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# New Mexico Bad Faith

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**NEW MEXICO BAD FAITH**

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## I. INTRODUCTION

With the introduction of the automobile came a marked increase in complaints and tension between insureds and their insurance companies.<sup>1</sup> As a result, a significant development in insurance law is that insurers may be held liable in tort for bad faith performance of their duties to insureds. The law of bad faith contemplates that a special relationship exists between insurance companies and their insureds.<sup>2</sup> Recognizing the unique peculiarities of the insurance environment, courts have fashioned the tort of bad faith as a way of regulating the insurer-insured relationship. The underlying premise of the law of bad faith is that insurers owe their insureds a duty of good faith and fair dealing.<sup>3</sup> Consequently, an insurer who refuses to deal fairly with its insured, or fails to conduct its affairs in good faith may be subject to compensatory and punitive damages upon a finding of bad faith.

Bad faith insurance actions arise in two contexts: 1) that of third-party claims, in which the insured is seeking defense and indemnification from liability to a third party,<sup>4</sup> and 2) first-party claims, in which the insured is seeking indemnification from the insurer for a loss suffered by the insured personally.<sup>5</sup> Although the law of bad faith has received wide recognition and acceptance, the term "bad faith" lacks a single, coherent definition, meaning different things in different contexts.<sup>6</sup>

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<sup>1</sup> Daniel S. Bopp, *Tort and Contract in Bad Faith Cases: Is the Honeymoon Over?* 59 Def. Couns. J. 524 (1992).

<sup>2</sup> *Id.*

<sup>3</sup> *Id.*

<sup>4</sup> See e.g., *Lujan v. Gonzales*, 84 N.M. 229, 501 P.2d 673 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 663 (1972).

<sup>5</sup> See *United Nuclear Corp. v. Allendale Mut. Ins. Co.*, 103 N.M. 480, 485, 709 P.2d 649, 654 (1985).

<sup>6</sup> See *Ambassador Ins. Co. v. St. Paul Fire & Marine*, 102 N.M. 28, 30, 690 P.2d 1022 (1984) (New Mexico does not adhere to a single definition of bad faith).

The purpose of this paper is to put the term “bad faith” into context by explaining the development and application of the law of bad faith in New Mexico.

## II. THE HISTORICAL DEVELOPMENT OF INSURANCE BAD FAITH: THE IMPLIED COVENANT OF GOOD FAITH AND FAIR DEALING

Before the creation of the bad faith action, it was not unusual for insurers to disregard the interests of their policyholders by refusing to settle third-party claims or pay the proceeds on first-party claims.<sup>7</sup> Consumers who tried to challenge abusive insurance practices were limited to seeking contractual remedies which allowed them to recover only the amount of the benefits due under the policy.<sup>8</sup> Contractual remedies were often inadequate in the context of insurance and faulted because they did nothing to control unscrupulous insurance practices.<sup>9</sup>

With the invention of the automobile, problems in insurance claim settlement practices grew steadily worse.<sup>10</sup> As the number of automobiles increased, so did the number of motor vehicle accidents and related insurance claims.<sup>11</sup> Consequently, courts began to encounter a proliferation of disputes concerning the insurer’s alleged failure to meet contract expectations.<sup>12</sup> Most of the complaints arose in the third-party context where insurers were alleged to have engaged in abusive claim settlement practices.<sup>13</sup> As a result, courts began to reconsider the implied covenant of good faith and fair dealing found in all contracts in an attempt to regulate the insurer-insured relationship.<sup>14</sup>

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<sup>7</sup> Stephen S. Ashley, *Bad Faith Actions: Liability and Damages*, 2<sup>nd</sup> Edition, 1-1 (West, 1997).

<sup>8</sup> *Id.*

<sup>9</sup> Robert H. Jerry, II, *Understanding Insurance Law* 43, 2nd Edition., 155 (Matthew Bender, 1996).

<sup>10</sup> Ashley, *supra*, 1-2.

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Id.*

## A. The Implied Duty of Good Faith and Fair Dealing

Insurance policies are contracts between the insurer and the insured. The Restatement (Second) of Contracts states that every contract imposes upon each party a duty of good faith and fair dealing in performance and enforcement of the contract.<sup>15</sup> Thus, the implied duty of good faith requires that neither party do anything that will injure the other's right to receive the benefit of their agreement.<sup>16</sup>

Parties to an insurance contract share a special contractual relationship. This relationship arises out of the parties' perceived unequal bargaining power and the personal nature of the insurance relationship, which potentially allows an unscrupulous insurer to take advantage of its insured.<sup>17</sup> As one commentator has stated, "An insurance contract is the bringing together of a vulnerable seeker of protection and a financially hyper-fortified institution."<sup>18</sup> The insured-insurer relationship is also characterized by elements of public interest, adhesion and fiduciary responsibility.<sup>19</sup> Thus, the implied contractual duty of good faith requires the insurer to make an honest, intelligent, and fair weighing of the probabilities of liability; to make a diligent effort to ascertain the facts upon which only an intelligent and good faith judgment may be predicated; and to investigate claims.<sup>20</sup>

Furthermore, by accepting the terms of their insurance policies, insureds relinquish the right to control their litigation and to decide whether or not to accept

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<sup>15</sup> Restatement (Second) of Contracts § 205 (1981).

<sup>16</sup> Douglas R. Richmond, *An overview of Insurance Bad Faith Law and Litigation*, 25 Seton Hall. L. Rev. 74 (1994).

<sup>17</sup> *Id.* at 76.

<sup>18</sup> Bopp, *supra*, at 524.

<sup>19</sup> Steven W. Shaw, *What is Insurance Bad Faith?* 38 AUG Advocate (Idaho) 15 (1995) (citing *White v. Unigard*, 112 Idaho 94, 99, 730 P.2d 1014, 1019 (1986)).

settlement offers.<sup>21</sup> Although such constraints are intended to prevent collusive settlement agreements, these restrictions often expose policyholders' vulnerability.<sup>22</sup> For example, if an insurer unjustifiably refuses to settle a suit against its insured. In this situation, the insured bears the risk of an excess judgment despite his or her having no control over the litigation.

The duty of good faith and fair dealing found in insurance contracts often includes certain fiduciary elements. However, it is not improper for an insurer to give consideration to its own interests, as long as it gives equal consideration to the welfare of its policyholder.<sup>23</sup> Consequently, an insurance company's contract to provide insurance does not in and of itself create a fiduciary relationship. In a true fiduciary relationship, the agent owes its principal a duty of undivided loyalty, treating the interests of the principal as paramount.<sup>24</sup> Once the insurer acts on behalf of its insured, either within the course of litigation or in determining whether or not to accept an offer of settlement, a fiduciary relationship is created.<sup>25</sup> It is the breach of this duty that subjects the insurer to bad faith remedies.

#### B. Tort Remedies in Bad Faith Actions

Although the duty of good faith and fair dealing in insurance has connections to the implied duty of good faith and fair dealing found in other contract situations, it has developed its own unique characteristics. For example, damages in a breach of contract

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<sup>20</sup> *Ambassador, Ins. Co. v. St. Paul Fire & Marine*, 102 N.M. 28, 690 P.2d 1022 (1984).

<sup>21</sup> *Ashley, supra*, 4-26.

