IN THE SUPREME COURT OF THE STATE OF NEVADA
CASE NO. 70504

JAMES NALDER, GUARDIAN AD LITEM ON BEHALF OF CHRISTINE NALDER; AND GARY LEWIS, INDIVIDUALLY;

Appellants,

v.

UNITED AUTOMOBILE INSURANCE COMPANY,

Respondent.

APPELLANTS' OPENING BRIEF

Ninth Circuit Case No. 13-17441
U.S.D.C. No. 2:09-cv-01348-RCJ-GWF

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I. ROUTING STATEMENT

This matter involves a question of law certified by the Ninth Circuit Court of Appeals and is, therefore, presumptively retained by the Supreme Court of Nevada pursuant to NRAP 17(a)(7).

II. JURISDICTIONAL STANDARD FOR CERTIFICATION

On June 1, 2016, the Ninth Circuit Court of Appeals asked this Court to answer the following question:

> Whether, under Nevada law, the liability of an insurer that has breached its duty to defend, but has not acted in bad faith, is capped at the policy limit plus any costs incurred, or is the insurer liable for all losses consequential to the insurer's breach?

In re Nalder, 824 F.3d 854, 855 (9th Cir. 2016).

Pursuant to the certification order, no other issues are before this Court. On July 22, 2016, this Court issued its Order Accepting Certified Question.

The Supreme Court of Nevada may answer questions of law certified to it by a United States Court of Appeals when requested by the certifying court. Nev. R. App. P. 5(a). "The certifying order must include a statement of facts relevant to the question certified in its order certifying questions to this court." *In re Fountainbleau Las Vegas Holdings, LLC*, 127 Nev. 941, 955, 267 P.3d 786, 794 (2011) (citing Nev. R. App. 5(c)(2)). The Supreme

Court of Nevada is "bound by the facts as stated in the certification order." *Id.* at 956, 795. As a result, this Court cannot make findings of fact in response to a certified question. *Id.* Although a party to the certification case may provide an appendix to provide this Court with a better understanding of the underlying action, "this Court may not use information in the appendix to contradict the certification order." *Id.*

In its certification order, the Ninth Circuit provided this Court with the requisite factual background that it found presumptively relevant to this narrow issue of law. *In re Nalder*, 824 F.3d at 855. Thus, this Court must accept the facts as stated in the certification order and answer the question of law so that the certifying court can then apply the law to those facts. *In re Fountainbleau*, 127 Nev. at 955-56, 267 P.3d at 794. "This approach prevents the answering court from intruding into the certifying court's sphere by making factual findings or resolving factual disputes." *Id.* (citing *Alexander v. Certified Master Builders*, 268 Kan. 812, 1 P.3d 899, 908 (Kan. 2000); *Puckett v. Rufenacht, Bromagen & Hertz*, 587 So. 2d 273, 277 (Miss. 1991) ("This Court is not called upon to decide the case. Nor should we go behind the facts presented by the certifying court.")).

Based on the foregoing, Appellants provide the following factual background relevant to this narrow question of law that this Court agreed to answer.

III. FACTUAL BACKGROUND

This matter arises out of an incident in which Gary Lewis ran over Cheyanne Nalder, a nine-year-old girl at the time, on July 8, 2007. *In re Nalder*, 824 F.3d at 855. Lewis maintained an auto insurance policy with Appellee, United Auto Insurance Company ("UAIC"), which was renewable on a monthly basis. *Id.* Prior to the subject incident, Lewis received a statement from UAIC that instructed him that his renewal payment was due by June 30, 2007. *Id.* The renewal statement also instructed Lewis that he remit payment prior to the expiration of his policy "[t]o avoid lapse in coverage." *Id.* The statement provided June 30, 2007 as the effective date of the policy. *Id.* The statement also provided July 31, 2007 as the expiration date of the policy. *Id.* On July 10, 2007, Lewis made payment to renew his UAIC policy. Lewis's policy limit at this time was $15,000.00. *Id.*

Cheyanne's father, James Nalder, extended an offer to UAIC to settle Cheyanne's claim for Lewis's policy limit of $15,000.00. *Id.* UAIC rejected Nalder's offer. *Id.* UAIC rejected the offer because it believed that

Lewis was not covered under his insurance policy because he did not renew his policy by June 30, 2007. *Id.* at 856. UAIC never informed Lewis that Nalder offered to settle Cheyanne's claim. *Id.*

After UAIC rejected Nalder's offer, Nalder, on behalf of Cheyanne, filed a lawsuit against Lewis in the State Court of Nevada. *Id.* After Lewis failed to appear and answer the complaint, Nalder obtained a default judgment against Lewis in the amount of $3,500,000.00. *Id.* Nalder and Lewis then filed the underlying action against UAIC in which they alleged breach of contract, breach of the implied covenant of good faith and fair dealing, bad faith, fraud, and violation of NRS 686A.310. *Id.*

After UAIC removed the underlying case to federal court, UAIC filed a motion for summary judgment as to all of Lewis and Nalder's claims alleging Lewis did not have insurance coverage on the date of the subject collision. *Id.* Initially, the federal district court granted UAIC's summary judgment motion because it concluded that the insurance contract was not ambiguous as to when Lewis had to make a payment to avoid a lapse in coverage. *Id.* Nalder and Lewis appealed to the Ninth Circuit. *Id.* The Ninth Circuit reversed and remanded the matter back to the district court because Lewis and Nalder had facts to support their position that the renewal statement was ambiguous as to the date when payment was required to avoid

a lapse in coverage. *Id.* The Ninth Circuit affirmed the district court's order as to all other claims. *Id.*

On remand, the district court concluded the renewal statement was ambiguous and therefore, Lewis was covered on the date of the incident because the court construed this ambiguity against UAIC. *Id.* The district court further determined that UAIC breached its duty to defend Lewis, but did not award damages because Lewis did not incur any fees or costs in defense of the Nevada state court action. *Id.* Based on these conclusions, the district court ordered UAIC to pay the policy limit of $15,000.00. *Id.* Both Nalder and Lewis appealed to the Ninth Circuit, which in turn, addressed a legal question to this Court concerning what damages are recoverable in breaching the duty to defend. *Id.* at 855.

The certification order was, in part, based upon the ruling in *Andrew v. Century Surety Co.*, 134 F. Supp. 3d 1249, 1259 (D. Nev. 2015), where the Court determined that a liability insurer that breaches its duty to defend is liable for a resulting default judgment in excess of the policy limit because a default judgment in excess of the policy limit is a reasonably foreseeable consequence of the insurer's breach. *In re Nalder*, 824 F.3d at 858. The *Andrew* Court further determined that the insurer was liable for the full

amount of the default judgment even though it did not commit bad faith. *Andrew*, 134 F. Supp. at 1257-58; *In re Nalder*, 824 F.3d at 858.

IV. THE DUTY TO DEFEND IS CONTRACTUAL IN NATURE AND IS NOT IMPLIED IN LAW

A policy of insurance is a contract. *Lumbermen's Underwriting Alliance v. RCR Plumbing, Inc.*, 114 Nev. 1231, 1235, 969 P.2d 301, 304 (1998). Therefore, insurance policies should be interpreted under traditional contract principles. *Cotter Corp. v. Am. Empire Surplus Lines Ins. Co.*, 90 P.3d 814, 819 (Colo. 2004); *Auto-Owners Ins. Co. v. Merillat*, 167 Ohio App. 3d 1148, 153 854 N.E.2d 513, 517 (Ohio Ct. App. 2006) ("Insurance policies are generally interpreted by applying rules of contract law"). "A policy is to be interpreted and construed like any other contract according to general contract principles to determine the mutual intent of the parties." *Bakker v. Continental Ca. Ins. Co.*, 941 F. Supp. 828, 829 (W.D. Ark. 1996). Thus, "the policy is enforced according to its terms so as to effectuate the parties' intent." *Lumbermen's*, 114 Nev. at 1231, 969 P.2d at 304.

A. Insureds Depend on Their Insurers to Provide them with a Defense Pursuant to the Terms of the Insurance Policy

In Nevada, an insurance policy is a contract of adhesion. *Farmers Insurance Group v. Stonik*, 110 Nev. 64, 67, 867 P.2d 389, 391 (1994). Any ambiguity ***or uncertainty*** as to an obligation in an insurance policy must be

construed against the insurer and in favor of the insured. *Vitale v. Jefferson Ins. Co.*, 116 Nev. 590, 594, 5 P.3d 1054, 1057 (2000). Construing any uncertainty in an insurance policy against the insurer is appropriate because the insurer is in a "superior bargaining position to the insured." *United Rentals Highway Techs., Inc. v. Wells Cargo, Inc.*, 128 Nev. ___, 289 P.3d 221, 229 (2012). As a result, this arrangement, chosen by insurers, subjects them to deal with various consequences that stem not only from their power over insureds, but also from their ability to dictate the insurance policy on their terms.

> These principles of interpretation of insurance contracts have found new and vivid restatement in the doctrine of the adhesion contract. As this court has held, a contracted entered into between two parties of unequal bargaining strength, expressed in the language of a standardized contract, written by the more powerful bargainer to meet its own needs, and offered to the weaker party on a "take it or leave it basis" ***carries some consequences that extend beyond orthodox implications. Obligations arising from such a contract inure not alone from the consensual transaction, but from the relationship of the parties.***

Gray v. Zurich Ins. Co., 65 Cal. 2d. 263, 269, 419 P.2d 168, 171 (Cal. 1966) (emphasis added).

