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

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

Appellants,

v.

UNITED AUTOMOBILE INSURANCE COMPANY,

Respondent.

APPELLANTS' REPLY BRIEF

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

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I. RESPONDENT AND *AMICI CURIAE* IMPROPERLY CITE TO FACTS OUTSIDE OF THE CERTIFICATION ORDER THAT ARE NOT INSTRUCTIVE TO DETERMINE THIS NARROW ISSUE OF LAW

Respondent and *Amici Curiae* both provide this Court with facts far beyond the certification order that are not relevant to this Court's determination. The Nevada Supreme Court is "…bound by the facts as stated in the certification order." *In re Fountainbleau Las Vegas Holdings, LLC*, 127 Nev. 941, 956, 267 P.3d 786, 795 (2011). Nowhere in the Ninth Circuit's certification order is the federal district court quoted, at length, regarding the lack of causal connection between the default judgment and Respondent's breach of the duty to defend. *In re Nalder*, 824 F.3d 854 (9th Cir. 2016). Moreover, the district court's findings concerning the bad faith claim, which are the subject of appeal, are not relevant to this court's resolution of the question. The Ninth Circuit will handle the disposition of the appellate issues. Yet, Respondent quotes the federal district court at length regarding this opinion in its brief under the guise of providing context to the issues. *See* Respondent's Answering Brief, at p. 1, n.1. This quote is meant to unduly influence the Nevada Supreme Court. The same can be said for the footnote in *Amici Curiae*'s brief that Appellants were "friends" in an effort to speculate that they could have settled Cheyanne Nalder's claim. *See Amici Curiae* Brief, at p. 5, n.1.

The question this Court is called to answer is critical to the further development of insurance law in Nevada. It is not dependent on the facts in this case. There is no need for Respondent or *Amici Curiae* to provide this Court with additional context related to the federal district court's decision regarding this issue, especially because the Ninth Circuit previously reversed the federal district court's grant of summary judgment. This matter is back before the Ninth Circuit a second time. *Id.* at 856.

II. THE NATURE OF THE RELATIONSHIP BETWEEN INSURER AND INSURED DOES NOT ENTITLE THE INSURER TO A SPECIAL RULE THAT ABSOLVES IT OF LIABILITY FOR CONSEQUENTIAL DAMAGES RESULTING FROM A BREACH OF THE DUTY TO DEFEND

Respondent and *Amici Curiae* disregard the unique relationship between an insurer and an insured to support their untenable argument that insurers should be treated differently from all other contracting parties in Nevada and not be liable for all foreseeable consequential damages. "The insurance industry is heavily regulated by the state because it is an important ***public trust."*** *Ainsworth v. Combined Ins. Co.*, 104 Nev. 587, 592, 763 P.2d 673, 676 (1988) (emphasis added). The important role insurance plays in society serves as the requisite foundation for an insurer's relationship with an insured to be one of special confidence. *Id.* at 592, 676.

"Insurance contracts are unlike ordinary bilateral contracts." *Goodson v. Am. Std. Ins. Co.*, 89 P.3d 409, 414 (Colo. 2004). "Insureds enter into insurance

contracts for financial security obtained by protecting themselves from unforeseen calamities and for peace of mind, rather than to secure commercial advantage." *Id.* "[T]here is a disparity of bargaining power between the insurer and the insured; because the insured cannot obtain materially different coverage elsewhere, insurance policies are generally not the result of bargaining." *Id.* Thus, an insurance company maintains a position of trust with regard to its insured to form a "quasi-fiduciary relationship." *Id.* at 414-15.

Nevada has recognized this special relationship as being fiduciary in nature. *Powers v. United Servs. Auto Ass'n.*, 114 Nev. 690, 700, 962 P.2d 596, 603 (1998). The nature of this "…relationship requires that the insurer adequately protect the insured's interests." *Allstate v. Miller*, 125 Nev. 300, 311, 212 P.3d 318, 326 (2009). "Thus, at a minimum, an insurer must equally consider the insured's interests and its own." *Id.*

Insurance contracts are ones of adhesion. *Farmers Insurance Group v. Stonik*, 110 Nev. 64, 67, 867 P.2d 389, 391 (1994). An insurance policy is an agreement over terms in which the consumer has no control and the insurance company has unimpeded control. *Century Sur. Co. v. Jim Hipner, LLC*, 377 P.3d. 784, 789 (Wyo. 2016). Insurance policies are presented to prospective policyholders on a take it or leave it basis. *Meier v. N.J. Life Ins. Co.*, 101 N.J. 597, 612, 503 A.2d 862, 869 (N.J. 1986). It is widely recognized that "…a lay

person lacks the necessary expertise to read and understand insurance policies, which are typically long, set out in very small type and written from a legalistic insurance expert's perspective." *Atwater Creamery Co. v. Western Nat'l Mut. Ins. Co.*, 366 N.W.2d 271, 277 (Minn. 1985). As such, it is the insureds, not the insurers, who always remain the more vulnerable party because of the inequality in not only bargaining power, but also sophistication.