<sup>22</sup> *Jerry, II, supra*, at 763, 764.

<sup>23</sup> *Lujan v. Gonzales*, 84 N.M. 220, 501, P.2d 673 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 553 (1972).

<sup>24</sup> William Barker, Paul Glad, & Steven Levy, *Is an Insurer a Fiduciary to Its Insured?* 25 *Tort & Ins. L.J.* 1,2 (1989).

action are generally limited to those that reflect the contemplation of the parties at the time the bargain was struck.<sup>26</sup> Consequential damages are normally not available in a contract action since they are limited to the realm of tort law.<sup>27</sup> Under the law of bad faith, an insurer's breach of the implied duty of good faith and fair dealing subjects the insurer to the broader range of tort remedies.<sup>28</sup>

The primary motivation for recognizing the remedial powers of tort law was the inadequacy of contract remedies to fully compensate insureds or to deter unscrupulous insurance practices.<sup>29</sup> Take the example of the insurer who unjustifiably refuses to settle a claim against its insured. At trial, a judgment is entered against the insured for damages exceeding the policy limits. Under normal contract principles, the insurer is only liable to the insured for the amount of the policy limits. However, upon a finding of bad faith, the insurer is exposed to liability for the excess judgment, the insured's costs and emotional distress, as well as punitive damages.<sup>30</sup>

A number of commentators believe courts were too quick to embrace the law of bad faith.<sup>31</sup> In particular, critics argue that tort remedies are really unnecessary.<sup>32</sup> If an insurer unjustifiably fails to settle a third party claim against its insured, potential exposure to a judgment exceeding policy limits is a foreseeable consequence of the

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<sup>25</sup> *Chavez v. Chenoweth*, 89 N.M. 423, 430, 553 P.2d 703, 710 (Ct. App. 1976).

<sup>26</sup> Richmond, *supra*, at 76.

<sup>27</sup> Roger C. Henderson, *The Tort of Bad Faith in First-Party Insurance Transactions After Two Decades*, 37 Ariz. L. Rev. 1153 (1995).

<sup>28</sup> Jerry, II, *supra*, at 155.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.*

<sup>31</sup> See Jerry, II, *supra*, at 155.

<sup>32</sup> *Id.*

insurer's breach.<sup>33</sup> Under normal contract principles, an insurer would still be liable for the excess judgment. On the other hand, contract law does nothing to deter unfair insurance practices, and allows insurers to continue to take advantage of the vulnerable position of their insureds.<sup>34</sup> By viewing the insurance relationship as any other contract, critics ignore the consequences of this special relationship.<sup>35</sup>

### III. THIRD-PARTY BAD FAITH

Only liability insurance is truly third-party insurance.<sup>36</sup> Liability insurance is described as third-party insurance because the interests protected by the policy are strangers who are injured by the insured.<sup>37</sup> For example, if the policyholder negligently causes an automobile accident that injures a third party, the third party may bring a claim against the insured. A policy containing liability coverage promises to indemnify the insured against the risk of liability he may incur to third parties as a result of his or her negligence.<sup>38</sup> Liability coverage can generally be found in both automobile and homeowners insurance.<sup>39</sup> A third-party bad faith action involves a situation where the third party has sued the insured and the insurance company has acted in such a way that the rights and interests of the insured are adversely affected.

For example, an injured party sues the insured for damages exceeding the limits of his or her liability policy. Later, the third party offers to settle the claim for an amount

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<sup>33</sup> *Id.*

<sup>34</sup> *Id.*

<sup>35</sup> Richmond, *supra*, 74, 76.

<sup>36</sup> Douglas R. Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?* 77 Marq. L. Rev. 41, 43 (1993).

<sup>37</sup> *Id.* at 44.

<sup>38</sup> Jerry, II, *supra*, at 43.

<sup>39</sup> Ashely, *supra*, at 1-10.



equal to or less than the limits of the policy.<sup>40</sup> The problem with this scenario is that the insurer has little or no financial motive to accept the third party's offer.<sup>41</sup> By rejecting the settlement offer, the insurer's only risk for breach of contract is for damages up to its policy limits.<sup>42</sup> Another problem is that the insurer could force its insured to contribute to the settlement by threatening to withhold consent to settle.<sup>43</sup>

Troubled by the mounting problems and abuses in insurance litigation, courts began to recognize that the insurance relationship "carries with it a standard of care that exists independent of the contract and without reference to the specific terms of the contract."<sup>44</sup> The implied covenant of good faith and fair dealing was slowly transformed into the law of bad faith as a way to deal with the complexities of the insurance relationship.

In 1957, the California Court of Appeals, in *Brown v. Guarantee Insurance Company*,<sup>45</sup> applied the principle of good faith and fair dealing to an insurance dispute. In that case, the court reversed the trial court's dismissal of the insured's complaint alleging that the insurer "did not exercise good faith" when it refused to settle an automobile accident damage claim within policy limits. The court reasoned that when an insurer undertakes to defend the insured and enters into settlement negotiations on the insured's behalf, the insurer has an obligation to act in good faith.<sup>46</sup>

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<sup>40</sup> Ashley, *supra*, at 2-2.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.* at 2-3.

<sup>44</sup> Douglas R. Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?* 77 Marq. L.Rev. 41,43 (1993).

<sup>45</sup> 319 P.2d 69 (Cal. Ct. App. 1957).

<sup>46</sup> *Id.*

A year later, in *Crisci v. Securty Ins. Co.*,<sup>47</sup> the California Supreme Court expanded the law of bad faith when it held that an insurer's breach of the duty of good faith and fair dealing in the settlement context amounted to an independent tort. Consequently, the implied duty of good faith and fair dealing became the major standard by which courts considered the obligation of insurers.

A. To Whom the Duty of Good Faith and Fair Dealing is Owed

To understand the insurer's liability for bad faith in the third party context, it is important to remember that the insurer's duty of good faith is toward its insured. Because the insurance relationship is contractual, the insurer does not owe an outside third party a duty of good faith and fair dealing.<sup>48</sup> This distinction was first raised in New Mexico in the case of *Chavez v. Chenoweth*.<sup>49</sup>

In *Chavez*, the plaintiff was injured in an automobile accident and attempted to sue the defendant's insurance company for bad faith. The plaintiff argued that the defendant's insurance agent told her not to seek the assistance of an attorney, reassuring her that his company would take care of all her medical bills. However, the company never did. The court held that the duty of good faith and fair dealing applied only within the contract for insurance.<sup>50</sup> As a result, the plaintiff in that case did not bring a direct action against the insurer for bad faith.<sup>51</sup> For a third party to pursue a bad faith

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<sup>47</sup> 426 P.2d 173 (Cal. 1967).

<sup>48</sup> *Chavez v. Chenoweth*, 89 N.M. 423, 553 P.2d 703 (Ct. App. 1976).

<sup>49</sup> 89 N.M. 423, 553 P.2d 703 (Ct. App. 1976).

<sup>50</sup> *Id.* at 709.