Insurers play a vital role in our complex American economy. An insurer's relationship with an insured is akin to a fiduciary relationship. *Powers v. United Servs. Auto. Ass'n*, 114 Nev. 690, 701-02, 962 P.2d 596,

603 (1998). Consumers place significant trust, confidence, and reliance on insurers to perform their obligations under a contract of insurance. In terms of artificially limiting recoverable damages arising from failures to perform their obligations, insurers should not be treated any differently than any other contracting parties. The duty to defend is an expansive contractual covenant in a liability insurance agreement, the breach of which can result in substantial damages. There are no special or individualized rules that consequential damages should somehow be limited to the stated policy limit for insurance companies that breach their contractual duties to their insured. An insurer should be liable for all consequential damages that result from its breach of the duty to defend, regardless of whether the insurer committed bad faith because the duty to defend is so vital to an insured. Further, such a ruling actually encourages insurers to fulfill their obligations.

An insured relies on a liability insurer to defend third-party injury claims potentially within the scope of a complaint, regardless of whether the claim winds up being covered under the insurance policy. Without a defense and assistance from the insurer, an insured is unnecessarily exposed to potential substantial liability for a judgment from the injured third-party claimant.

Where an insurer fails to defend, an adverse judgment against an insured, by default or otherwise, is a foreseeable outcome as an insured may lack the necessary sophistication and funds to mount a defense against an injured third-party's claim. Insurers uniquely understand the likelihood of an adverse judgment being entered against their insureds if they breach the duty to defend. This is precisely why insurers reserve their right to control litigation against their insureds. Liability insurers are in the best position to provide a defense and yet still protect their rights of only paying a covered claim if a court later determines that the third-party's claim is not covered under the policy. Insurers who disavow their obligation to defend their insureds should be liable for all damages that result from their conduct. Given that Nevada follows the rule that a breaching party is liable for all damages consequential to its breach, it follows that an insurer should similarly be liable for all consequential damages caused by a failure to perform an essential duty under a policy of insurance. Liability insurers should not be treated any differently than any other contracting party in terms of being held accountable for the damages they cause. A substantial adverse judgment in excess of the policy limit, by default or otherwise, is a direct foreseeable consequence of an insurer's breach of its duty to defend.

…

B. The Duty to Defend is an Expansive Contractual Obligation Designed to Meet the Reasonable Expectations of Insureds

An insurer's duty to defend is contractual in nature. *Allstate v. Miller*, 125 Nev. 300, 309, 212 P.3d 318, 324 (2009); s*ee also*, *Archdale v. American Internat. Specialty Lines Ins. Co.*, 154 Cal. App. 4th 449, 468-70, 64 Cal. Rptr. 3d 632, 648-50 (Cal. Ct. App. 2007). A liability insurance policy creates a hierarchy of contractual duties between the insurer and the insured. *Allstate*, 125 Nev. at 309, 212 P.3d at 324. These duties include the duty to defend and the duty to indemnify. *Id.* The insurer's duty to defend is, by definition, broader than the duty to indemnify because it is triggered whenever the potential for indemnification arises. *Benchmark Ins. Co. v. Sparks*, 127 Nev. 407, 412, 254 P.3d 617, 620 (2011) (citing *United Nat'l Ins. Co. v. Frontier Ins. Co.*, 120 Nev. 678, 686-87, 99 P.3d 1153, 1158 (2004)). The insurer's duty to defend continues until the potential for indemnification ends. *Benchmark Ins. Co.*, 127 Nev. at 412, 254 P.3d at 620. The duty to defend is of vital importance to the insured. *Amato v. Mercury Cas. Co.*, 53 Cal. App. 4th 825, 832, 61 Cal. Rptr. 2d 909, 913 (Cal. Ct. App. 1997). "If there is a doubt as to whether the insurer must defend, the doubt should be resolved in the insured's favor." *St. Paul Fire & Marine Ins. Co. v. Superior Court*, 161 Cal. App. 3d 1199, 1202, 208 Cal. Rptr. 5, 7 (Ct. App. Cal. 1984).

The duty to defend contains two potentially conflicting contractual rights: the insurer's right to control settlement discussions and its right to control litigation against the insured. *Allstate*, 125 Nev. at 309, 212 P.3d at 324. The right to control litigation creates the contractual duty to defend insureds from lawsuits that contain allegations that fall within the scope of the policy's insurance coverage. *Id.* The implied duty of good faith and fair dealing during negotiations arises from the insurer's right to control settlement discussions. *Id.* An insurer's duty to defend commences upon notice of a demand against the insured. *Id*. at 309, 325.

In Nevada, an insurer has an absolute duty to defend an action brought against its insured that potentially seeks damages within the coverage of the policy. *Rockwood Ins. Co. v. Federated Capital Corp.*, 694 F. Supp. 772, 776 (D. Nev. 1988). "[I]f facts are alleged which if proved would give rise to the duty to indemnify the insurer must defend." *Id.* "It is immaterial whether the claim asserted is false, fraudulent or unprovable." *Id.* Thus, the duty to defend is triggered by "comparing the allegations of the complaint with the terms of the policy." *United Nat'l Ins. Co.*, 120 Nev. at 687, 99 P.3d at 1158.

One of the reasons why the duty to defend is so broad is because it applies not only to claims for which an insured may be liable, but also

claims which an insured could even potentially be found liable. *United Nat'l Ins. Co.*, 120 Nev. at 668, 99 P.3d at 1158. The breadth of the duty to defend is meant to protect the insured because of the disparity in bargaining strength between the insurer and the insured that results from the insurance contract being one of adhesion. *Gray. Co.*, 65 Cal. 2d. at 269-70, 419 P.2d at 171-72. Further, the duty to defend is defined so expansively to also meet the objectives and reasonable expectations of the insured. *Id*. at 270, 172. The *Gray* Court further explained:

> When we test the instant policy by these principles, we find that its provisions as to the obligation to defend are uncertain and undefined; ***in light of the reasonable expectation of the insured, they require performance of that duty***. At the threshold we note that the nature of the obligation to defend is itself uncertain. Although insurers have often insisted that the duty arises only if the insurer is bound to indemnify the insured, this very contention creates a dilemma. No one can determine whether the third party suit does or does not fall within the indemnification coverage of the policy until that suit is resolved...[.] ***The carrier's obligation to indemnify inevitably will not be defined until the adjudication of the very action which it should have defended. Hence the policy contains its own seeds of uncertainty; the insurer has held out a promise that by its very nature is ambiguous.***

Id. at 271-72, 173 (emphasis added).

Nevada, like California, construes insurance contracts to achieve the reasonable expectations of the insured. *Powell v. Liberty Mut. Fire Ins. Co.*, 127 Nev. 156, 162, 252 P.3 668, 672 (2011); *see also*, *Gray*, 65 Cal. 2d at

271-72, 173. This interpretation is necessary because insurers have taken it upon themselves to exercise their superior power over the unsophisticated insured in every way imaginable. As a result of this arrangement, policyholders are faced with various layers of uncertainty stemming from the insurance policy because the policy is a contract of adhesion. *Farmers Insurance Group*, 110 Nev. at 67, 867 P.2d at 391. Therefore, insurers must accept an insured's reasonable expectations of what the policy provides, including the expectation that insurers will defend them even if the claim is false or fraudulent. *Rockwood*, 694 F. Supp. at 776; Gray, 65 Cal. 2d. at 275, 419 P.2d at 175 n.14 (An ordinary insurance consumer would expect his insurer "to defend him whenever there was a threat of liability to him and the threat was based on facts within the policy."). To hold otherwise would allow insurers to profit from their superior bargaining position to the detriment of their insureds. Insurers alone must face the uncertainties that arise from their insurance policies because they unilaterally drafted them and are are better equipped to deal with uncertainties by design. As the *Gray* Court explained:

> The insured is unhappily surrounded by concentric circles of uncertainty: the first, the unascertainable nature of the insurer's duty to defend; the second, the unknown effect of the provision that the insurer must defend even a groundless, false, or fraudulent claim; the third, the uncertain extent of the indemnification coverage. Since we must resolve uncertainties

> in favor of the insured and interpret the policy provisions according to the layman's reasonable expectations, and since the effect of the exclusionary clause is neither conspicuous, nor plain, nor clear, we hold that in the present case, the policy provides for an obligation to defend and that such obligation is independent of the indemnification coverage.

Gray, 65 Cal. 2d at 273-74, 419 P.2d at 174-75.

The duty to defend an insured is a critical promise an insurer makes to its insureds. *Id.* at 271-72, 173. Liability insurers are highly regulated sophisticated business entities. *Indep. Ins. Agents v. Fabe*, 63 Ohio St. 3d 310, 312, 587 N.E.2d 814, 816 (Ohio 1992) ("[T]he insurance industry is a mature, highly regulated industry with sophisticated legal and legislative advisors."). Their contracts are ones of adhesion. *Farmers Insurance Group*, 110 Nev. at 67, 867 P.2d at 391. Given the disparity in power and bargaining strength, specific obligations are imposed upon insurers, including the duty of good faith and fair dealing and duty to defend. *Allstate*, 125 Nev. at 308-09, 212 P.3d at 324-25. These duties also include the duty to settle claims within policy limits when "there is a great risk of recovery beyond the policy limits so that the most reasonable manner of disposing of the claims is a settlement which can be made within those limits…[.]" *Archdale*, 154 Cal. App. 4th at 463, 64 Cal. Rptr. 3d at 644-45 (internal quotations omitted). These duties exist because insurers reserve this power to defend or settle claims exclusively to themselves. *Security*

Officers Service, Inc. v. State Compensation Ins. Fund, 17 Cal. App. 4th 887, 895, 21 Cal. Rptr. 2d 653, 657 (Cal Ct. App. 1993). This reservation of power includes the right to control the litigation and defend its insured against the injury claim of a third-party. *Allstate*, 125 Nev. at 309, 212 P.3d at 324.

