faith verdicts can rest upon a myriad of conduct by an insurer. State statutes and regulations impose rigorous and detailed requirements on insurers, such as specific deadlines to respond to a notice of a claim and mandatory notices that must appear in correspondence to a policyholder concerning a claim. The irrationality of the Washington presumptions (which flow from *Butler's* mandate to ignore the nature of the conduct) is that such presumptions effectively remove any causal relationship between the bad faith "wrong" and any actual "harm."

The Washington Supreme Court revisited *Butler* and *Besel* again in *Mutual of Enumclaw Ins. Co. v. Dan Paulson Construction, Inc.*, 161 Wash.2d 903 (2007). In *Paulson*, the insurer (MOE) defended its insured against construction defect claims under a reservation of rights. The claimants offered to settle for an amount within the policy limits, but no settlement was reached. Shortly before the arbitration hearing on the construction claims, MOE's coverage lawyer sent two *ex parte* letters to the arbitrator explaining its coverage issues, along with a subpoena soliciting information (to be produced after the arbitration) needed to resolve the coverage dispute. During the arbitration hearing, the insured and claimant reached a settlement that included an assignment of

the insured's claims against MOE and a covenant not to execute.

The Supreme Court held the insurer's subpoena to and *ex parte* communications with the arbitrator were acts of bad faith that "interfered" with the insured's defense by causing uncertainty for the insured's defense counsel and by interfering with the insured's final hearing preparation. *Paulson, supra*, 161 Wash.2d at 922-923. Although these acts were merely "associated with the insured's defense," the Court held that MOE was estopped from denying coverage, the *Butler* presumption of harm could not be overcome, and the amount of the stipulated settlement was deemed the measure of harm, as instructed by *Besel*. *Paulson, supra*, 161 Wash.2d at 924.

These decisions disregard the parties' rights and obligations under the insurance policy terms. More fundamentally, they also have a troublesome due process infirmity: because of the harm and damage presumptions, there is no causal relationship between the insurer's conduct and the stipulated judgment. It is impossible to imagine how an insurer that delays in sending a reservation of rights letter, or improperly writes to an arbitrator, leaves its insured with no choice but to stipulate to a covenant judgment. It is not "necessarily or universally true" that such conduct would result in any harm to the insured. *Vlandis*, supra at 452. And, through a trial in the subsequent bad faith action, the actual damages could readily be determined. In short, the *Butler* presumption of harm is neither fair nor rational, without considering the nature or actual consequences of the insurer's conduct.

For these same reasons, it is particularly egregious to presume as a matter of law that the amount of the covenant judgment – almost always well in excess of the policy limit – is automatically an appropriate measure of the damages attributable to the insurer's conduct, when the facts of that conduct vary widely.

This case is a perfect example. Farmers has been held liable for a $17 million covenant judgment, entered without its consent, even though it defended the insured without reservation. It never received an offer to settle within its $100,000 policy limit, and it previously offered its limit only to have it rejected. Binding Farmers to a $17 million covenant judgment under these circumstances is fundamentally unfair, and an infringement of its due process rights.

CONCLUSION

For all these reasons, the FDCC urges this Court to grant Farmer's Petition for Writ of Certiorari, so these important issues can be fully considered on their merits.

Respectfully submitted,

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