<sup>51</sup> *Id.*

action, the insured must assign over his or her bad faith action or there must be a “direct action” statute.<sup>52</sup>

## B. The Duty to Defend

Liability insurers owe their insureds a duty of defense and a duty of indemnity.<sup>53</sup>

An insurer’s breach of either duty can lead to a bad faith claim. Most general liability policies contain the standard, or similarly worded clause that defines the insurer’s duty to defend:<sup>54</sup>

The Company shall have the right and duty to defend any suit against the insured seeking damages on account of such personal injury or property damage, even if such suit is groundless, false or fraudulent, and may make such investigation and settlement of any claim or suit.

Thus, the duty to defend is contractual; the insurer agrees to undertake the defense of covered claims by the language of the policy itself. Duty-to-defend clauses are liberally construed by the courts.<sup>55</sup> In the majority of states, the duty to defend is independent of insurance company’s obligation to pay and is much broader than its duty to indemnify.<sup>56</sup> Under the terms of the policy, the insurer agrees to defend the policyholder against meritless or fraudulent suits it will not have to later indemnify.<sup>57</sup>

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<sup>52</sup> See Jerry, II, *supra*, at 548-550.

<sup>53</sup> *Lujan v. Gonzales*, 84 N.M. 220, 233, 501, P.2d 673, 677 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 553 (1972).

<sup>54</sup> Stephen J. Smirti, Jr. & Dana M. Workman, *Claims Handling and Prelitigation Considerations, The Insurer’s Perspective*, 718 PLI/Comm 307, 323 (1995); *Lujan v. Gonzales*, 84 N.M. 220, 233, 501, P.2d 673, 677 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 553 (1972)(policy language provides for a duty to defend “any lawsuit, even groundless, false or fraudulent, against any insured for such damages which are payable under the terms of this policy”).

<sup>55</sup> Ashley, *supra*, at 4-4.

<sup>56</sup> *Foundation Reserve Ins. Co. v. Mullenix*, 97 N.M. 618, 619, 642 P.2d 604, 605 (1982).

<sup>57</sup> *Lujan v. Gonzales*, 84 N.M. 220, 501, P.2d 673 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 553 (1972) (under the terms of the insurance policy, insurer had a duty to defend any lawsuit, even if groundless, false or fraudulent); Smirti & Workman, *supra* at 323(The insurer’s duty to indemnify exists as soon as the contract is formed, however, this duty is conditional: the insurance company does not pay the proceeds until the insured’s liability has been established under the terms of the policy).

As stated by one court:<sup>58</sup>

The test is not the ultimate proof of the allegations but rather whether sufficient facts are stated so as to invoke coverage under the policy. The duty to defend arises not from the probability of recovery but from its possibility, no matter how remote. Any doubt as to coverage must be resolved in favor of the insured.

C. When the Duty to Defend Arises

In determining whether in a particular case the insurer has a duty to defend, one starts with the traditional principle that if the third party's complaint alleges a course of action for which the policy provides coverage, the insurer must defend.<sup>59</sup> However, the mere fact that the third party's complaint does not allege a claim within policy coverage does not establish that the insurer has no duty to defend.<sup>60</sup> To adjust for the fluid and conclusory nature of modern pleadings, courts have extended the traditional rule to require the insurer to defend claims that present even potential liability.<sup>61</sup> If only one of several pleaded theories potentially triggers coverage, the insurer is obligated to defend

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<sup>58</sup> *George Muhlstock & Co. v. American Home Assur. Co.*, 7 F.3d 93 (7<sup>th</sup> Cir. 1993); *See also Valley Improvement Ass., Inc. v. United States Fidelity & Guaranty Corp.*, 129 F.3d 1108 (10<sup>th</sup> Cir. 1997).

<sup>59</sup> *Ashley, supra*, at 4-4; *American Employers' Ins. Co. v. Continental Cas. Co.*, 85 N.M. 346, 512 P.2d 647, 677 (1973); *See also Lopez v. New Mexico Pub. Sch. Ins. Auth.*, 117 N.M. 207, 209, 870 P.2d 745, 747 (1994) (The duty to defend is determined by comparing the factual allegations of the complaint with provisions of insurance policy). *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 684 P.2d 524 (Ct. App.), cert. denied, 101 N.M. 362, 683 P.2d 44 (1984) (Before the duty to defend arises there must be a demand). Overruled on other grounds in *Ellingwood v. N.N. Investors Life Ins. Co.*, 111 N.M. 301, 306, 805 P.2d 70 (1991).

<sup>60</sup> *Asley, supra*, at 4-5; *American Motorist Ins. Co. v. Southwestern Greyhound Lines, Inc.*, 283 P.2d 684, 649 (10<sup>th</sup> Cir. 1960).

<sup>61</sup> *Ashley, supra*, at 4-7.

the suit.<sup>62</sup> Thus, as long as the complaint alleges at least one issue that is covered under the terms of the policy, the insurer must defend.<sup>63</sup>

Where there is a question as to coverage or where a claim is ambiguous, the insurer is required to resolve ambiguities in favor of potential coverage for purposes of its duty to defend.<sup>64</sup> Although certain claims in the underlying action may be outside the policy, claims within the scope of the policy will invoke the duty to defend.<sup>65</sup> Therefore, when doubt exists as to whether any of the allegations of a third-party complaint are covered, the denial of coverage should not be determined unilaterally by the insurer, but should be made in favor of the insured or by the court.<sup>66</sup>

As an example, in *Foundation Reserve Insurance Co. v. Mullinex*,<sup>67</sup> the insured was sued for negligently causing a motor vehicle accident which damaged a truck he was towing. The allegations of the complaint were unclear about the circumstances of the accident, and merely stated that the insured had operated his tow truck negligently and that the claimants towed truck was damaged as a result. The insured made demand on his insurer to defend, but the insurer refused citing the policy's exclusion for towed vehicles.

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<sup>62</sup> *American Employers' Insurance Co. v. Continental Cas. Co.*, 85 N.M. 346, 512 P.2d 664, 677 (1973); See also *Bernalillo County Deputy Sheriffs Ass'n v. County of Bernalillo*, 114 N.M. 695, 697-99, 845 P.2d 789, 791-93 (1992) (if allegations of complaint clearly fall outside provisions of the policy, defense is not required).

<sup>63</sup> *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 442, 684 P.2d 524, 528 (Ct. App.), cert. denied, 101 N.M. 362, 683 P.2d 44, 48 (1984)(As long as the claimant has pleaded any grounds against the insured coming within the terms of the policy, the insurer is required to defend).

<sup>64</sup> *Marshall v. Providence Washington Ins. Co.*, 1997 WL 765625 (N.M. Ct. App.); *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 684 P.2d 524 cert. denied, 101 N.M. 363, 683 P.2d 44 (1984), overruled on other grounds.

<sup>65</sup> *Valley Improvement Ass., Inc. v. United States Fidelity & Guaranty Corp.*, 129 F.3d 1108 (10th Cir. 1997)(citing *Employers Insurance Co. v. Continental Cas. Co.*, 85 N.M. 346, 512 P.2d 674, 677 (1973)("Although certain claims in the underlying state court action may have been outside the policy, other claims clearly were within the scope of the policy.").

<sup>66</sup> *American*, 512 P.2d at 677; See also *Servants of the Paraclete, Inc. v. Great American Ins. Co.*, 857 F. Supp. 822, 832 (D.N.M. 1994).