The duty to defend is of serious importance to individuals, and corporations alike, because frequently individuals and businesses have likely never been through the litigation process before. Insureds look to their insurers to protect their interests from the time a complaint is filed. Insurers protect these interests by selecting competent counsel to oversee the insured's defense throughout the litigation, approve and hire expert witnesses, and pay for all costs of litigation. *Griffin Dewatering Corp. v. Northern Ins. Co. of New York*, 176 Cal. App. 4th 172, 196, 97 Cal. Rptr. 3d 568, 586 (Cal. Ct. App. 2009). This is true even if coverage is in doubt. *Armstrong World Industries, Inc. v. Aetna Casualty & Surety Co.*, 45 Cal. App. 4th 1, 107, 52 Cal. Rptr. 2d 690, 744 (Cal. Ct. App. 1996). Often, the coverage issues will not be resolved until the trial in the underlying case is complete. *Gray*, 65 Cal. 2d at 279, 419 P.2d at 178. However, the lack of resolution regarding coverage does not absolve an insurer of its duty to provide a defense to its insured. *United States Fire Ins. Co. v. Green Bay*

Packaging, Inc., 66 F. Supp. 2d 987, 995 (E.D. Wis. 1999). This result is justified because the failure of an insurer to provide a defense places the insured at a significant legal disadvantage and can lead to disastrous results, as is the case here.

As a professional litigant with significant expertise and considerable power in litigating injured third-party liability claims, insurers are or should, at a minimum, be aware of the scope of their duty to defend imposed by the insurance contract they created. Given an insurer's ultimate right to control litigation, the insurer should know that a judgment, by default or otherwise, in excess of the policy limit is the very type of consequence that will likely occur if it breaches the duty to defend. *Allstate*, 125 Nev. at 309, 212 P.3d at 324.

V. AN INSURER THAT BREACHES ITS DUTY TO DEFEND SHOULD BE LIABLE FOR ALL LOSSES CONSEQUENTIAL TO ITS BREACH EVEN IF THEY ARE ABOVE THE POLICY LIMIT

One issue raised by the certification order is whether the damages against a liability insurer should somehow be limited to the policy limit. *In re Nalder*, 824 F.3d at 855. The policy limit restricts only the amount the insurer may have to pay a third-party claimant as a result of an insured's actions or omissions. *Comunale v. Traders & General Ins. Co.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 201 (Cal. 1958). The policy limit is ***not*** applicable

to the damages the insurer causes the insured as a result of the insurer breaching its obligation to its insured. *Allstate*, 125 Nev. at 311, 212 P.3d at 326. It is entirely foreseeable and often a likelihood for an insurer to cause an insured substantial harm well in excess of the policy limit by reason of its breach of an essential covenant in a policy of insurance.

A. An Insurer's Obligation to Pay the Limits of the Insurance Policy to a Third Party Arises from its Duty to Indemnify, Not a Breach of its Duty to Defend

An insurer has two general duties: the duty to defend and the duty to indemnify. *Allstate*, 125 Nev. at 309, 212 P.3d at 324. Unlike the duty to defend, which is broader than the duty to indemnify, the duty to indemnify "arises when an insured becomes legally obligated to pay damages in the underlying action that gives rise to a claim under the policy." *United Nat'l Ins. Co.*, 120 Nev. at 686, 99 P.3d at 1157 (quoting *Zurich Ins. v. Raymark Industries*, 118 Ill. 2d 23, 514 N.E.2d 150, 163 (Ill. 1987)). "In other words, for an insurer to be obligated to indemnify an insured, the insured's activity and the resulting loss or damage [must] actually fall within the policy coverage." *Id.* (quoting *Outboard Marine v. Liberty Mut. Ins.*, 154 Ill. 2d 90, 607 N.E.2d 256, 259 (Ill. 1992)).

On the other hand, the duty to defend has nothing to do with the insurer's promise to pay a sum of money on the insured's behalf up to the

policy limit. *Comunale*, 50 Cal. 2d at 659, 328 P.2d at 201. Rather, the duty to defend represents an assurance that the insurer will provide a defense to its insured even when the claims only potentially implicate coverage. *United Nat'l Ins. Co.*, 120 Nev. at 687, 99 P.3d at 1158; *Gray*, 65 Cal. 2d at 266, 419 P.2d at 169. Therefore, it makes no sense to tie the damages one can recover for its insurer's breach of the duty to defend to the policy limit. *Comunale*, 50 Cal. 2d at 659, 328 P.2d at 201.

"The duty to defend is not based on the contractual promise to pay a certain amount of money to an injured person." *Andrew*, 134 F. Supp. 3d at 1256. "Instead, it is a promise to provide a defense, the breach of which may result in consequential damages to the insured beyond the policy limits." *Id.* By contrast, a breach of the duty to indemnify, in the absence of bad faith, obligates an insurer to pay only the policy limits on indemnification, which the insured and insurer would both reasonably expect. *Id.*; *see also*, *Allstate*, 125 Nev. at 311, 212 P.3d at 326. There is no reason why an insurer's breach of the duty to defend, which is a completely separate duty from the duty to indemnify, should be similarly subject to the policy limit. *Andrew*, 134 F. Supp. 3d at 1256; *see also*, *Comunale*, 50 Cal. 2d at 659, 328 P.2d at 201.

An insured has a reasonable expectation that his insurer will defend him against any claim that could potentially be covered under the policy. *United Nat'l Ins. Co.*, 120 Nev. at 687, 99 P.3d at 1158. Thus, an insurer that fails to provide a defense should be held liable to its insured for all foreseeable consequential damages caused by the breach of the duty to defend as a result of not meeting the expectations of its insured. *See Gray*, 65 Cal. 2d at 274, 419 P.2d at 174-75; *Amato*, 53 Cal. App. 4th at 834, 61 Cal. Rptr. 2d at 913; *Pershing Park Villas Homeowners Ass'n v. United Pac. Ins. Co.*, 219 F.3d 895, 901-02 (9th Cir. 2000).

This result is consistent with Nevada law, which allows a non-breaching party to recover all consequential damages that stem from a breach of contract. This result is also consistent with many other jurisdictions in the United States, which have held insurers liable for the full amount of a resulting judgment, even in the absence of bad faith, as a result of breaching the duty to defend.

B. Consequential Damages are Recoverable in a Breach of Contract Action in Nevada

The duty to defend is contractual in nature. *Allstate*, 125 Nev. at 309, 212 P.3d at 324. Thus, the legal standards for recoverable contractual damages must be equally applicable to the non-breaching insured.

In a breach of contract case, Nevada law allows the nonbreaching party to seek compensatory damages. *Hornwood v. Smith's Food King No. 1*, 107 Nev. 80, 84, 807 P.2d 208, 211 (1991). The purpose of compensatory damages are to place the nonbreaching party in the same position he would have been in if the contract was not breached. *Covington Bros. v. Valley Plastering, Inc.*, 93 Nev. 355, 363, 566 P.2d 814, 819 (1977). It is well established that compensatory damages "are awarded to make the aggrieved party whole…." *Road & Highway Builders v. N. Nev. Rebar*, 128 Nev. ___, 284 P.3d 377, 382 (2012) (citing *Hornwood*, 107 Nev. at 84, 807 P.2d at 211). Compensatory damages also include expectancy damages, which are defined in the Restatement (Second) of Contracts § 347. *Id.* (citing *Colorado Environments v. Valley Grading*, 105 Nev. 464, 470-71, 779 P.2d 80, 84 (1989)). An insured's recovery of expectancy damages is reasonable given that his reasonable expectations are that the insurer will abide by the contractual terms of the insurance policy that it unilaterally created. *Gray*, 65 Cal. 2d at 278, 419 P.2d at 178.

The Restatement (Second) of Contracts Section 347 states the method for determining expectancy damages as follows:

> [s]ubject to the limitations stated in §§ 350-53, the injured party has a right to damages based on his expectation interest as measured by (a) the loss in value to him of the other party's performance caused by its failure or deficiency, ***plus (b) any***

> ***other loss, including incidental or consequential loss, caused by the breach***, less (c) any cost or other loss that he has avoided by not having to perform.

See Restatement (Second) of Contracts, § 347 (1981); *see* also, Colorado *Environments*, 105 Nev. at 470-71, 779 P.2d at 84 (emphasis added)

Under Section 347(b) of the Restatement (Second) of Contracts, a non-breaching party can recover consequential damages a result of a breach of contract. Recovery of consequential damages is appropriate when the damages are foreseeable. *Clark County School Dist. v. Rolling Plains Const., Inc.*, 117 Nev. 101, 106, 16 P.3d 1079, 1082 (2001) (overruled on other grounds by *Sandy Valley Assocs v. Sky Ranch Estates Owners Ass'n*, 117 Nev. 948, 35 P.3d 964 (2001)). In reliance on the "watershed case, *Hadley v. Baxendale*, 156 Eng. Rep. 145, 151 (1854)", this Court in *Clark County* determined that foreseeability requires that:

> (1) damages for loss must fairly and reasonably be considered as arising naturally . . . from such breach of contract itself, and (2) the loss must be such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract as the probable result of the breach of it.