> It is a matter of almost common knowledge that a very small percentage of policy holders are actually cognizant of the provisions of their policies and many of them are ignorant of the names of the companies issuing said policies. The policies are prepared by the experts of the companies, they are highly technical in their phraseology, they are complicated and voluminous and in their numerous conditions and stipulations furnishing what may be veritable traps for the unwary. Courts, while zealous to uphold legal contracts, should not sacrifice the spirit to the letter nor should they be slow to aid the confiding and innocent.

United States Fid. & Guar. Co. v. Ferguson, 698 So.2d 77, 81 (Miss. 1997).

Despite the disparity in bargaining power and expertise, Respondent and *Amici Curiae* contend insurers should be protected by a special rule absolving them of all liability for foreseeable consequential damages from their breach of the duty to defend. This not only undermines the importance of the duty to defend to an insured, but also provides no incentive for an insurer to fulfill its duties. In fact, it creates a disincentive for an insurer to fulfill its duty to defend if it knows the damages are capped at the policy limits for breaching this duty.

Respondent contends that the courts will be clogged with declaratory relief actions if an insurer is held liable for all foreseeable consequential damages

resulting from its breach of the duty to defend. This argument is not persuasive. "An insurer seeking to avoid its duty to defend an insured bears a heavy burden." *Hecla Mining Co. v. New Hampshire Ins. Co.*, 811 P.2d 1083, 1089 (Colo. 1991).

> The appropriate course of action for an insurer who believes that it is under no obligation to defend, is to provide a defense to the insured under a reservation of rights to seek reimbursement should the facts at trial prove that the incident resulting in liability was not covered by the policy, or to file a declaratory relief action after the underlying case has been adjudicated.

Id.

An insurer has an absolute duty to defend an action brought against its insured that even potentially seeks damage covered by the policy. *Rockwood Ins. Co. v. Federated Capital Corp.*, 694 F. Supp. 772, 776 (D. Nev. 1988). In determining whether an insurer has a duty to defend, the insured must receive the benefit of the doubt. *United Servs. Auto. Assn. v. Speed*, 179 Wn. App. 184, 196, 317 P.3d 532, 539 (Wash. Ct. App. 2014). Liability insurers, as sophisticated professional litigants, have numerous legal options available to avoid the consequences of breaching the duty to defend.

Amici Curiae believe that public policy is best served if insurers are not liable for all foreseeable consequential damages resulting from their breach of the duty to defend. They believe that holding insurers liable for the policy limits plus attorneys' fees and costs provides for a "simple and certain measure of damages," which is important to "the predictability and certainty of insurance contracts." *See*

Amici Curiae Brief, at p. 13. This view completely disregards the interests of Nevada's insureds who are already in a vulnerable position to begin with. Insurers uniquely understand that without a defense, an insured faces a substantial adverse judgment, default or otherwise. This is well known at the time the policy is issued, which is why insurers promise to defend in the event of a lawsuit and control the litigation. Thus, insurers are in a better position to take this outcome into account and protect their interests. The argument of increased premiums and unnecessary burdens on insurance companies is completely unsubstantiated and speculative, at best. Insurers are the most frequent users of declaratory relief proceedings to gain legal guidance and a determination as to the scope of their obligations. The financial interests of insurance companies should not be placed above Nevada consumers, particularly when insurers' conduct is wrongful. An industry that occupies such a superior bargaining position deserves no special rules limiting its damages for breach of contract to the policy limits.

III. AN INSURER'S BREACH OF THE DUTY TO DEFEND IS UNREASONABLE CONDUCT THAT SHOULD RESULT IN LIABILITY FOR CONSEQUENTIAL DAMAGES EVEN IF THEY EXCEED THE POLICY LIMITS

Respondent and *Amici Curiae* argue that damages in excess of the policy limits are solely reserved for insurers who commit the tort of bad faith. They believe the liability limits of the policy act as a cap on damages for breaching the duty to defend. The insurance industry, which is one of the most sophisticated,

regulated and important to society, seeks a special rule from this Court that excuses conduct (*i.e.* breach of contract) that is legally wrongful and unreasonable by definition. An insurer who breaches its contract by not fulfilling one of the most important covenants available under the policy (*i.e.* duty to defend) has, by definition, acted unreasonably. An insurer who does not provide a defense based upon its belief coverage does not apply does so at its own risk. *Howard v. American National Fire Ins. Co.*, 187 Cal. App. 4th 498, 529, 115 Cal. Rptr. 3d 42, 69 (Cal. Ct. App. 2010). A failure to provide a defense even under the erroneous belief there is no coverage is wrongful. *Id.* Insurers should be held to the same standard as all other contracting parties and be liable for all foreseeable losses, including consequential damages, that result from their breach.