The court stated that from the face of the complaint itself, it could not be determined with certainty that the incident came within the exclusionary language.<sup>68</sup> When the allegations of a complaint are ambiguous, the insured is entitled to a defense. The insurer cannot just unilaterally decide that there is no coverage for the purpose of its duty to defend.<sup>69</sup>

The insurer's duty to defend extends even to actions where the insurance company's own investigation has revealed that the claim sued upon is not in fact covered.<sup>70</sup> Most jurisdictions agree that for the purposes of establishing the duty to defend, an insurer may not rely upon facts outside of the complaint to demonstrate that the claim is not covered.<sup>71</sup> Similarly, if the allegations of the complaint are not dispositive and the insurer learns from extrinsic evidence that coverage probably exists, the duty to defend is triggered.<sup>72</sup> For example, suppose a complaint alleges that the insured committed an intentional tort. Standing alone, the allegations do not give rise to the duty to defend because intentional acts generally fall under policy exclusions. However, if the insurer becomes aware of extrinsic evidence tending to show that the insured negligently injured the plaintiff, the duty to defend is triggered.<sup>73</sup> This rule is designed to protect insureds by preventing insurance companies from escaping their

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<sup>67</sup> 97 N.M. 618, 642 P.2d 604 (1982).

<sup>68</sup> *Id.* at 605, 606.

<sup>69</sup> *Id.*

<sup>70</sup> *Foundation Reserve, Ins. Co. v. Mullenix*, 97 N.M. 618, 620, 642 P.2d 604, 606 (1982).

<sup>71</sup> *Smirti & workman, supra*, at 330.

<sup>72</sup> *See Valley Improvement Ass. Inc. v. United States Fidelity & Guaranty Corp.*, 129 F.3d 1108 (10<sup>th</sup> Cir. 1997) (citing *American General Fire & Cas. Co. v. Progressive Cas. Co.*, 110 N.M. 741, 799 P.2d 1113, 1116 (1990) ("the duty to defend may also arise from unpleaded facts actually known to the insurer which arguably bring the claim within the scope of coverage").

<sup>73</sup> *Id.*

obligations simply because the plaintiff failed to allege the proper facts in his or her complaint.<sup>74</sup>

#### D. Conflicts of Interest and Reservation of Rights

A common issue in bad faith duty to defend suits is the conflict of interest between the insurer and the insured.<sup>75</sup> If the insurer undertakes to defend the insured and believes that it will not have an obligation to pay the third party claim despite a judgment against the insured, the insurer can protect itself by having the insured sign a non-waiver agreement or by sending the insured a reservations of rights notice.<sup>76</sup> A non-waiver agreement is a contract between the insured and insurer in which the insurer agrees to continue with the defense, but reserves the right to contest coverage in the event a judgment is entered against the insured.<sup>77</sup> In effect, it is a reservation of rights letter to which the insured has consented.<sup>78</sup> A reservation of rights notice is basically a notice sent by the insurer stating its right to contest coverage.<sup>79</sup> The reservation of rights notice has a weaker effect than the non-waiver agreement because it does not demonstrate the insured's consent.<sup>80</sup>

Conflicts of interest generally arise where an insurer defends under a reservation of rights, although the reservation does not automatically create a conflict of interest.<sup>81</sup> A conflict arises when the basis for the reservation of rights is such as to cause the insurer to

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<sup>74</sup> Jerry, II, *supra*, at 797

<sup>75</sup> See, e.g. *American Employers Ins. Co. v. Crawford*, 87 N.M. 375, 533 P.2d 1203 (1975)  
*Satterwhite v. Stolz*, 79 N.M. 320, 442 P.2d 810 (Ct. App. 1968).

<sup>76</sup> *Id.* at 797.

<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

<sup>79</sup> *Id.* at 798.

<sup>80</sup> *Id.*

<sup>81</sup> Smirti & Workman, *supra* at 341.

assert factual or legal theories that undermine or are contrary to the positions to be asserted in the liability case.<sup>82</sup> Suppose a third party makes two claims against the insured in a personal injury case—negligence and assault and battery. If the policy specifically excludes intentional acts, the insurer will not be liable for payment of a judgment entered against the insured if liability is established. However, if the injuries were the result of the insured's negligence, then the insurer will be liable for any judgment up to the policy limits.

When a complaint alleges both covered and excluded acts, the insurer is put in a difficult position of defending its insured and protecting its own interests.<sup>83</sup> If the insurer tries to exculpate itself by showing an intentional injury, it exposes the policyholder to a greater liability.<sup>84</sup> On the other hand, if the insurer foregoes the exclusionary provision of the policy, it exposes itself to liability in the event a judgment is entered against the insured. Under a reservation of rights, the insurer is able to defend the insured while maintaining its defenses to coverage under the policy.<sup>85</sup>

Once a conflict arises, the insurer can continue to provide counsel disclosing the conflict, or the insurer can choose to waive its defenses. However, in New Mexico, the insurer is not excused from defending the insured simply because a conflict arises.<sup>86</sup> If the insurer chooses to defend the insured under a reservation of rights, the conflict may be resolved by hiring independent counsel to control the insured's defense, allowing the insured to select private counsel, or by hiring two sets of attorneys, one to represent the

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<sup>82</sup> *State Farm Ins. Co. v. Superior Court*, 216 Cal.App.3d 1222, 265 Cal.Rptr. 372, 374 (1989).

<sup>83</sup> See *Satterwhite v. Stolz*, 79 N.M. 320, 442P.2d 810 (Ct. App. 1968).

<sup>84</sup> *Id.*

<sup>85</sup> *Id.*



insurer and another the insured.<sup>87</sup> Note, however, that the loyalty of counsel hired by the insurer may later be questioned by the insured in a claim for bad faith failure on the basis the insurer failed to retain defense of the insured's case.<sup>88</sup> Although there is no way to completely eliminate possible prejudice to the insured, an insurer can take steps to reduce its potential liability by fully informing the insured of the conflict of interest, and advising the insured of the right to obtain other counsel.<sup>89</sup>

#### E. Settlement Obligations

Although liability insurance policies typically create a duty to defend, they do not by their terms create a duty to settle.<sup>90</sup> Instead, the typical policy language allows the insurer to exercise its discretion in deciding whether or not to settle a claim against the insured.<sup>91</sup> Nonetheless, this discretion is limited. Although an insurer has discretion in deciding whether to accept an offer of settlement, the insurer must timely investigate and fairly evaluate a claim against its insured before making any settlement decisions.<sup>92</sup> The implied covenant of good faith and fair dealing requires insurers to settle claims against their insureds within policy limits whenever there is a substantial likelihood of recovery in excess of policy limits.<sup>93</sup>

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<sup>86</sup> *American Employers' Ins. Co. v. Crawford*, 87 N.M. 375, 381, 533 P.2d 1203, 1209 (1975).

<sup>87</sup> *Id.*

<sup>88</sup> See e.g. *American Employers'* at 379, 533 P.2d 1207.

<sup>89</sup> *Id.*

<sup>90</sup> *Ambassador Ins. Co. v. St. Paul Fire & Marine*, 102 N.M. 28, 30, 690 P.2d 1022, 1024 (1984).