Id. at 106, 1082.

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Section 351 of the Restatement (Second) of Contracts reaffirms the requirement that damages must be foreseeable to be recovered in a breach of contract:

> (1) Damages are not recoverable for loss that the party in breach did not have reason to foresee as a probable result of the breach when the contract was made.
>
> (2) Loss may be foreseeable as a probable result of a breach because it follows from the breach
>
> (a) in the ordinary course of events, or
>
> (b) as a result of special circumstances, beyond the ordinary course of events, that the party in breach had reason to know.

See Restatement (Second) of Contracts, § 351(1), (2) (1981); *see also*, *Hornwood v. Smith's Food King No. 1*, 105 Nev. 188, 190, 772 P.2d 1284, 1286 (1989) ("Damages from a breach of contract should be such as may fairly and reasonably be considered as arising naturally, or were reasonably contemplated by both parties at the time they made the contract.").

In *Hornwood*, Smith's Food King (Smith's) entered into a thirty-year lease of a shopping center property owned by the Hornwoods. *Id.* at 188, 1284. The lease required about $92,398.00 for minimum annual rent, and about $2.7 million in total rent over the thirty year span. *Id.* at 188, 1285. Smith's closed its store about 11 years after it signed the lease without providing notice to the Hornwoods, but continued to pay the minimum rent

after the store closed. *Id.* The Hornwoods then filed suit against Smith's for breach of contract. *Id.* They sought compensatory damages and consequential damages that resulted from the diminution in value of the shopping center, lost future percentage rents from Smith's and other tenants in the shopping center, and lost rents and other expenses associated with other tenants. *Id.*

On appeal, this Court reversed the district court's ruling that the consequential damages were unforeseeable as a matter of law. *Id.* at 190, 1286. This Court provided the following reasoning why the diminution in value of the shopping center arose naturally and foreseeably from Smith's closure of its store:

> Smith's is a sophisticated business entity. Smith's knew that its presence as the anchor tenant had a critical impact on the shopping center's success. Without an anchor tenant, obtaining long-term financing and attracting satellite tenants is nearly impossible for a shopping center. Perhaps more importantly, the anchor tenant insures the financial viability of the center by providing the necessary volume of customer traffic to the shopping center. Therefore, we find that the district court clearly erred in concluding, as a mater of law, that the diminution in value of the Hornwoods' shopping center was unforeseeable. *(citation omitted)*. Accordingly, we reverse that portion of the district court's ruling and remand to the district court for an assessment of the Hornwoods' damages as a consequence of the loss of their anchor tenant.

Hornwood, 105 Nev. at 191, 772 P.2d at 1286.

Several other Nevada cases have confirmed that consequential damages are recoverable so long as they are foreseeable. *See Colorado*, 105 Nev. at 471, 779 P.2d at 84 (damages to a subcontractor for a contractor's breach of contract can include lost profits and standby equipment or delay damage because "these losses, when foreseeable, are a natural consequence of the defendant's delay, and thus, are compensable"); *Road & Highway*, 284 P.3d at 378-79 (contractor's breach of contract resulted in subcontractor losing the benefit of the bargain, *i.e.* lost profits, and the unpaid labor and material costs it provided on the job); *Eaton v. J.H., Inc.*, 94 Nev. 446, 449, 581 P.2d 14, 16 (1978) (damages for breach of contract include "loss of profits to plaintiff for the remainder of the term of the agreement" and that the damages for the defendants' breach of contract should include "losses caused and gains prevented by the defendants' breach").

An insurer's duty to defend is one of the main benefits of the insurance contract. *Dewitt Constr., Inc. v. Charter Oak Fire Ins. Co.*, 307 F.3d 1127, 1137 (9th Cir. 2002). "The insured's desire to secure the right to call on the insurer's superior resources for the defense of third-party claims is, in all likelihood, typically as significant a motive for the purchase of insurance as is the wish to obtain indemnity for possible liability." *Amato*, 53 Cal. App. 4th at 832, 61 Cal. Rptr. 2d at 913. Further, the insurer has

complete control over the litigation and settlement process when a third-party initiates a complaint for injuries against the insured. *Rupp v. Transcon. Ins. Co.*, 627 F. Supp. 2d 1304, 1319 (D. Utah 2008). As a result, the insured completely relies on the insurer to protect the insured's interests through providing a defense and/or indemnification for covered claims. *Id.* at 1319.

An insurer, like UAIC, should not be held to a lesser standard than any other entity that breaches a contract. There is no justification for excluding an insurer from liability for consequential damages to its insured when it breaches an insurance contract that its insured was forced to accept without any say. "It seems only fair that an insurer whose contracts are by their very nature adhesive should be held at least to the same standard of damages applicable to other contracting parties." *Thomas v. Western World Ins. Co.*, 343 So. 2d 1298, 1304 (Fla. Ct. App. 1977). This is especially true given the likelihood that an insured will face severe consequences if its insurer fails to provide a defense, including a resulting default judgment. Unlike an insurer, an insured generally lacks the sophistication to mount a defense to the injury claims made by a third-party, which is why an insured pays for its insurer to defend him against such claims in the first place. *See Towne Realty v. Zurich Ins. Co.*, 201 Wis. 2d 260, 268 548 N.W. 2d 64, 67

(Wis. 1996) ("Insurers are usually more sophisticated and knowledgeable than insureds regarding the insurer's duty to defend and insurers are in a better position than insureds to facilitate clear communications between the parties."). Specifically, an insurer knows when it reviews a complaint against its insured whether the allegations contained therein potentially implicate coverage. An insurer also knows that it must fulfill its duty to defend, even if the claims alleged by the third-party are false or fraudulent. *Rockwood Ins. Co.*, 694 F. Supp. at 776; *United Nat'l Ins. Co.*, 120 Nev. at 687, 99 P.3d at 1158.

In light of this Court's view that a non-breaching party can recover consequential damages that result from a breach of contracts, Appellants request that this Court follow its well-established rule and conclude an insurer that breaches its contractual duty to defend is liable for all reasonable and consequential damages, including those in excess of the policy limit. *See Stockdale v. Jamison*, 330 N.W. 2d 389, 392 (Mich. 1989) ("If the insurer had an obligation to defend and failed to fulfill that obligation, then, like any other party who fails to perform its contractual obligations, it becomes liable for all foreseeable damages flowing from the breach."); *Polaroid Corp. v. Travelers Indem. Co.*, 414 Mass. 747, 763, 610 N.E.2d 912 (Mass. 1993) ("When an insurer's good faith refusal to defend an insured is ruled to have

been unjustified, there is no reason not to apply normal contract damages principles."); *Bucci v. Essex, Ins. Co.*, 323 F. Supp. 2d 84, 92 (D. Me. 2004) ("[N]ormal contract principles apply to a breach of the duty to defend.").

By reason of its sophistication and extensive experience, an insurer knows or should know that its failure to defend will result in a default judgment. A default judgment is a foreseeable consequence of an insurer failing to hire counsel to timely appear and provide counsel to the insured in furtherance of the duty to defend.

This result is in harmony with numerous other jurisdictions that have concluded that an insurer is liable for all consequential damages that result from its breach of the duty to defend, even in excess of the policy limit. This result also encourages liability insurers to fulfill their duties and at the same time, protect their interests in determining whether there is a duty to indemnify. *Gray*, 65 Cal. 2d at 279, 419 P.2d at 178.

C. An Insurer is Liable for all Losses Consequential to an Insurer's Breach of the Duty to Defend, Including a Judgment against its Insured Even if Coverage is in Doubt

UAIC and other insurers cannot dispute that a foreseeable consequence of their breach of the duty to defend is that their insureds will be subject to a judgment, default or otherwise, in excess of the policy limit. "An insurance company which refuses to defend believing there to be no

coverage, does so at its peril, even if in good faith, and must bear the legal consequences of its breach of contract." *Space Conditioning, Inc. v. Insurance Co. of North America*, 294 F. Supp. 1290, 1295 (E.D. Mich. 1968). The Court in *Andrew* relied upon the Seventh Circuit when it discussed the ramifications to an insurer who breaches the duty to defend:

> An insurance company that refuses a tender of defense by its insured takes the risk not only that it may eventually be forced to pay the insured's legal expenses but also that it may end up having to pay for a loss that it did not insure against. If the lack of a defender causes the insured to throw in the towel in the suit against it, the insurer may find itself obligated to pay the entire resulting judgment even if it can prove lack of coverage.

Andrew v. Century Surety Co., 134 F. Supp. 3d at 1255 (quoting *Hamlin Inc. v. Hartford Accident & Indem. Co.*, 86 F.3d 93, 94 (7th Cir. 1996)).