Respondent and *Amici Curiae* overlook the critical distinctions between the measure of damages under contract versus tort law. These distinctions are critical to the Court's inquiry. Under a breach of contract theory, damages are already limited by what is reasonably foreseeable at the time of contracting. *Hornwood v. Smith's Food King No. 1*, 105 Nev. 188, 190, 772 P.2d 1284, 1286 (1998). However, if the conduct is sufficiently egregious to rise to the level of bad faith, an insured may recover damages proximately caused by the insurer's bad faith, regardless of foreseeability. *Vanderbeek v. Vernon Corp.*, 50 P.3d 866, 871 (Colo. 2002); *see also Guaranty Nat'l Ins. Co. v. Potter*, 112 Nev. 199, 208, 912 P.2d

267, 273 (1996). The line of demarcation between a contractual breach of the duty to defend and the tort of bad faith is not blurred if this Court holds an insurer liable for all foreseeable consequential damages that result from its breach of the duty to defend, even in excess of the policy limits.

Appellants acknowledge that some courts hold that in the absence of bad faith, an insured can only recover up to the policy limits plus attorney's fees and costs in defending the underlying action. *Mesmer v. Maryland Auto Ins. Fund*, 353 Md. 241, 725 A.2d 1053 (Md. Ct. App. 1999); *Mannheimer Bros. v. Kansas Casualty & Surety Co.*, 149 Minn. 482, 184 N.W.2d 189 (Minn. 1921). However, these decisions are not persuasive because they overlook the strict distinction between the remedies available for a breach of contract and the tort of bad faith.

Respondent and *Amici Curiae*'s view of the contractual duty to defend downplays its significance. Insureds rely on their insurers to provide the security and protection needed to defend against claims in which the insured may or even potentially could be found liable. *United Nat'l Ins. Co. v. Frontier Ins. Co.*, 120 Nev. 678, 687, 99 P.3d 1153, 1158 (2004). The duty to defend is, in many ways, even more important to an insured than the duty to indemnify. As a result, insurers, who are more sophisticated, should not be incentivized to breach their duty to defend knowing their liability is limited to the policy limits. This view not only contravenes Nevada law regarding recoverable damages for a breach of

contract, but also creates an environment in which insurers are apt to abandon their insureds and manufacture a reason why no defense was provided.

A. Bad Faith is Not a Prerequisite for Insurers to be Liable for All Losses Consequential to An Insurer's Breach of the Duty to Defend, Including a Judgment, Default or Otherwise

Respondent and *Amici Curiae* overlook the distinction this Court has enumerated regarding a tort theory and contract theory of liability for breach of the implied covenant of good faith and fair dealing. The covenant of good faith and fair dealing is implied into every commercial contract. *Ainsworth*, 104 Nev. at 592 n.1, 763 P.2d at 676. A plaintiff may recover tort damages for a breach of the implied covenant of good faith and fair dealing where a special relationship exists. *United States Fidelity & Guar. Co. v. Peterson*, 91 Nev. 617, 619-20, 540 P.2d 1070, 1071 (1975). Alternatively, a plaintiff may recover contract damages for breach of the implied covenant of good faith and fair dealing in a commercial contract. *A.C. Shaw Constr. v. Washoe County*, 105 Nev. 913, 915, 784 P.2d 9, 10 (1989). "[A]n action in tort for breach of the covenant arises only in rare and exceptional cases when there is a special relationship between the victim and tortfeasor, such as insured and insurer. *Ins. Co. of the West v. Gibson Tile Co.*, 122 Nev. 455, 461, 134 P.3d 698, 702 (2006); *see also*, *Hilton Hotels Corp. v. Butch Lewis Prods.*, 107 Nev. 226, 233, 808 P.2d 919, 923 (1991). (The difference between the two actions in good faith covenant cases is that the tort action requires

"a special element of reliance or fiduciary duty"). "A special interest is characterized by elements of public interest, adhesion, and fiduciary responsibility. *Ins. Co. of the West*, 122 Nev. at 461, 134 P.3d at 702. The tort remedy is therefore, a narrow one found, for instance, in insurance cases. *Peterson*, 91 Nev. at 619-20, 540 P.2d at 1071 (1975). A tort remedy is meant to ensure a victim is fully compensated for all damages proximately caused by tortious conduct, regardless of foreseeability. Contractual damages alone do not provide a sufficient remedy for the tort of bad faith.

> The rationale for allowing tort liability is that …ordinary contract damages do not adequately compensate the victim because they do not require the party in the superior position, such as the insurer…to account adequately for grievous and perfidious misconduct; and contract damages do not make the aggrieved, weaker, "trusting" party whole.