<sup>91</sup> *Id.* at 1025

<sup>92</sup> *Id.*

<sup>93</sup> See *Torrez v. State Farm Mutual Auto. Ins. Co.*, 705 F.2d 1192, 1195 (10<sup>th</sup> Cir. 1982).

F. Negligent Failure to Settle

A number of courts have construed the insurer's duty in responding to settlement offers in terms of good faith rather than due care.<sup>94</sup> An insured may not recover damages from the insurer for negligently refusing to accept a settlement offer. For example, an insured cannot sue the insurer merely because the insurance company failed to correctly predict the outcome of the third party's action against the insured.<sup>95</sup>

In *Ambassador Insurance Company v. St. Paul Fire & Marine Insurance Company*,<sup>96</sup> the New Mexico Supreme Court determined that New Mexico would not recognize an action for an insurer's negligent failure to settle. In that case, the excess insurance carrier brought an action against the primary insurance carrier alleging that the primary insurer negligently failed to settle a medical malpractice claim.<sup>97</sup>

The *Ambassador* court reasoned that there is always a chance that the insured's case will fail at trial and a judgment could be entered in excess of policy limits.<sup>98</sup> Under a theory of negligence, the only precaution available to the "ordinary and prudent man" would be to settle within policy limits.<sup>99</sup> Such a standard would force insurers to settle every case despite their honest belief that the settlement offer is much higher than the amount that would ultimately be awarded.<sup>100</sup> Moreover, the court felt that by imposing a

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<sup>94</sup> Ashley, *supra*, 2-9

<sup>95</sup> *Id.* at 2-14

<sup>96</sup> 102 N.M. 28, 690 P.2d 1022 (1984).

<sup>97</sup> *Id.* at 1023.

<sup>98</sup> *Id.* at 1024.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.*

negligence standard on insurers, it would be creating a duty that has not been expressly agreed to by the parties.<sup>101</sup>

Whether the court's decision is sound on public policy grounds remains to be debated. The reasoning behind the court's decision also raises questions as to whether the action for bad faith is grounded in contract or in tort.<sup>102</sup> Nevertheless, the court did clarify that the implied covenant of good faith and fair dealing was an exception to the general rule that only those obligations contained in the written agreement will be imposed upon the parties.<sup>103</sup>

When the insurer has taken over the defense of a third party claim against its insured, the insurer must do so in good faith.<sup>104</sup> An insurer who fails to properly investigate the claim or to become familiar with the applicable law, or who refuses to settle while disregarding the interests of its insured may be liable for bad faith.<sup>105</sup> In this instance, the insurer's negligence in evaluating or settling the case is an element tending to prove bad faith.<sup>106</sup>

#### G. The Breach of Settlement Obligations

Prior to the development of the law of bad faith, insurers often used the threat of a judgment in excess of the policy limits to coerce the insured into contributing to a

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<sup>101</sup> *Id.*

<sup>102</sup> Although in a later opinion, *Jessen v. National Excess Ins. Co.*, 776 P.2d 1244 (N.M. 1989) the court reaffirmed that an insurer's refusal to pay a first-party claim raises a bad faith action sounding in tort.

<sup>103</sup> *Id.*

<sup>104</sup> *Id.* at 1025

<sup>105</sup> See *Lujan v. Gonzales*, 84 N.M. 229, 237, 501 P.2d 673, 681 (Ct. App.), cert. denied. 84 N.M. 219, 501 P.2d 663 (1972)

<sup>106</sup> *Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 102 N.M. 28, 690 P.2d 1022 (1984), (instances where the insurance company failed to settle a claim because it was negligent in investigating the claim or it failed to become familiar with the applicable law were strong evidence of bad faith).

settlement.<sup>107</sup> Today such conduct generally subjects the insurer to liability for bad faith.<sup>108</sup> The same is true where the insurer refuses to settle unless a codefendant or its insurer contributes to the settlement.<sup>109</sup> If a third-party plaintiff offers to settle a claim against the insured for an amount exceeding policy limits, the insurer must be careful to respond in a manner that avoids incurring liability for bad faith.<sup>110</sup>

Moreover, the insurer may not put its own interests over those of its insured by ignoring settlement offers simply because they ask for more than the policy limits.<sup>111</sup> The insurer is required to fully disclose to its insured all matters that could affect the insured's interest, including any and all settlement offers.<sup>112</sup> If the insured wishes, he or she may make up the difference between the amount demanded and the policy limits.<sup>113</sup>

An insurer is also required to examine the facts surrounding the third party's claim against its insured, evaluating the strengths and weaknesses of the third party's case.<sup>114</sup> If the insurer fails to conduct a competent investigation or to evaluate the case honestly, this can be evidence of bad faith.<sup>115</sup>

In most jurisdictions, the insurer is not held liable for breaching its duty to settle unless a settlement offer has been made and the insurer is presented with a covered claim.<sup>116</sup> Although there is no precise definition of what constitutes breach of the duty to

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<sup>107</sup> Ashley, *supra*, 3-4.

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* at 3-5

<sup>110</sup> *Id.* at 3-8

<sup>111</sup> *Id.* at 3-9; See also *Lujan v. Gonzales*, 84 N.M. 229, 237, 501 P.2d 673, 681 (Ct. App.), cert. denied, 84 N.M. 219 501 P.2d 663 (1972).

<sup>112</sup> *Id.* at 3-21

<sup>113</sup> *Id.* at 3-9

<sup>114</sup> *Id.* at 3-10

<sup>115</sup> *Id.* at 3-13

<sup>116</sup> *Id.*

settle, the duty of good faith requires at a minimum, “an honest, intelligent, and fair weighing of the probabilities of liability of the insured, and a diligent effort to ascertain the facts and law upon which only an intelligent and good faith judgment may be predicated.”<sup>117</sup> The duty of good faith compels acceptance of a settlement offer only if the offer is within policy limits.<sup>118</sup> Nevertheless, settlement offers that exceed the primary insurer’s policy limits present special problems.<sup>119</sup>

The primary insurer’s response to a settlement offer above policy limits depends on whether the insured has excess liability insurance.<sup>120</sup> If there is excess insurance and the primary insurer tenders its policy limits to settle the case, then the burden rests upon the excess carrier to respond in good faith.<sup>121</sup> If there is no excess insurance, the insurer must take care to inform its insured without appearing to demand contribution.<sup>122</sup>

#### H. Settlements Made By the Insured.

When an insurer has denied that its policy affords coverage for a claim brought against its insured, the insured may enter into a settlement or agree to have judgment entered against him or her on the condition the judgment is collectible only from available insurance.<sup>123</sup> Such an agreement is binding on the insurer as long as the

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<sup>117</sup> *Ambassador Ins. Co. v St. Paul Fire & Marine Ins. Co.*, 102 N.M. 28, 30, 690 P.2d 1022, 1024 (1984).

<sup>118</sup> *Id.*

<sup>119</sup> Ashley, *supra*, 3-31.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> *Id.*, 3-31.