The Supreme Court of Nevada looks to persuasive authority for guidance regarding issues of first impression. *Whitemaine v. Aniskovich*, 124 Nev. 302, 311, 187 P.3d 137, 143 (2008). The California Court of Appeals, California Supreme Court, and the Ninth Circuit all concluded that an insurer that breached its duty to defend is liable for the full amount of a resulting judgment, default or otherwise, against its insured. *See Gray*, 65 Cal. 2d at 279, 419 P.2d at 178; *Pershing Park Villas Homeowners Assn'*, 219 F.3d 895 (9th Cir. 2000); *Amato*, 53 Cal. App. 4th 825, 61 Cal. Rptr. 2d 909.

In *Gray*, the insured, Dr. Vernon Gray, sued his insurer, Zurich, because it failed to defend him in an action filed against him alleging that he committed an assault. 65 Cal. 2d. at 266, 419 P.2d at 169. As a result, Dr. Gray unsuccessfully defended himself and a judgment was entered against him for 6,000.00. *Id.* at 267, 269.

Zurich argued that it failed to render a defense because it claimed that the exclusionary clause of its policy excused defense of an action alleging the insured intentionally caused bodily injury. *Id.* However, the Court concluded that Zurich should have tendered a defense because the effects of the policy's exclusionary clause were unclear when read with the general language that the company shall defend any suit alleging bodily injury. *Id.* at 273-75, 174-75. As a result, the Court determined that Zurich breached its duty to defend because the policy led Gray to reasonably expect a defense. *Id.* at 275, 176.

The *Gray* Court also held that Zurich was liable not only for the costs Gray incurred in defending the action, but also the resulting judgment. *Id.* at 280, 179. The Court provided the following reasoning in support of its holding:

> Having defaulted such agreement the company is manifestly bound to reimburse its insured for ***the full amount of any obligation reasonably incurred by him. It will not be allowed to defeat or whittle down its obligation on the theory that***

> ***plaintiff himself was of such limited financial ability that he could not afford to employ able counsel, or to present every reasonable defense, or to carry his cause to the highest court having jurisdiction, ... Sustaining such a theory ... would tend ... to encourage insurance companies to similar disavowals of responsibility with everything to gain and nothing to lose.***

Id. at 280, 179 (quoting *Arenson v. National Auto & Cas. Ins. Co.*, 48 Cal. 2d 528, 539, 310 P.2d 961 (Cal. 1957)) (emphasis added).

The Ninth Circuit reaffirmed the imposition of automatic liability for a judgment, default or otherwise, when an insurer fails to defend. *Pershing Park Villas Homeowners Ass'n*, 219 F.3d at 901-02. In *Pershing Park*, a homeowners association sued real estate developers alleging defects and property damage at their condominium complex. *Id.* at 898. The real estate developers tendered the defense to their property damage insurer, United Pacific Insurance Company. *Id.* United's parent company, Reliance Insurance Company, initially assumed the defense under a reservation of rights, but later withdrew its defense because the alleged damage was not covered under the policy. *Id.* The developers did not retain new counsel to defend the suit and, as a result, the homeowners obtained a default judgment for $339,000.00, which Reliance refused to pay. *Id.* The developers and homeowners sued Reliance alleging breach of contract, bad, faith and other tort-based causes of action. *Id*. The district court ruled "Reliance was liable

for the entire default judgment as a ***consequence*** of its failure to defend the developers." *Id.* (emphasis added).

The Ninth Circuit affirmed the district court's decision based on the "long-settled" rule that "an insurer that wrongfully refuses to defend is liable on the judgment against the insured." *Id.* at 901 (citing *Gray*, 65 Cal. 2d 263, 419 P.2d 168; *Amato*, 53 Cal. App. 4th 825, 61 Cal. Rptr. 2d 909). "It is no defense that the ultimate judgment against the insured is not necessarily rendered on a theory within the coverage of the policy." *Id.* at 901. The insured is also not responsible for proving that the judgment would have been smaller or would not have occurred if the insurer tendered a defense. *Id.* at 902.

In *Amato*, the insurer, Mercury Casualty Co., did not defend its insured, Anthony Amato, against a personal injury suit because it did not believe there was coverage. 53 Cal. App. 4th at 829, 61 Cal. Rptr. 2d at 911. After Mercury refused to defend, the injured third-party obtained a default judgment against Amato for $165,750.00, well above the policy limit of $15,000. *Id.* at 830, 912. The *Amato* Court subsequently held:

> [w]hen the insurer refuses to defend and the insured does not employ counsel and presents no defense, it can be said the ensuing default judgment is proximately caused by the insurer's breach of the duty to defend.

Id. at 834, 915.

While *Amato* discussed an insurer's commission of the breach of the covenant of good faith and fair dealing, in which tort remedies are available, *Amato* distinguished the damages recoverable for a breach of contract and damages recoverable in tort. *Id.* at 831, 912-13. "Contractual damages are the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom." *Id.* "Tort damages are the amount which will compensate for ***all*** the detriment proximately caused thereby, ***whether it could have been anticipated or not***." *Id.* (emphasis added). [1] The *Amato* Court specifically relied on this distinction when it held that an ensuring default judgment is proximately caused by the insurer's breach of the duty to defend when it refuses to defend and the insured presents no defense. *Id.* at 834, 915.

> [D]amages for breach of the duty to defend are not inexorably imprisoned within the policy limit but are measured by the consequences proximately caused by the breach.

State Farm Mut Auto. Ins. Co. v. Allstate Ins. Co., 9 Cal. App. 3d 508, 529, 88 Cal. Rptr. 246, 259 (Cal. Ct. App. 1970).

[1] As discussed in Subsection V, A, *infra*, an insurer's commission of the tort of bad faith renders it liable for damages, regardless of foreseeability, including non-economic damages and potentially punitive damages.

Several other jurisdictions also concluded that an insurer that breaches its duty to defend is liable for the full amount of a resulting judgment.

> [T]he duty to defend is an express contractual undertaking, the breach of which subjects the insurer to pay all damages that foreseeably flow from the breach, including a judgment against the insured in excess of the policy limits, attorneys fees and other expenses

Robinson v. State Farm Fire & Casualty Co., 583 So. 2d 1063, 1068 (Fla. Ct. App. 1991) (citing *Thomas*, 343 So. 2d at 1303-04). *See also, Maxwell v. Hartford Union High Sch. Dist.*, 341 Wis. 2d 238, 814 N.W.2d 484, 496 (Wis. 2012) ("Damages which naturally flow from an insurer's breach of the duty to defend include: (1) the amount of the judgment or settlement against the insured plus interest …[.]").

In *Delatorre v. Safeway Ins. Co.*, 989 N.E.2d 268 (Ill. App. Ct. 2013), the Court eloquently explained why a default judgment directly results from a breach of the duty to defend:

> The entry of the final judgment by default in the underlying personal injury action, including that portion in excess of policy limits, directly flows from the breach of contract; that is, the proximate cause of the default judgment ... was defendant's [insurer's] breach. This situation could have been averted altogether had defendant seen to it that its insured was actually defended as contractually required. ***To hold otherwise, we would subject the insured to the likelihood of paying some or all of the default judgment out of his own pocket, an incongruous result, considering that the entry of neither the default order nor the default judgment was of his instigating or choosing, or even known to him until years later, but***

> ***instead, was the natural consequence of his insurer's breach of contract***.

989 N.E.2d at 276 (emphasis added).

The Court's analysis in *Gray* is particularly analogous to the facts in this matter because both cases involve ambiguities in documents prepared by the insurers that the insureds relied upon. In this case, the federal district court concluded that UAIC's renewal notice was ambiguous as to when Lewis had to pay his renewal payment before his policy lapsed. *In re Nalder*, 824 F.3d at 856. Based on this ambiguity, UAIC should have provided a defense to Lewis when Nalder filed his lawsuit. Like Zurich in *Gray*, UAIC should similarly be liable for the default judgment entered against Lewis because it was a direct consequence of UAIC's breach of the duty to defend. It is no defense that UAIC had a reasonable basis to deny coverage (*i.e.* implicating the duty to indemnify), as the Nevada federal district court concluded, because the duty to defend requires an insurer defend its insured if the Complaint implicates coverage even if the claims are false. *Rockwood Ins. Co.*, 694 F. Supp. at 776 ("It is immaterial whether the claim asserted is false, fraudulent or unprovable.").

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D. An Insurer's Liability for Consequential Damages that Stem from its Contractual Breach of the Duty to Defend are Not Capped at the Policy Limit

Two California cases, *Comunale*, 50 Cal. 2d 654, 328 P.2d 198 and *Archdale*, 154 Cal. App. 4th 449, 64 Cal. Rptr. 3d 632 further support Appellants' position that damages for breaching the insurance contract are not limited to the policy limit. Both *Comunale* and *Archdale* hold that under an insurer's breach of contract, an insurer is liable in excess of the policy limit for a resulting judgment, default or otherwise, irrespective of bad faith. *Comunale*, 50 Cal. 2d at 659-61, 328 P.2d at 201-02; *Archdale*, 154 Cal. App. 4th at 466, 64 Cal. Rptr. 3d at 647.