K Mart Corp. v. Ponsock, 103 Nev. 39, 49, 732 P.2d 1364, 1371 (1987).

Given the ability to recover in contract ***or*** in tort for breach of the implied covenant of good faith and fair dealing, a plaintiff need not prove a tort was committed to recover contractual damages.

> The law would be incongruous if the covenant is implied in *every* contract, and yet the only remedy for breach of that covenant is if tort damages are alleged and there exists a special relationship between the tort victim and the tortfeasor.

A.C. Shaw, 105 Nev. at 915, 784 P.2d at 10.

A.C. Shaw and *Butch Lewis* establish that a party's breach of contract allows a plaintiff to recover contract damages for breach of the implied covenant of good

faith and fair dealing. A plaintiff who sues for breach of contract does not have to also prove the breaching party committed a tort to recover consequential damages. Yet, Respondent and *Amici Curiae* argue an insured not only has to prove his insurer breached its contractual duty to defend, but also that his insurer committed the tort of bad faith simply to recover purely contractual damages above the policy limits. This argument places an unreasonable burden on insureds harmed by a breach of contract that no other plaintiff has to bear with regard to the breach of any other commercial contract. To prove that an insurer committed the tort of bad faith, a plaintiff must show an actual or implied awareness of the absence of a reasonable basis for its claim decision-making. *Miller*, 125 Nev. at 308, 212 P.3d at 324. The standard for insurance bad faith in Nevada is significantly more rigorous as it gives rise to a tort remedy and potential punitive damages. *Ainsworth*, 104 Nev. at 592-94, 763 P.2d at 676-77.

An insured should not have to prove additional wrongful conduct on the part of an insured that breaches its contractual duty to defend in order to recover foreseeable consequential damages, which may exceed the policy limits. *See Luke v. American Family Mut. Ins. Co.*, 476 F.2d 1015, 1020 (8th Cir. 1972) ("A breach of contract is never justified simply because the offending party in good faith believes he is entitled to refuse performance"). The existence of good faith or bad

faith is of no consequence for a non-breaching party to recover all damages that stem from the insurer's breach of contract.

The duty to defend arises solely from the language of the insurance contract. *Miller*, 125 Nev. at 309, 212 P.3d at 324.; *see also*, *Stockdale v. Jamison*, 416 Mich. 217, 224, 330 N.W.2d 389, 392 (Mich. 1982) (overruled on other grounds). "A breach of that duty can be determined objectively, without reference to the good or bad faith of the insurer." *Stockdale*, 416 Mich. at 224, 330 N.W.2d at 392.

> 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.
>
> In the commercial contract situation, unlike the tort and marriage contract actions, the injury which arises upon a breach is a financial one, susceptible of accurate pecuniary estimation. ***The wrong suffered by the plaintiff is the same, whether the breaching party acts with a completely innocent motive or in bad faith***.

Id. at 225, 392.

Respondent and *Amici Curiae* attempt to minimize the culpability of an insurer that fails to provide a defense and litigation management. Respondent and *Amici Curiae* argue a special rule should apply to insurers. Insurers do not require any special protection. Creating such a special rule for insurers will place their interests over Nevada's insureds and will provide no incentive for insurers to fulfill their obligation.

B. An Insurer's Liability for Consequential Damages that Stem from its Contractual Breach of the Duty to Defend Does Not Make a Breach of Contact Claim Indistinguishable from a Bad Faith Claim

Respondent and *Amici Curiae* believe that holding an insurer liable for all consequential damages, in excess of the policy limits, from a breach of the duty to defend will "transform an ordinary breach of contract into a bad faith claim." *See Amici Curiae* Brief, at p. 3. However, the distinction between damages recoverable for an insurer's breach of contract versus the tort of bad faith breach of contract will not be affected.

Nevada law expressly allows a nonbreaching party to a contract to recover consequential damages provided those damages are foreseeable. *Hornwood*, 105 Nev. at 190, 772 P.2d at 1286; *Clark County School Dist. v. Rolling Plains Constr., Inc.*, 117 Nev. 101, 106, 16 P.3d 1079, 1082 (2001). The amount of foreseeable damages is irrelevant to this inquiry. *Harmon Cable Communications Ltd. Partnership v. Scope Cable Television, Inc.*, 237 Neb. 871, 888, 468 N.W.2d 350, 362 (Neb. 1991). Consequential contractual damages are already limited by foreseeability. They should not be further arbitrarily limited by an insurer's policy limits.

A party who breaches a contract is "…responsible for those damages that he should reasonably have contemplated as the probable result of a breach at the time the contract was entered into." *Clark County*, 117 Nev. at 106, 16 P.3d at 1082.