<sup>123</sup> Smirti & Workman, *supra*, at 337.

settlement entered into without the insurer's consent or knowledge is reasonable and conducted in good faith.<sup>124</sup>

Generally, a settlement is "reasonable" if a reasonably prudent person in the insured's position would have accepted it after considering the facts regarding liability and damages and the risks of going to trial.<sup>125</sup> In evaluating the reasonableness of the insured's settlement, the trier of fact may take into consideration "any evidence of bad faith, collusion or fraud" on the part of the insured.<sup>126</sup> A negotiated settlement becomes collusive when its purpose is to injure the interests of the absent insurer.<sup>127</sup> Possible indicators of the insured's bad faith in making the settlement include unreasonableness, misrepresentation, concealment, secretiveness and profit to insured.<sup>128</sup> Consequently, even though the insurance company wrongfully fails to defend or settle a claim against its insured, it may be able to assert as a defense that the settlement was itself tainted.<sup>129</sup>

#### I. Third-Party Remedies

An insurer suffers serious consequences when it breaches its duty to defend.<sup>130</sup> The consequences for a breach of the duty to defend fall into two categories: damages for harm caused to the insured, and loss of the insurer's rights under the policy.<sup>131</sup> In particular, upon breach by the insurance company, the insured may assume control of his

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<sup>124</sup> *American Gen. Fire & Cas. Co. v. Progressive Cas. Co.*, 110 N.M. 741, 746, 799 P.2d 1113, 1118 (1990)(even where insurer's failure to defend is wrongful, any "settlement must be reasonable, and the insurer is not precluded from asserting as a defense that the settlement was unreasonable").

<sup>125</sup> *Smirti & Workman, supra*, at 337.

<sup>126</sup> *Servants of the paraclete, Inc. v. Great American Ins. Co.*, 866 F.Supp. 1560, 1574 (D.N.M. 1994).

<sup>127</sup> *Continental Cas. Co. v. Westerfield*, 961 F. Supp. 1502, 1504 (D.N.M. 1997).

<sup>128</sup> See *Continental Cas. Co.*, 961 F.Supp. at 1504 (D.N.M. 1997).

<sup>129</sup> *Id.*

<sup>130</sup> *Lujan v. Gonzales*, 84 N.M. 220, 501, P.2d 673 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 553 (1972).

<sup>131</sup> *Ashley, supra*, 4-13.

or her defense and is no longer obligated to cooperate with the insurer.<sup>132</sup> The insured is also relieved of its obligations in claims processing and is not required to file proof of loss or give other notice.<sup>133</sup> The insured may also enter into reasonable settlements without the insurer's knowledge or consent.<sup>134</sup>

An insurer who refuses to participate in or at least monitor the progress of settlement negotiations abdicates any rights to object to the final settlement and may be liable for damages.<sup>135</sup> Moreover, if the insurer refuses to defend and then refuses to settle a claim against its insured in bad faith, it could be held liable for the judgment entered against its insured even if the judgment exceeds policy limits.<sup>136</sup> An insurer may also be bound by a settlement agreement made by its insured despite having a good faith belief that there was no coverage and a court later finds coverage.<sup>137</sup> Added to these damages are the costs of bringing the bad faith action against the insurer, the costs incurred in defending the original action and damages for mental anguish.<sup>138</sup>

Courts hold insurers to the terms of settlement agreements made without their involvement because of the significant influence the company's absence can have on the

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<sup>132</sup> *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 684 P.2d 524 (Ct. App.), cert. denied, 101 N.M. 362, 683 P.2d 44 (1984). Overruled on other grounds.

<sup>133</sup> *Id.*

<sup>134</sup> See e.g. *American Gen. Fire & Cas. Co. v. Progressive Cas. Co.*, 110 N.M. 741, 746, 799 P.2d 1113, 1118 (1990).

<sup>135</sup> *Lujan v. Gonzales*, 84 N.M. 229, 244, 501 P.2d 673, 688 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 663 (1972).

<sup>136</sup> *Foundation Reserves Ins. Co. v. Kelly*, 388 F.2d 528, 532 (10<sup>th</sup> Cir. 1968); *Lujan v. Gonzales*, 84 N.M. 229, 244, 501 P.2d 673, 688 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 663 (1972).

<sup>137</sup> *Rummel v. Lexington Ins. Co.*, 945 P.2d 970 (1997).

<sup>138</sup> *Lujan v. Gonzales*, 84 N.M. 229, 244, 501 P.2d 673, 688 (Ct. App.), cert. denied, 84 N.M. 219, 501 P.2d 663 (1972). (insurer is liable to the insured for the reasonable and necessary expenses which the insured has incurred in conducting the defense, attorney's fees incurred in the defense of the action brought against him, and for attorney fees incurred in bad faith suit);

final outcome in the case against the insured.<sup>139</sup> An insurer who abandons its insured exposes the insured to a greater risk of personal liability.<sup>140</sup> Under these circumstances, it is not unreasonable for an abandoned insured to enter into an agreement limiting his or her liability in order to avoid litigation of the claim at his or her own expense.<sup>141</sup> Therefore, if the court finds coverage, the insurer will be bound by the terms of the settlement.<sup>142</sup>

The New Mexico Supreme Court has not specifically addressed whether an insurer can argue the issue of coverage after breaching its duty to defend. In *State Farm Fire & Casualty Co. v. Price*,<sup>143</sup> the appellate court held that an insurer who breaches its duty to defend loses the right to claim: 1) the insured breached the policy provisions, 2) failed to cooperate, 3) failed to forward suit papers, 4) settled without its consent, and 5) becomes liable for a judgment entered against the insured and for any settlement entered into by the insured in good faith.<sup>144</sup> A number of jurisdictions have held that an insurer who fails to defend its insured is properly estopped from later denying coverage.<sup>145</sup> The policy underlying this decision is that by breaching its duty under one part of the contract, the insurer should not be allowed to enforce another part of the contract to assert protection.<sup>146</sup>

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<sup>139</sup> *Id.*

<sup>140</sup> *Id.* at 984.

<sup>141</sup> *Id.* (citing *State Farm Mut. Auto. Ins. Co. v. Paynter*, 122 Ariz. 198, 201, 593 P.2d 948, 951 (Ct. App. 1979)) (“an abandoned insured may enter into a reasonable agreement limiting his liability in order to avoid litigation of the claim at his own expense”).

<sup>142</sup> *Id.* at 984.

<sup>143</sup> 101 N.M. 438, 684 P.2d 524 (Ct. App. 1984).

<sup>144</sup> *Id.*

<sup>145</sup> Jerry, II, *supra*, at 348.

<sup>146</sup> See, e.g. *Clemmons v. Travelers Ins. Co.*, 88 Ill.2d 469, 430 N.E.2d 1104 (1981); *Missionaries of Co. of Mary, Inc. v. Aetna Cas. & Surety Co.*, 155 Conn. 104, 230 A.2d 21 (1967).



However, in *the Servants of the Paraclete, Inc. v. Great American Insurance Company*,<sup>147</sup> the United States District Court applied the principles of normal contract law to a bad faith failure to defend suit. In that case, the court held that the insurer had a right to raise the issue of coverage stating, “the injured party in a contract breach is entitled to receive what would have been obtained had there been no breach.”<sup>148</sup> The *Servants* court reasoned, “by finding the insurer had a duty to indemnify as a penalty for refusing to defend, even if no coverage exists, the court has improperly enlarged the bargained-for coverage.”<sup>149</sup>

This finding appears to be inconsistent with New Mexico bad faith law. The *Servants* court is correct when it states that the insurance contract determines what duties exist. However, New Mexico imposes the duty of good faith and fair dealing into all insurance contracts. An insurer who breaches its duty of good faith and fair dealing is subject to liability for extra contractual damages.

