

London Practice Law Update

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Washington Court of Appeals Heralds New Developments in Damages for an Insurer's Bad Faith Duty to Defend

SYNOPSIS

On April 4, the Washington Court of Appeals issued its decision in *Unigard Insurance Company v. Mutual of Enumclaw Insurance Company*. The case pertains to the scope of damages that may be assessed for an insurer's bad faith failure to defend and the applicable rate of prejudgment interest. The Court held that where the policyholder did not admit liability or confess judgment in a specific amount, the presumed harm from the insurer's failure to defend — and therefore the bad faith damages — was the policyholder's maximum potential liability in the underlying case. The Court also held that the prejudgment interest rate for torts, rather than the rate for contracts, applied to a bad faith and breach of contract case.

THE FACTS

This bad faith litigation arose out of an underlying claim for environmental contamination under Washington's Model Toxics Control Act ("MTCA"). The policyholder was briefly the owner of property that had been used as a dry-cleaning facility. Seventeen years after the policyholder sold it, the Washington Department of Ecology identified the subsequent owner, Newmarket, as potentially liable for soil and groundwater contamination. Newmarket incurred clean-up costs, and then sued the policyholder and other former owners. The policyholder sought coverage from Mutual of Enumclaw ("MOE"), which declined to defend the contribution action. The policyholder then settled with Newmarket, assigning Newmarket its rights against MOE, but did not admit liability or confess judgment for any amount of damages. Newmarket then assigned the claim to its own insurer, Unigard.

DISCUSSION

The Court of Appeals set out the “pattern frequently seen in litigation over bad faith by an insurance company:”

A defendant is sued and seeks coverage. The defendant's insurer refuses to defend. The defendant enters into a settlement agreement with the plaintiff. The defendant stipulates to entry of a judgment and assigns to the plaintiff any claims against the insurer in exchange for the plaintiff's promise not to execute the judgment against the defendant. This is called a covenant judgment. The plaintiff, now standing in the defendant's shoes, sues the insurer for bad faith and related claims, seeking to recover the agreed settlement amount. If the insurer is liable for bad faith and the covenant judgment is reasonable, the presumptive measure of damages is the amount in the covenant judgment.

The Court noted that in this case, there was no covenant judgment, and therefore no presumptive measure of damages. MOE argued that the measure of damages was the policyholder's allocable share of the clean-up costs. The Court held that MOE waived this theory by failing to defend, and held that the presumed harm from the failure to defend was the policyholder's exposure to *all* the clean-up costs — the policyholder's maximum potential liability under the MTCA statutory framework. In short, by failing to defend *one* of the parties potentially liable for the environmental cleanup — and there appears to have been no evidence that the policyholder actually caused any of the environmental contamination — MOE became liable in tort for *all* clean-up costs attributable to *all* parties.

The Court's ruling may have a significant impact on the bad faith duty to defend. First, it would appear either to allow the actual polluting parties to escape without liability or award a windfall to Unigard in the form of double recovery for the clean-up costs. Second, the Court did not confront the antecedent question, which is that even if MOE was estopped from asserting defenses to indemnity, the policyholder never admitted liability or confessed judgment, and arguably there was nothing to indemnify. Third, the Court held that even though no court had ever found the policyholder's settlement with Newmarket to be “reasonable,” which is generally

required as described above, MOE was not entitled to a determination of reasonableness in the bad faith action because it did not request such a determination in the underlying matter. This appears to be a significant departure from Washington's past approach.

Finally, the Court addressed the proper rate for prejudgment interest in cases involving bad faith and breach of contract claims. The Court applied the lower interest rate applicable to torts, rather than the higher interest rate for contracts.

Ultimately, the Court's approach to assignments of right with no admission of liability or covenant judgment potentially opens the door to a new paradigm for the consequences of bad faith. At a minimum, it underscores the importance of making an accurate determination with respect to the duty to defend in Washington.

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