This rule is logical because both parties accounted for the possibility of these losses when the contract was formed:

> Because the party is aware, or should be aware, that these damages are a potential consequence of breach, he presumably will take into account the risk that these contingencies will occur…. Thus, by limiting contractual liability to those damages foreseen by the parties at the time the contract was formed, [this rule] ensures that the bargain struck reflects a mutually agreeable allocation of the risks and costs of breach.

Vanderbeek, 50 P.3d at 871.

In contrast, a tort "…[involves] a right taken without consideration of any agreement or contract. *Id.* A tort victim has no ability to negotiate with the tortfeasor and, as a result, no opportunity to allocate the risk that a specific consequence will occur or evaluate the cost if it should. *Id.* Thus, whether a tort victim contemplated a particular consequence as the probable result of the tort when it occurred is irrelevant. *Id.*

> The distinction between damages in tort and damages for breach of contract is not a mere matter of form, since a party to a contract is given the legal option to perform or pay damages, and in order to allow the party to evaluate his options in a meaningful way, one who breaks a contract is liable only for those damages which one could reasonably anticipate.

Id.

The standard for recovery of damages in tort, even if the tort involves interference with the performance of a contract, is based upon proximate cause as opposed to contemplation of the parties. *Id.* at 872. This Court expressly adopted

this standard in *Miller*: "Once an insurer violates its duty of good faith and fair dealing, it is liable to pay ***all*** compensatory damages proximately caused by its breach…." 125 Nev. at 314, 212 P.3d at 327-38 (emphasis added).

"General damages for a breach of the duty to defend include those flowing naturally from the breach: the costs and reasonable attorney fees incurred by the insured in defending itself against the claims asserted." *Bainbridge, Inc. v. Travelers Cas. Co.*, 159 P.3d 748, 756 (Colo. App. 2006).

> ***Additionally, the insured may recover consequential damages for the breach which, if based on contract principles, include those damages that arose naturally from the breach and were reasonably foreseeable at the time of the contract.***

Id. (citing *Vanderbeek*, 50 P.3d at 870-72) (emphasis added).

On the other hand, if the insurer commits the tort of bad faith then the consequential damages include all damages that were ***proximately caused*** by the breach, ***regardless of foreseeability***. *Id.*; *see also*, *Miller*, 125 Nev. at 314, 212 P.3d at 327-28.

An insurer's commission of a tort exposes it to a wide variety of noneconomic damages, regardless of foreseeability, that are not recoverable for a breach of contract. A bad faith claim can result in three types of potential damages: "(1) benefit of the bargain damages for an accompanying breach of contract claim, (2) compensatory damages for the tort of bad faith, and (3) punitive damages for intentional, malicious, fraudulent, or grossly negligent conduct."

Transp. Ins. Co. v. Moriel, 879 S.W.2d 10, 17 (Tex. 1994). This Court has recognized the different types of damages in bad faith cases. *See e.g.*, *Peterson*, 91 Nev. at 618-20, 654 P.2d at 1070-71; *Potter*, 112 Nev. 199, 912 P.2d 267; *Miller*, 125 Nev. at 314, 212 P.3d at 327-28.

In *Peterson*, K.H. Peterson Construction Co. entered into an agreement with the U.S. Forest Service for construction of a roadway in Elko County. 91 Nev. at 618, 654 P.2d at 1070. The U.S. Forest Service had a contract with Nevada Power regarding a pipe and trestle that ran alongside the roadway construction that provided for liquidated damages if interruption of the flow of water occurred. *Id.* at 61, 1071. K.H. covered this contingency by purchasing liability insurance from Fidelity. *Id.* During construction, damage occurred to the pipe and trestle. *Id.* When K.H. submitted claims under his policy, Fidelity deliberately delayed and eventually refused to submit payment even though it knew about K.H.'s worsening financial condition. *Id.*

K.H. sought to recover consequential damages from Fidelity's bad faith refusal to pay, which caused K.H. to lose his business and credit. *Id.* On appeal, this Court concluded that an insured could recover consequential damages that occur as a result of bad faith breach of the implied covenant of good faith and fair dealing. *Id.* However, "[t]he duty violated arises not from the terms of the insurance contract but is a duty imposed by law, the violation of which is a tort."

Id. Here, Fidelity's commission of bad faith caused consequential damages that adversely impacted K.H.'s financial condition and placed stress on the company. *Id.* at 620, 1071. This led to K.H.'s exhaustion of operating capital necessary to run his business and loss of economic opportunity by seeking other business. *Id.*

This Court upheld the award of similar compensatory tort damages stemming from an insurer's commission of bad faith in *Potter*. 112 Nev. at 206, 912 P.2d at 272. In *Potter*, Valerie and Gerald Potter were injured in a motor vehicle accident and made an underinsured motorist claim with their insurer, GNIC. *Id.* at 200, 269. In response, GNIC requested the Potters submit to independent medical exams ("IME") pursuant to their policy. *Id.* Under the policy, GNIC was required to pay for the IMEs. *Id.* However, after the Potters underwent the IMEs, GNIC failed to pay the medical provider. *Id.* at 202-03, 270.