For example, an insurer unjustifiably fails to defend its insured against a meritless suit. The insured lacks the financial means to pay for an attorney to defend the suit and subsequently incurs liability for a settlement the insured would not otherwise have suffered. Following the reasoning in *Servants*, the insurer would not have a duty to pay the settlement upon a finding of breach since there was no coverage under the policy to begin with. The error in this analysis is that situations similar to this scenario were largely responsible for courts imposing the implied covenant of good faith and fair dealing into the law of insurance bad faith.

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<sup>147</sup> 857 F.Supp. 822 (D.N.M. 1994).

<sup>148</sup> *Id.* at 832.

*Valley Improvement Association, Inc. v. United States Fidelity & Guaranty Corp.*, appears to have overruled *Servants*. In *Valley*, the Tenth Circuit Court held that an insurer who breached its duty to defend could be held liable for its pro rata share of settlements made on certain claims without a determination of whether the claims settled were within policy coverage.<sup>150</sup> The court noted that an insurer who breached its duty to defend could not later challenge a settlement complaining that the claims were not within coverage.<sup>151</sup> An insurer who abandons its insured within the course of litigation will be bound to a reasonable settlement entered into by the insured.<sup>152</sup> The only restriction on this principle is that the settlement be reasonable.<sup>153</sup> Thus, rather than applying traditional contract law to the insurer's assertion of non-coverage, the *Valley* court more appropriately focused its analysis on the principles of good faith and fair dealing.

#### IV. FIRST-PARTY BAD FAITH

The second context in which bad faith actions have arisen is that of first-party insurance. In a first-party bad faith action, the insured asserts a claim for the insurer's wrongdoing or bad faith performance of its obligations under the insurance contract. A typical first-party action is one where the insured is seeking to recover for his or her own loss or injuries covered under the terms of the insurance policy.<sup>154</sup>

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<sup>149</sup> *Id.*

<sup>150</sup> 129 F.3d 1108 (1997).

<sup>151</sup> *Id.* at 1125.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.*

<sup>154</sup> *Charter Services, Inc. v. Principal Mut. Life Ins. Co.*, 117 N.M. 82, 87, 868 P.2d 1307, 1312 (ct. App. 1994).

Although the law of bad faith has been widely received in the third-party context, it has not acquired such acceptance in first-party cases.<sup>155</sup> In the first-party context, an insured generally has a clear and express breach of contract claim which allows the insured to sue on the policy.<sup>156</sup> Moreover, the fiduciary relationship inherent in the third-party setting (in which the insurer undertakes the defense of the insured) does not exist in the first-party setting. According to critics, it is the establishment of the fiduciary relationship in the third-party context that justifies the need for tort remedies.<sup>157</sup>

Jurisdictions following a contractual approach, limit the recovery of damages in first-party cases to those either arising naturally out of the breach or those within the contemplation of the parties at the time the contract was made.<sup>158</sup> However, a number of jurisdictions including New Mexico, have applied the law of bad faith to first-party actions.<sup>159</sup>

The breach of an insurer's obligation of good faith and fair dealing was first extended to the area of first-party insurance by the California Court of Appeals in *Fletcher v. Western National Life Insurance Co.*<sup>160</sup> In that case, the insured sued his insurance company for fraud and intentional infliction of emotional distress for its refusal to indemnify him under a disability policy. The court affirmed a lower court's judgment on the latter cause of action. The court held that the duty of good faith and fair dealing

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<sup>155</sup> Douglas R. Richmond, *An overview of Insurance bad Faith Law and Litigation*. 25 Seton Hall. L. Rev. 74, 104 (1994).

<sup>156</sup> Jerry, II, *supra*, at 158.

<sup>157</sup> *Id.*

<sup>158</sup> See Jerry, II, *supra*, at 158.

<sup>159</sup> *Hale v. Basin Motor Co.*, 110 N.M. 314, 759 P.2d 1006 (1990).

<sup>160</sup> 89 Cal.Reptr. 78 (Ct. App. 1970).

imposed a duty on the insurer not to withhold payments maliciously or without probable cause.<sup>161</sup>

However, courts adopting the first-party bad faith action are cautious not to interfere with the insurer's right to contest a claim when there is a reasonable basis for denying proceeds. A number of jurisdictions require that the insurer engage in some deliberate conduct, although this conduct need not rise to the level of unlawful or malicious behavior.<sup>162</sup> In New Mexico, an insurer is held liable for bad faith when it refuses to pay a claim for reasons that are determined to be "frivolous" or "unfounded."<sup>163</sup> An insurer does not act in bad faith by denying a claim for reasons which are reasonable under the terms of the policy.<sup>164</sup> Where payment of policy proceeds depends on an issue that is fairly debatable, the insurer is entitled to debate that issue.<sup>165</sup>

There is a multitude of misconduct that can be considered warranting a bad faith action. Some of these actions include: the insurer's failure to investigate the claim thoroughly; unreasonable delay in payment of a claim; unreasonable litigation tactics to avoid payment; using improper standards to deny claim; and other types of disregard.<sup>166</sup> Nevertheless, the term "unfounded" does not simply mean "erroneous" or "incorrect."

In *Jackson National Life Insurance Co. v. Receconi*,<sup>167</sup> the court held that the term "unfounded" meant the same thing as "reckless disregard." To hold an insurer liable for

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<sup>161</sup> *Id.* at 93.

<sup>162</sup> Jerry, II, *supra*, at 159.

<sup>163</sup> *Chavez v. Chenoweth*, 89 N.M. 423, 553 P.2d 703 (Ct. App. 1976).

<sup>164</sup> *United Nuclear Corp. v. Allendale Mut. Ins. Co.*, 103 N.M. 480, 790 P.2d 649 (1985).

<sup>165</sup> *Id.*

<sup>166</sup> H. Walter Croskey, Marcus M. Kaufman, David B. Casselman, Rex Heeseman, Thomas W. Johnson, Jr., & Patrick M. Kelly, *California Practice Guide Insurance Litigation*, Cal. Prac. Guide. Ins. Lit. Ch 12c-D (1995).

<sup>167</sup> 113 N.M. 403, 827 P.2d 118 (1992).

bad faith, the insurer must “utterly fail to exercise care for the interests of the insured” either in denying a claim or delaying payment of a claim.<sup>168</sup> Thus, for an insured to sue on the basis of bad faith the insurer’s refusal to pay proceeds must not only be unreasonable, the insurer’s refusal must lack any arguable support.<sup>169</sup>

The duty of the insurance company toward its insured includes a duty to the insured to make a reasonably prompt investigation of all relevant facts.<sup>170</sup> If the insurance company cannot give its insured a valid reason for denying the claim, it has a final duty to promptly honor it.<sup>171</sup> An insurer may not simply refuse to investigate the insured’s claim using its failure to verify the claim as a justification for denial of coverage.<sup>172</sup>

Delay also may form the basis of a bad faith action when there is evidence of a frivolous or unfounded refusal to pay.<sup>173</sup> Mere delay in the payment of insurance proceeds is generally not sufficient to support a bad faith action where the insurance company owes no policy benefits.<sup>174</sup> However, an insurer who drags its feet in paying a valid claim may incur liability for bad faith. If the insurer has no doubts concerning liability, it must promptly pay over the proceeds.<sup>175</sup>

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<sup>168</sup> *Id.* at 419, 827 P.2d 133(citing *Jessen v. National Excess Ins. Co.*, 108 N.M. 625, 628, 776 P.2d 1244, 1247 (1989) overruled on other grounds in *Paiz v. State Farm Fire & Cas. Co.*, 118 N.M. 203, 210, 880 P.2d 300, 307 (1994).