In *Comunale*, the insured, Sloan, assigned all of his rights against his insurer, Traders to Mr. and Mrs. Comunale after Traders refused to defend Sloan in the Comunales' underlying personal injury action. *Comunale*, 50 Cal. 2d at 657, 328 P.2d at 200. Traders also refused to effectuate a settlement after Sloan informed Traders that he received an offer, did not have the money to settle and that it was probable the jury would return a verdict in excess of his policy limits of $10,000.00 per person and $20,000.00 per accident. *Id.* The Comunales received a judgment in excess of the policy limits and then sued to recover from Traders the value of the judgment in excess of the policy limits. *Id.* The jury returned a verdict in

the Comunales' favor, but the trial court entered a judgment for Traders notwithstanding the verdict and an appeal followed. *Id.* On appeal, the California Supreme Court determined that Traders breached its insurance contract when it refused to accept a settlement offer within the policy limits because of the great risk of recovery beyond the policy limits. *Id.* at 659, 201. Thus, the Court held that Traders was liable for the entirety of the judgment in excess of the policy limits:

> If Traders had performed its contract, it would have settled the action against Sloan, thereby protecting him from all liability. ***The allowance of recovery in excess of the policy limits will not give the insured any additional advantage but merely place him in the same position as if the contract had been performed.***

Id. at 661, 202 (emphasis added).

In *Archdale*, the insured, Godinez assigned his rights against his insurer, American International Specialty Lines Insurance Company (AIS) to the Archdales after AIS rejected multiple settlement offers from the Archdales to resolve their personal injury claims stemming from a motor vehicle collision. *Archdale*, 154 Cal. App. 4th at 456-57, 64 Cal. Rptr. 3d at 639-40. At trial, the Archdales obtained a judgment of $1,292,945.00, which exceeded the AIS policy limit of $500,000.00. *Id.* In their Complaint against AIS, the Archdales alleged breach of contract and breach of the implied covenant of good faith and fair dealing. *Id.* at 458, 640. The

Archdale Court exclusively analyzed AIS's conduct under a breach of contract standard because Godinez's tort allegation of bad faith was barred by the statute of limitations and properly dismissed. *Id.* at 456, 638. The Court held that if such breach results in an excess judgment against the insured, it will support a claim sounding in contract and that the amount of the excess judgment is a consequential damage of the breach. *Id.* The Court noted that liability for damages beyond the policy limits are foreseeable because they flow from the insurer's failure to accept a reasonable settlement offer specifically when there is a risk of liability in excess of the policy limits. *Id.* at 469-70, 649-50. Thus, "the insured has a legitimate right to expect that the method of settlement within policy limits will be used to protect him or her from liability." *Id.*

Although *Comunale* and *Archdale* involved the insurers' failures to accept reasonable settlement offers, they are applicable to this case because these breaches sound in contract, not tort. The Supreme Court of Nevada concluded that an insurer's duty to defend commences upon notice of a demand against its insured and ***"carries with it the duty to communicate to the insured any reasonable settlement offer that could affect the insured's interests."*** *Allstate Ins. Co. v. Miller*, No. 49760, 2009 Nev. LEXIS 56, at

*2 (citing *Heredia v. Farmers Ins. Exchange*, 228 Cal. App. 3d 1345, 279 Cal. Rptr. 511, 519-20 (Cal Ct. App. 1991) (emphasis added)).[2]

In this case, Nalder extended a reasonable settlement offer to UAIC for Lewis's policy limit of $15,000.00. UAIC never communicated this offer to Lewis, and unilaterally rejected Nalder's offer, which ultimately led to its breach of the duty to defend.

> A breach which prevents the making of an advantageous settlement when there is great risk of liability in excess of the policy limits will, in the ordinary court of things, result in a judgment against the insured in excess of those limits.

Comunale, 50 Cal. 2d at 660-61, 328 P.2d at 202.

Therefore, an insurer, like UAIC, "who not only rejected a reasonable offer of settlement, but also wrongfully refused to defend should be in no better position than if it had assumed the defense and then declined to settle." *Id.* at 660, 202. "The insurer should not be permitted to profit by its own wrong." *Id.*

Even if an insurer, like UAIC in this case, believes that the claim is not covered under the policy when it rejects a reasonable settlement offer, it is still liable for all damages in excess of the policy limit because this conduct is subsumed within its breach of the duty to defend. *See*, *Allstate*,

[2] This decision reflects the Supreme Court of Nevada's modification of its opinion in *Allstate*, 125 Nev. 300, 212 P.3d 318, filed on July 30, 2009.

125 Nev. at 309, 212 P.3d at 325 (The right to control settlement discussions, which is part of the duty to defend, creates the duty of good faith and fair dealing during negotiations."). "Refusal to defend is somewhat analogous to wrongful refusal to settle although the latter may or may not include a denial of coverage." *State Farm Mut Auto. Ins. Co.*, 9 Cal. App. 3d at 528, 88 Cal. Rptr. at 259 (Cal. Ct. App. 1970). "[A]n insurer's good faith, through erroneous, belief in noncoverage affords no defense to liability flowing from the insurer's refusal to accept a reasonable settlement offer." *Johansen v. California State Auto Assn. Inter-Ins. Bureau*, 15 Cal. 3d 9, 16, 538 P.2d 744, 748 (Cal. 1975).

> Failure to settle because of the belief in noncoverage, even though in good faith, is an effort to further the insurer's own interests, and the insurer must therefore be willing to absorb losses resulting from its failure to settle.

Gibbs v. State Farm Mut. Ins. Co., 544 F.2d 423, 427 (9th Cir. 1976).

The *Comunale* Court's distinction between damages owed to a third-party versus an insured further highlights the reason why an insured's recovery for breach of the contractual duty to defend is not limited to the policy limit:

> There is an important difference between the liability of an insurer who performs its obligations and that of an insurer who breaches its contract. ***The policy limits restrict only the amount the insurer may have to pay in the performance of the contract as compensation to a third person for personal***

> ***injuries caused by the insured; they do not restrict the damages recoverable by the insured for a breach of contract by the insured***.

Comunale, 50 Cal. 2d at 659, 328 P.2d at 201.

The Arizona Court of Appeals has also acknowledged that a breach of the duty to defend could result in liability in excess of the policy limit:

> Obviously, there may be other circumstances in which a causal connection between the denial in coverage or the refusal to defend and the excess judgment occurs … like when the insured suffers a default or final judgment without the benefit of an attorney.

Rogan v. Auto-Owners Ins. Co., 171 Ariz. 559, 565, 832 P.2d 212, 218 n.4 (Ariz. Ct. App. 1991). *See also, Khan v. Landmark Am. Ins. Co.*, 326 Ga. App. 539, 545, 757 S.E.2d 151, 156 (Ga. Ct. App. 2014) (In a refusal to defend case, "the possible damages at issue are not merely those within the indemnity coverage of the policy, but are those further damages that may flow from breach of the contract to defend."); *Maxwell*, 341 Wis. 2d at 262, 814 N.W.2d at 496 ("When an insurer breaches a duty to defend its insured, the insurer is on the hook for all damages that result from that breach of its duty," which could include damages beyond the policy limits)

Nevada law permits a non-breaching party to recover all reasonably foreseeable consequential damages for breach of contract, regardless of whether the breaching party acted in good faith or bad faith. *Hornwood*, 105

Nev. 188, 190, 772 P.2d 1284. Therefore, an insured's recovery of a judgment, default or otherwise, that results from a breach of the duty to defend is consistent with Nevada law. An insurer's liability for all consequential damages, irrespective of policy limits, places the insured in the same position he would have been in if the insurer fulfilled its contractual duty to defend. *See Delatorre*, 989 N.E.2d at 276 ("The general rule is that damages for breach of contract should place the injured party in the same position it would have been in had the contract been fully performed."). Accordingly, Appellants request that this Court allow an insured to recover consequential damages that exceed the policy limit for an insurer's contractual breach of the duty to defend.

E. Insurance Companies Can Fulfill Their Duty to Defend and Adequately Protect Their Interests At the Same Time

Insurance companies, like UAIC, can protect their interests while discharging their duty to defend if they believe coverage does not apply. "The insurer can (1) seek a declaratory judgment before or pending trial of the underlying action; (2) defend the insured under a reservation of rights; or (3) refuse either to defend or seek a declaratory judgment at the insurer's peril that it might later be found to have breached its duty to defend." *Maneikis v. St. Paul Ins. Co.*, 655 F.2d 818, 821 (7th Cir. 1981). "[W]hen an insurer is in doubt as its obligation to defend, insurers should not desert their

policyholders, but agree to defend under a reservation of rights." *Newmont USA, Ltd. v. Am. Home Assur. Co.*, 676 F. 1146, 1157 (E.D. Wash. 2009). The *Newmont* Court further stated:

> [a]lthough the insurer must bear the expense of defending the insured, by doing so under a reservation of rights and seeking a declaratory judgment, the insurer avoids breaching its duty to defend and incurring the potentially greater expense of defending itself from a claim of breach.

Id. at 1157-58.

The Court in *Gray* described how simple it is for an insurer to avoid being bound by a resulting judgment for failing to discharge its duty to defend:

> In any event, if the insurer adequately reserves its right to assert the noncoverage defense later, it will not be bound by the judgment. If the injured party prevails, that party or the insured will assert his claim against the insurer. At this time, the insurer can raise the noncoverage defense previously reserved. In this manner, the interests of the insured and insurer in defending against the injured party's primary suit will be identical; the insurer will not face the suggested dilemma.

Gray, 65 Cal. 2d at 279, 419 P.2d at 178.