The Potters continually received bills demanding payment for the IMEs that culminated in the referral of these bills to collections. *Id.* at 203, 270. They received notices that their credit was being adversely affected and a notice from the collections company threatening to sue them. *Id.* at 204, 271. Despite informing GNIC of these bills, GNIC failed to take corrective action and the collections company filed suit against the Potters. *Id.* In turn, the Potters filed a third-party complaint against GNIC for breach of contract, tortious breach of the covenant of good faith and fair dealing, and fraud. *Id.* At the bench trial, the judge awarded

the Potters $150,000 in compensatory damages and $1,000,000 in punitive damages because the Potters met their burden of proof on their bad faith claim. *Id.* at 205, 271-72.

On appeal, this Court affirmed the award of compensatory damages totaling $75,000 to each of the Potters because the award was "…consistent with the two years of threats and subsequent litigation the Potters had to endure." *Id.* at 207, 273. The compensatory damage award also compensated the Potters for the damage to their credit reputation and their anxiety that resulted from the threats and litigation. *Id.* This Court reduced the punitive damages award stemming from GNIC's bad faith. *Id.*

As illustrated by *Peterson* and *Potter*, the commission of the tort of bad faith exposes an insurer to a wide range of both economic and non-economic damages that are not available in a normal breach of contract action. "Because actionable bad faith is a tort, a plaintiff should not be limited to the economic damages within the contemplation of the parties at the time the contract was made. *Coventry v. American States Ins. Co.*, 136 Wn.2d 269, 284, 961 P.2d 933, 93 (Wn. 1998).

> Not only do the factual requirements of a bad-faith claim differ from a breach-of-contract claim, the remedies are different too. The breach-of-contract claim entitles a plaintiff to recover the benefit-of-the-bargain damages. A bad-faith claim, however, is a tort. Among other things, compensatory, emotional distress, and punitive damages are available against the insurance company.

Villarreal v. United Fire & Cas. Co., 873 N.W.2d 714, 734 (Iowa 2016).

Requiring an insured to prove breach of contract ***and*** the tort of bad faith to recover consequential damages in excess of the policy limits imposes an unfair burden on insureds. Insureds are already placed in an untenable position because an insurance policy is a contract of adhesion. *United Nat'l*, 120 Nev. at 684, 99 P.3d at 1156. Insureds have a reasonable expectation that their insurers will defend them against any third-party claims that implicate coverage because they are required to do so under Nevada law. *Benchmark Ins. Co. v. Sparks*, 127 Nev. 407, 412, 254 P.3d 617, 620 (2011). Insurers should be held liable for all economic damages for breaching a contractual duty under the policy. In the case of a breach of the duty to defend, such damages include an adverse judgment, default or otherwise. Respondent and *Amici Curiae* fail to provide any legitimate basis to treat insurers differently than other contracting parties.

IV. AN INSURER'S LIABILITY FOR BREACH OF ITS CONTRACTUAL DUTY TO DEFEND SHOULD NOT BE CAPPED AT THE POLICY LIMITS PLUS REASONABLE ATTORNEY'S FEES AND COSTS INCURRED BY THE INSURED

Respondent and *Amici Curiae* believe the proper measure of damages for a breach of the contractual duty to defend is the policy limits plus reasonable attorney's fees and costs. While this is an issue the Nevada Supreme Court has not addressed, "[w]here Nevada law is lacking, its courts looked to the law of other jurisdictions, particularly California for guidance." *Mort v. United States*, 86 F.3d 890, 893 (9th Cir. 1996); *see also*, *Landow v. Medical Ins. Exch.*, 892 F. Supp.

239, 240 (D. Nev. 1995) (Nevada looked to California law to establish the implied covenant of good faith and fair dealing in insurance contracts).

The California Supreme Court and California Court of Appeals concluded an insurer that breaches its duty to defend is liable for the full amount of any resulting judgment against its insured. *Gray v. Zurich Ins. Co.*, 65 Cal. 2d. 263, 279, 419 P.2d 168, 178 (Cal. 1966); *Archdale v. American Internat. Speciality Lines Ins. Co.*, 154 Cal. App. 4th 449, 469-70, 64 Cal. Rptr 3d 632, 649-50 (Cal. Ct. App. 2007). In *Gray*, the California Supreme Court concluded "an insurer that wrongfully refuses to defend is liable on the judgment against the insured" because it is "manifestly bound to reimburse its insured for the full amount of any obligation reasonably incurred by him." 65 Cal. 2d at 280, 419 P.2d at 179. In *Archdale*, which was cited by this Court in *Miller*, 125 Nev. at 312, 212 P.3d at 326, the California Court of Appeals held an insured can recover damages in excess of the policy limits for an insurer's breach of contract because:

> [t]he allowance of a 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.