In this case, UAIC should have provided a defense for its insured, Lewis, under a reservation of rights and, if it so elected, filed a declaratory relief action if it believed coverage did not apply. Instead, UAIC abandoned Lewis and left him exposed to a $3,500,000.00 default judgment. As a sophisticated insurer, UAIC was well aware of the risk that Mr. Lewis would

be subject to a judgment, default or otherwise, without providing him with a defense. UAIC simply ignored this risk and did not consider Mr. Lewis's interests whatsoever. *See Allstate*, 125 Nev. at 309, 212 P.3d at 325 ("The insurer must act in good faith and give the insured's interests equal consideration with its own.") (citing 14 *Couch on Insurance* 3d § 203:1 (2005)). In fact, UAIC never even informed Lewis that Nalder was willing to settle his daughter's claim for the policy limit of $15,000.00, which culminated in Mr. Nalder's lawsuit against its insured. *Allstate*, 125 Nev. at 309, 212 P.3d at 325 ("If an insurer fails to adequately inform an insured of [a known reasonable settlement] opportunity *after* the filing of a claimant's lawsuit, then the insurer has breached its duty to defend the insured against lawsuits."). If UAIC actually provided Mr. Lewis with a defense, then he would not have been subject to a $3,500,000.00 default judgment because he would have had an attorney present to help him avoid this outcome and defend against the complaint. Therefore, it was reasonably foreseeable that a substantial default judgment would result when UAIC failed to provide a defense.

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F. An Insurer's Liability for All Losses Consequential to Its Breach is Consistent with Nevada Contract Law, Insurance Law and Serves the Bests Interests of Nevada Insureds

Mr. Lewis and all insureds have a reasonable expectation that their insurers, like UAIC, will provide them with a defense once a third-party files a complaint alleging personal injury that potentially falls within the policy's coverage. *United Nat'l Ins. Co.*, 120 Nev. at 687, 99 P.3d at 1158; *Gray*, 65 Cal. 2d at 266, 419 P.2d at 169. However, when an insurer, like UAIC, fails to provide that defense because it believes its insured was not covered under the policy at the time of the collision, it has breached its duty to defend. This breach is particularly egregious when an insurer declines to defend based on an ambiguity in the policy it created or, in this case, a renewal statement created by UAIC. A determination from this Court that an insurer that breaches its duty to defend is liable for all foreseeable consequential damages resulting from that breach will ensure that insurance companies are held to the same standard as other persons and entities who breach their contracts in Nevada. *See Hornwood*, 105 Nev. at 190, 772 P.2d at 1286. This determination is also consistent with this Court's view that the duty to defend is broad and arises whenever facts are alleged that give rise to potential liability under the policy. *See United Nat'l Ins. Co.*, 120 Nev. at 686-87, 99 P.3d at 1158.

Most importantly, a holding from this Court that an insurer is liable for all consequential damages will protect Nevada insureds from their insurance companies abandoning them at a time when they need them most. If this Court holds otherwise, it would place the onus on an insured, who very likely lacks the sophistication and funds, to mount a defense to the claims or hire an attorney to mount a defense to the claims. This is an inequitable result and places an unfair burden on the insured to participate in a case in which he lacks the knowledge to properly defend himself or select an attorney to defend himself against the third-party injury claim. The State of Nevada should not condone insurers deserting their insureds and skirting their duty to defend without consequence, especially when the insurer has all of the bargaining power over the vulnerable insured. *See* Gray, 65 Cal. 2d at 269, 419 P.2d at 171.

The Supreme Court of California perfectly captured the importance of ensuring that insureds receive the protection from their insurers that they paid for and relied upon:

> In summary, the individual consumer in the highly organized and integrated society of today must necessarily rely upon institutions devoted to the public service to perform the basic functions which they undertake. At the same time the consumer does not occupy a sufficiently strong economic position to bargain with such institutions as to specific clauses of their contracts of performance, and, in any event, piecemeal negotiation would sacrifice the advantage of uniformity.

> Hence, the courts in the field of insurance contracts have tended to require that the insurer render the basic insurance protection which it has held out to the insured. This obligation becomes especially manifest in the case in which the insurer has attempted to limit the principal coverage by an unclear exclusionary clause. We test the alleged limitation in the light of the insured's reasonable expectation of coverage…[.]

Id. at 280, 179.

Appellants request this Court answer the Ninth Circuit's certified question by determining that an insurer that has breached its duty to defend is liable for all losses consequential to the breach as a matter of law, even if they are in excess of the policy limit.

VI. AN INSURER SHOULD STILL BE LIABLE FOR ALL CONSEQUENTIAL DAMAGES THAT RESULT FROM ITS BREACH OF THE CONTRACTUAL DUTY TO DEFEND EVEN IN THE ABSENCE OF BAD FAITH

An insurer's liability for consequential damages that exceed the policy limit resulting from its breach of the duty to defend is the correct outcome because it results from a breach of contract. Therefore, the existence of bad faith, or lack thereof, is not relevant to this Court's inquiry. Rather, the implication that bad faith must somehow be present to render an insurer liable for consequential damages that exceed the policy limit overlooks the differences between causes of action for beach of the duty to defend and the tort of bad faith.

A. The Tort of Bad Faith is Separate and Distinct from a Breach of Contract because it Requires a Heightened Standard of Proof and Allows for the Recovery of Non-Economic Damages

"This court has defined bad faith as "an actual or implied awareness of the absence of a reasonable basis for denying benefits of the [insurance] policy. *Allstate*, 125 Nev. at 308, 212 P.3d at 324 (citing *Am Excess Ins. Co. v. MGM*, 102 Nev. 601, 605, 729 P.2d 1352, 1354-55 (1986)). The absence of bad faith has nothing to do with an insured's recovery of consequential damages beyond the policy limit because "[a] bad faith claim sounds in tort" whereas "a breach of the duty to defend sounds in contract." *See Roehl Trans., Inc. v. Liberty Mut. Ins. Co.*, 325 Wis. 2d 56, 76, 784 N.W.2d 542, 552 (Wis. 2010); *Mesmer v. Maryland Auto Ins. Fund*, 353 Md. 241, 257, 725 A.2d 1053, 1061 (Md. Ct. Spe. App. 1999). "The tort cause of action for bad faith arises out of a contractual arrangement, ***but is not a contract action***." *Roehl Trans, Inc.*, 325 Wis. 2d at 76, 784 N.W.2d at 552 (emphasis added). "Rather, the tort of bad faith is a separate intentional wrong, which results from a breach of a duty imposed as a consequence of the contractual relationship." *Id.* at 77, 552. "Thus, the breach of a duty from which the tort claim follows is ***not of any explicit term of the contractual obligations but of the implicit duty to act in good faith in carrying out the insurance contract***." *Id.* at 77-78, 554 (emphasis added).

The tort of bad faith also requires a heightened standard of proof than a breach of contract claim. *Allstate*, 125 Nev. at 317, 212 P.3d at 330. "[A] bad faith claim requires a showing that the insurer acted in deliberate refusal to discharge its contractual duties." *Id.*

Based on this heightened standard of proof, it is unreasonable for insureds to have to show that their insurers breached not only their contractual duty to defend, but also committed the tort of bad faith to recover damages that exceed the policy limit. Under Nevada's well-established rule of law, a non-breaching party can recover foreseeable consequential damages that result from a breach of contract. *Hornwood*, 105 Nev. at 191, 772 P.2d at 1286. Nevada does not require a non-breaching party to prove that the breaching party acted in bad faith when it breached the contract to recover consequential damages. Therefore, it makes no sense to require an insured to meet this heightened standard of proof to recover foreseeable consequential damages in excess of the policy limit that result from a breach of the duty to defend, particularly because an insurer knows or should know that its failure to defend its insured will result in damages that exceed the policy limit.

The tort of bad faith also allows an insured to recover damages that are otherwise not recoverable under a breach of contract theory. The tort of

bad faith is "intended to provide the insured with a vehicle for compensation for all damages incurred as a result of the insurer's misconduct, including damages for emotional distress" (*i.e.* general damages). *Miller v. Hartford Life Ins. Co.*, 126 Haw. 165, 175, 268 P.3d 418, 428 (Haw. 2011); *Amato*, 53 Cal. App. 4th at 831, 61 Cal. Rptr. 2d at 912-13. By contrast, a breach of contract entitles the party to seek redress under the contract (*i.e.* economic damages). *Cyprus Amax Minerals Co. v. Lexington Ins. Co.*, 74 P.3d 294, 304 (Colo. 2003) (citing *Vanderbeek v. Vernon Corp.*, 50 P.3d 866, 870-71 (Colo. 2002)); *Amato*, 53 Cal. App. 4th at 831, 61 Cal. Rptr. 2d at 912-13. Therefore, the absence of bad faith as a requirement for an insured to recover damages in excess of the policy limit "does not negate the distinction between a breach of the contractual duty to defend and a bad faith breach of contract." *Andrew*, 134 F. Supp. 3d at 1257.

Allowing an insured to recover foreseeable consequential damages for an insurer's breach of the duty to defend, absent bad faith, does not result in the same recovery of damages if an insurer actually commits bad faith. Rather, an insurer who breaches the duty to defend ***and*** commits the tort of bad faith may also be subject to unforeseeable consequential damages, punitive damages, or other non-economic damages. *See Bainbridge, Inc. v. Travelers Cas. Co. of Conn.*, 159 P.3d 748, 756 (Colo. App. 2006) ("If the

circumstances are sufficiently egregious to constitute a tort, then the consequential damages include all damages that were proximately caused by the breach, regardless of foreseeability."); *United Fire Ins. Co. v. McClelland*, 105 Nev. 504, 512, 780 P.2d 193, 198 (1989) (Proof of bad faith, along with evidence of oppression, fraud, or malice, express or implied, establishes liability for punitive damages). Bad faith focuses on the insurer's misconduct and allows for recovery of ***non-economic*** damages because an insurer that commits bad faith "damages the very protection or security which the insured sought to gain by buying insurance." *Miller*, 126 Haw. at 175, 268 P.3d at 428; *see also*, *Campbell v. State Farm Mut. Auto Ins. Co.*, 65 P.3d 1134, 1149 (Utah 2001) (awarding punitive damages because Campbell (the insured) suffered from sleeplessness, heartache, and stress in his marriage and family relationships that resulted from State Farm's bad faith) (overruled on other grounds by *State Farm Mut. Auto. Ins. Co. v. Campbell*, 538 U.S. 408, 123 S. Ct. 1513 (2003)). Insurers' deliberate failure to pay for a loss pursuant to the policy terms can cause an insured, anxiety, financial stress, and worry, which an insured may recover damages for in a bad faith action. *See Gourley v. State Farm Mut. Auto. Ins. Co.*, 53 Cal. 3d 121, 127, 822 P.2d 374, 377 (Cal. Ct. App. 1991); *Purscell v. Tico Ins. Co.*, 959 F. Supp. 2d 1195, 1200 (W.D. Mo. 2013) ("Bad faith consists

of the insurer's intentional disregard of the financial interests of its insured in the hope of escaping its responsibilities under the policy.").

Insurers that consciously and deliberately ignore their insureds' rights to payment of benefits by committing the tort of bad faith may also be liable for punitive damages, which they would not be liable for if they just breached the insurance contract. *See Ainsworth v. Combined Ins. Co.*, 104 Nev. 587, 592, 763 P.2d 673, 675 (1988) (Combined Insurance Company of America was liable for punitive damages when it immediately denied the Ainsworths' claim for insurance benefits without investigation.) (overruled in part by *Powers*, 114 Nev. 690, 962 P.2d 596; *Albert H. Wohlers & Co v. Bartgis*, 114 Nev. 1249, 969 P.2d 949 (1998)).

It makes no sense to impose the burden of requiring an insured to prove the tort of bad faith to recover foreseeable ***economic*** damages for a breach of contract he otherwise would be entitled to outside of the insurance policy context. If an insurer commits the tort of bad faith, in addition to foreseeable economic consequential damages, it will also be liable for other non-economic damages, regardless of foreseeability, that include damages for emotional distress and potentially punitive damages. All of the cases cited above awarded these non-economic damages only when the insurer committed the tort of bad faith, not when the insurer only breached the

insurance contract. Thus, there are other far-reaching consequences for an insurer that commits bad faith along with a breach of the insurance contract. Therefore, an insured should be allowed to recover all foreseeable consequential damages resulting from the contractual breach of the duty to defend in excess of the policy limit, absent bad faith. These recoverable foreseeable consequential damages include the amount of an adverse judgment, default or otherwise, attorney's fees, and costs the insured incurs in mounting his own defense that result from the insurer's breach of the duty to defend.

B. <u>While Some Courts Determined that Bad Faith is Required for an Insured to Recover Damages in Excess of the Policy Limit, these Courts Failed to Acknowledge that Consequential Damages Result from a Breach of the Duty to Defend</u>

There are Courts that have determined that, absent bad faith, insureds may only recover for damages that result from a breach of the insurers' duty to defend to the extent of the policy limit. *Andrew*, 134 F. Supp. 3d at 1256. (citing *State Farm Mut. Auto Ins. Co. v. Paynte*, 122 Ariz. 198, 593 P.2d 948 (Ariz. Ct. App. 1979); *Waite v. Aetna Cas. & Sur. Co.*, 77 Wn.2d 850, 467 P.2d 847 (Wash. 1970)). The *Paynte* Court relied on the general rule that "the measure of damages for the breach of a contract for the payment of money is the amount agreed to be paid with interest." *Mannheimer Bros v. Kansas Casualty & Surety Co.,* 149 Minn. 482, 486, 184 N.W. 189, 191

(Minn. 1921). However, this rationale fails to acknowledge the recovery of foreseeable consequential damages, which a non-breaching party can recover in Nevada. As stated by the federal district court in *Andrew*:

> The duty to defend is not based on the contractual promise to pay a certain amount of money to an injured person. Instead, it is a promise to provide a defense, the breach of which may result in consequential damages to the insured beyond the policy limits.

Andrew, 134 F. Supp. 3d at 1256.

"Contract damages seek to place the aggrieved party in the same economic position he would have been in had the contract been performed." *Frankenmuth Mut. Ins. Co. v. Keeley*, 433 Mich. 525, 557, 447 N.W.2d 691, 705 (Mich. 1989). If insureds were only required to pay the policy limit to the injured third-party as a result of their insurers' breach of the duty to defend, then it would make sense to limit the recoverable damages to the policy limit. However, insurers' breach of the duty to defend almost assuredly will result in a judgment, default or otherwise, against the insured that is in excess of the policy limit. As such, there should be no artificial limitation on insurers' breach of the duty to defend up to only the policy limit, even in the absence of bad faith. To hold otherwise would incentivize insurers to blatantly disregard their duty to defend their insureds because their liability would essentially be capped at the policy limit. This is

especially in true in this case because Lewis's policy limit with UAIC was only $15,000.00. Capping insurers' liability for their breach of the duty to defend at the policy limit would also unfairly expose insureds to excess liability that results from a default judgment without any recourse. This cap would also invite insurers to relitigate the facts alleged in a complaint even though they had the opportunity to dispute these facts before judgment was entered. *See American States Ins. Co. v. Walker*, 223 Ga. App. 194, 196, 477 S.E.2d 360, 363-64 (Ga. Ct. App. 1996) (acknowledging "that such an interpretation would mean that a party could fail to answer any suit, have a judgment entered against him, and then relitigate with impunity and fact issue alleged in the complaint. This cannot be true."). In essence, insurers would be able to profit from their own wrongdoings to the detriment of their insureds and defeat the very purpose of purchasing insurance. As the *Gray* Court explained:

> We have explained that the insured would reasonably expect a defense by the insurer in all personal injury actions against him. It he is to be required to finance his own defense and then, only if successful, hold the insurer to its promise by means of a second suit for reimbursement, we defeat the basic reason for the purchase of insurance. In purchasing his insurance the insured would reasonably expect that he would stand a better chance of vindication if supported by the resources and expertise of his insurer than if compelled to handle and finance the presentation of his case. He would, moreover, expect to be able to avoid the time, uncertainty and capital outlay in finding and retaining an attorney of his own. The courts will not

> sanction a construction of the insurer's language that will defeat the very purpose or object of the insurance.

Gray, 65 Cal. 2d at 278, 419 P.2d at 178.

Insurers should not be encouraged to disregard their duty to provide a defense to their insureds by capping the recovery at the policy limit. Capping insurers' liability for damages up to the policy limit for a breach of the duty to defend will leave insureds to constantly worry if their insurers will abandon them at a time when they need them the most. Insurers that abandon their insureds must face the appropriate repercussions for failing to provide a defense. The only way to ensure that insurers will not leave their insureds without any defense is to hold that an insurer is liable for all foreseeable consequential damages that result from a breach of contract for not providing a defense. This result will not only protect Nevada's insureds, but will also remain consistent with longstanding Nevada law that allows for the recovery of foreseeable consequential damages that stem from a breach of contract.

VII. CONCLUSION

For the reasons set forth above, Appellants respectfully request that this Court conclude, in response to the Ninth Circuit Court of Appeal's certified question of law, that an insurer that has breached its duty to defend,

but has not acted in bad faith, is liable for all losses consequential to its breach including amounts in excess of the policy limit.

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NRAP 26.1 DISCLOSURE STATEMENT

The undersigned counsel of record certifies that the following are the persons and entities as described in NRAP 26.1(a)(1), and must be disclosed. These representations are made in order that the justices of this Court may evaluate possible disqualification or recusal:

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CERTIFICATE OF COMPLIANCE

1. I hereby certify that this brief complies with the formatting requirements of NRAP 32(a)(4), the typeface requirements of NRAP 32(a)(5) and the type style requirements of NRAP 32(a)(6). This brief has been prepared in a proportionally spaced typeface using Microsoft Word for Mac 2011, Version 14.4.1, in 14 point, double-spaced Times New Roman font.

2. I further certify that this brief complies with the type-volume limitations of NRAP 32(a)(7) because, excluding the parts of the brief exempted by NRAP 32(a)(7)(C), it is proportionately spaced, has a typeface of 14 points and contains 13,433 words.

3. Finally, I hereby certify that I have read this appellate brief, and to the best of my knowledge, information, and belief, it is not frivolous or interposed for any improper purpose. I further certify that this brief complies with all applicable Nevada Rules of Appellate Procedure, in particular NRAP 28(e)(1), which requires every assertion in the brief regarding matters in the record to be supported by a reference to the page and volume number, if any, of the transcript or appendix where the matter relied on is to be found. I understand that I may be subject to sanctions in

the event that the accompanying brief is not in conformity with the requirements of Nevada Rules of Appellate Procedure.

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I HEREBY CERTIFY that on the 7th day of November, 2016, I served the foregoing **Appellants' Opening Brief** by electronically filing and serving the document(s) listed above with the Nevada Supreme Court.

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