154 Cal. App. 4th at 469-70, 64 Cal. Rptr. 3d at 649-50.

This result makes sense because the purpose of liability policy limits is to pay injured third parties, not to limit damages caused by the insurer itself.

A. The Policy Limits of an Insurance Policy Should Not Restrict an Insurer's Liability for Consequential Losses

Liability policy limits "[are only] a restriction of the amount the insurer may have to pay to a third party claimant in connection with a claim on the policy" caused by an insured's wrongful conduct. *Comunale v. Traders General Ins. Co.*, 50 Cal. 2d 654, 659, 328 P.2d 198, 201 (Cal. 1958). Policy limits do not restrict the damages recoverable by an insured for breach of contract by the insurer. *Id; see also Newhouse v. Citizens Sec. Mut. Ins. Co.*, 176 Wis. 2d 824, 837, 501 N.W.2d 1, 6 (Wis. 1993). Thus, an insured contracts for the insurer to pay up to the policy limits as compensation to a third-party claimant, not as the amount the insurer is liable for if it breaches the insurance contract. *Comunale*, 50 Cal. 2d at, 659, 328 P.2d at 201.

> The general rule is that where an insurer wrongfully refuses to defend on the grounds that the claim against the insured is not within the coverage of the policy, the insurer is guilty of breach of contract which renders it liable to the insured for all damages that naturally flow from the breach.

Newhouse, 176 Wis. 2d at 837, 501 N.W.2d at 6.

"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." *Andrew v. Century Surety Co.*,

134 F. Supp. 3d 1249, 1255 (D. Nev. 2015) (holding, under Nevada law, an insurer liable for the full amount of a default judgment for breach of the duty to defend).

> 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; (2) costs and attorney fees incurred by the insured in defending the suit; and (3) any additional costs that the insured can show naturally resulted from the breach.

Newhouse, 176 Wis. at 837, 501 N.W.2d at 6; *see also*, *Andrew*, 134 F. Supp. 3d at 1255.

Respondent and *Amici Curiae* argue to this Court that insurers should be held to a lower standard when they breach their duty to defend, one of the most important benefits of an insurance contract. They believe that because insurers contract to pay, at most, the policy limits plus attorneys' fees and costs if they defend an insured, that this should also be enough when they do not defend. Not only does this argument place an unreasonable cap on recoverable damages that stem from a breach of contract, but also unfairly holds insurers less accountable for their own actions. Respondent and *Amici Curiae* would have this Court believe that insurers lack the understanding of the ramifications associated with breaching their duty to defend. This is absurd.

Insurers have the right to control the defense and settlement of a third party action against their insureds, which makes them a direct participant in the litigation. *Gafcon, Inc. v. Ponsor & Associates*, 98 Cal. App. 4th 1388, 1407, 120 Cal. Rptr. 2d 392, 405 (Cal. Ct. App. 2002). The duty to defend requires that

insurers control every aspect of the defense to give their insureds peace of mind and assistance while they navigate through the foreign process of litigation. Insureds depend on insurers to provide this defense because this is one of the main benefits that insureds pay premiums to receive.

Insurers routinely defend thousands, if not more, third-party liability lawsuits every year and should know that their failure to defend has consequences. One of those consequences is a default judgment. Therefore, an adverse judgment entered against an insured is a reasonably foreseeable result of an insurer's breach of the contractual duty to defend.

Consider for example the case of a legal malpractice lawsuit filed against an attorney along with an allegation of breach of contract. *See Hewitt v. Allen*, 118 Nev. 216, 219, 43 P.3d 345, 346 (2002) (a client may recover under either a malpractice [tort] or breach of contract theory). Suppose the client pays the attorney a $2,500 retainer pursuant to the terms of the agreement in exchange for legal services related to the defense of a lawsuit. After receiving payment of the retainer, the attorney fails to file an answer on behalf of his client, which results in a default judgment of $10,000. Pursuant to *Hornwood* and *Clark County*, the client is entitled to recover not only his $2,500 retainer, but also the $10,000 default judgment as a consequential damage resulting from his attorney's breach of their retainer agreement. This is so because the $10,000 default judgment is a

reasonably foreseeable consequential damage that resulted from the breach of contract. Insurers must be held to the same standard.

Respondent and *Amici Curiae* believe that payment up to the policy limits plus attorneys' fees and costs will put the insured in as good a position as if the contract was performed. This is simply not the case. If a default judgment is entered, the insured is responsible for paying it. Respondent and *Amici Curiae* fail to explain why an insured "should be placed in the predicament of potential responsibility for payment of any of the default judgment." *Delatorre v. Safeway Ins. Co.*, 989 N.E.2d 268, 276 (Ill. App. Ct. 2013). If an insurer provides a defense, then it nearly eliminates the chance that a default judgment will be entered against the insured. However, the failure to defend exposes the insured to a potential default judgment. Capping an insurer's liability of the breach of the duty to defend to the policy limits fails to hold insurers fully accountable for their breach. The policy limits are meant to pay a third-party for injuries caused by the insured, not as a limitation for an insurer's breach of the duty to defend to its insured.

"An insurer's duty to defend is independent of its duty to pay, and damages for breach of that duty are not limited to the face amount of the policy." *Stockdale*, 416 Mich. at 225, 330 N.W.2d at 392. "The insurance company must pay damages necessary to put the insured in the same position he would have been in had the

insurance company fulfilled the insurance contract." *Newhouse*, 176 Wis. 2d at 838, 501 N.W.2d at 7. Payment of an adverse judgment, default or otherwise, that directly flows from the insurer's breach of the contractual duty to defend is the only way an insured will be put in the same position.

> We do not see any justification for a special rule limiting the amount of damages recoverable for an insurer's failure to defend or any reason why it should not be held to be responsible, just as any other party to a contract who fails to perform it, for all the loss arising naturally from the breach.

Stockdale, 416 Mich. at 226, 330 N.W.2d at 393.[1]

B. Insureds Will Likely Not Incur Attorneys' Fees and Costs if an Insurer Breaches the Contractual Duty to Defend because of Their Lack of Sophistication

Respondent and *Amici Curiae* presume that insureds will have the foresight, experience, and financial ability to hire their own attorneys if their insurers fail to provide them with a defense. As a result, they believe this is the only other additional cost insurers should be responsible for when they breach the contractual duty to defend. However, this argument overlooks the differences between insurers fulfilling their duty to defend and mere reimbursement for defense

[1] Michigan follows the minority view that assignees of the rights of insureds can only recover the amount which they would have recovered against the insureds if they sought to enforce their judgments. Nevada has implicitly rejected this view and follows the judgment rule. *See Miller*, 125 Nev. at 307, 212 P.3d at 323. Specifically, in *Miller*, the insured recovered $1,079,784.88 against the insurer, which was more than the underlying judgment against him for $703,619.88. *Id.*

expenditures that an insured, in all likelihood, will not incur. They are not synonymous as explained by the Minnesota Supreme Court:

> The burden of litigation extends beyond the monetary costs of litigation and encompasses hiring attorneys and managing lawsuits. As the insurers argue, if an insurer breaches its duty to defend, the insured must do twice what it contracted to avoid: hire attorneys and manage a lawsuit….

In re Silicone Implant Ins. Coverage Litig., 667 N.W.2d 405, 425 (Minn. 2003)

Insureds pay premiums to their insurers in exchange for them to defend them against claims that are at least potentially covered under the policy. This is done because insureds understand that insurance companies maintain a level of expertise that is above their own with regard to litigation. *Garner v. American Mut. Liability Ins. Co.*, 31 Cal. App. 3d 843, 849, 107 Cal. Rptr. 604, 608 (Cal. Ct. App. 1973) (An insurance company owes its insured its experience and expertise in total claims evaluation). Thus, it is unreasonable to expect an insured to hire an attorney at his own cost to defend himself when his insurance company abandons him at a time he needs it the most. In all likelihood, the insured will not know what to do when his insurance company breaches its duty to defend and will be responsible for an adverse judgment because of the breach. This effectively means that an insurer would only ever have to pay the policy limits for its breach of the duty to defend, which is completely unrelated to the resulting damage from the breach. This will result in a windfall for insurance companies because they will never have to pay above the policy limits despite their deliberate failure to abide by

the terms of their contracts. Insurers will also take a more liberal position that a third-party claim is not covered by the policy and not tender a defense because they know that, even if they are wrong, they will never have to pay above the limits. The ruling that Respondent and *Amici Curiae* seek from this Court will lead to this disastrous outcome for Nevada's insureds.

V. CONCLUSION

Based on the foregoing, Appellants respectfully request that this Court conclude that an insurer that has breached its duty to defend, in the absence of bad faith, is liable for all losses consequential to its breach including any amount in excess of the policy limits.

DATED this 16th day of February, 2017.

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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 6,917 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.

DATED this 16th day of February 2017.

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that this document was filed electronically with the Nevada Supreme Court on the 16th day of February, 2017. Electronic service of the foregoing **APPELLANTS' REPLY BRIEF** shall be made in accordance with the Master Service List as follows:

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