<sup>169</sup> *Id.*

<sup>170</sup> *Id.*

<sup>171</sup> *Jessen v. National Excess Ins. Co.*, 776 P.2d 1244, 1248 (1989) (citing *Bankers Life & Cas. Co. v. Crenshaw*, 483 So.2d 254, 276 (Miss. 1985) overruled on other grounds.

<sup>172</sup> *Id.*

<sup>173</sup> *Chavez v. Chenoweth*, 89 N.M. 423, 553 P.2d 703 (Ct. App. 1976).

<sup>174</sup> *Woodmen Accident & Life Co. v. Bryant*, 784 F.2d 1052 (10<sup>th</sup> Cir. 1986)(five month delay preceding denial of coverage could not be bad faith where court determined ultimately that there was no duty to pay, relying on *Chavez*, supra.)

#### A. Issues in Contract Interpretation

First-party cases often arise out of disagreements between the insurer and the insured concerning the coverage afforded by the policy. The interpretation of a contract's terms can have a significant impact on whether the insurer acted in bad faith by its deliberate misrepresentation of the terms to the insured; misinterpreting the policy language to avoid paying premiums; or whether its denial of premiums will be construed as arbitrary and unfounded.

When separate sections of a policy appear to conflict with one another, or terms appear ambiguous or do not expressly address whether certain matters are covered, their resolution becomes a matter for the court.<sup>176</sup> In determining the existence of an ambiguity, the court considers the language at issue from the viewpoint of the "reasonably intelligent layman," in accordance with the usual and natural meaning of the words.<sup>177</sup> Moreover, the contract is construed as a whole.<sup>178</sup> If any provisions appear ambiguous on their face, or the insuring clauses conflict with exclusionary clauses, the contract will be construed in favor of the insured.<sup>179</sup>

The New Mexico Supreme Court has stressed the importance of protecting ordinary policyholders untutored in the intricacies of insurance."<sup>180</sup> Insurance contracts are complex contracts of adhesion, prepared by the insurer without negotiation as to

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<sup>175</sup> *Travelers Ins. Co. v. Montoya*, 90 N.M. 556, 566 P.2d 105 (Ct. App. 1977).

<sup>176</sup> *Rummel v. Lexington Ins. Co.*, 945 P.2d 970 (1997).

<sup>177</sup> *Id.* at 976.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 977.

<sup>180</sup> *King v. The Travelers Ins. Co.*, 84 N.M. 550, 556, 505 P.2d 1226, 1232 (1973)(citing *Pribble v. Aetna Life Ins. Co.*, 84 N.M. 211, 501 P.2d 255 (1972)).

policy terms.<sup>181</sup> Therefore, to protect the reasonable expectation of insureds, they should be given a broad measure of protection.<sup>182</sup> It is the responsibility of the insurer to make sure all the exclusions and vital conditions are made plain, clear and prominent to the average policyholder.<sup>183</sup>

The rules of contract construction are especially narrow when applied to the exclusionary provisions of insurance policies. If the insurer urges an exception to coverage that the policy does not clearly express, “the courts will not write an exclusion into it by construction, for the purpose of exempting the insurer from liability.”<sup>184</sup>

Insurers must make exclusionary language clear and specific. Such requirements not only protect the reasonable expectation of insureds, they also serve as a guideline for courts in determining the reasonableness of the insurer’s refusal to pay policy proceeds.

#### B. First-Party Remedies

The most basic element of recovery by the insured is the amount of proceeds of the policy that have been withheld by the insurer. As noted earlier, the aspects of the relationship between insurers and their insureds are contractual (e.g., an insurer’s failure to pay proceeds after receiving notice of a covered loss generally constitutes breach of contract). Under general contract principles, the insured is to be put in the position he or she would have enjoyed had there been no breach. Under the general tort principles of

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<sup>181</sup> *Id.* See also, *Federal Ins. Co. v. Century*, 113 N.M. at 168, 824 P.2d at 308 (“giving effect to the insured’s reasonable expectations in cases of policy ambiguity, is of course a well-settled approach to construing and applying language in insurance policies.”)

<sup>182</sup> *Id.* at 557.

<sup>183</sup> *Id.*

<sup>184</sup> *Rummel v. Lexington Ins. Co.*, 945 P.2d 970, 982.

bad faith, the insured may also recover attorneys fees, interest, damages for emotional distress and punitive damages.<sup>185</sup>

## V. PUNITIVE DAMAGES

Punitive damages are allowed in bad faith actions as a way to punish the wrongdoer and as a means of deterring unfair insurance practices.<sup>186</sup> The assessment of punitive damages for breach of an insurance contract requires evidence of either bad faith or malice on the part of the insurer.<sup>187</sup> However, where the evidence supports a jury instruction on compensatory damages for the insurer's bad faith, an instruction for punitive damages may also be given.<sup>188</sup>

In New Mexico, the standard of conduct required for punitive damages in bad faith actions appears to be the same whether the action is brought on some type of first party coverage or on a liability policy.<sup>189</sup> New Mexico has historically allowed the award of punitive damages in insurance bad faith cases under what has appeared to be a more relaxed standard, in part because of the fiduciary obligations inherent in insurance

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<sup>185</sup> See e.g. *Charter Services, Inc., v. Principal Mut. Life Ins. Co.*, 117 N.M. 82, 868 P.2d 1307 (1994)(award of pre-judgment interest pursuant to statute applicable to all actions is discretionary with the trial court, but interest should be awarded as a matter of right where defendant has breached contract to pay a definite sum of money), *Jackson National Life Ins. Co. v. Receconi*, 113 N.M. 403, 420, 827 P.2d 118, 135 (1992)(when insurer has unreasonably failed to pay claim, there is a presumption in favor of award of attorney fees, and thus there must be good reason for not awarding fees in that circumstance)(citing NMSA 1978, § 39-2-1); *Jackson National Life Ins. Co. v. Receconi*, 113 N.M. 403, 827 P.2d 118 (1992)(assessment of punitive damages requires evidence of bad faith); *Woodmen Accient & Life Ins. Co. v. Bryant*, 784 F.2d 1052, 1057 (10<sup>th</sup> Cir. 1986)(emotional distress damages are awardable in a breach of contract action when the breach causes bodily harm or if the breach results in serious emotional distress).

<sup>186</sup> *Charter Services, Inc. v. Pricipal Mut. Life Ins. Co.*, 117 N.M. 82, 87, 868 P.2d 1307, 1312 (Ct. App. 1994) (citing *Conant v. Rodruguez*, 113 N.M. 513, 828 P.2d 425 (Ct. App. 1992).

<sup>187</sup> *Jackson Nat. Life Ins. Co. v. Receconi*, 113 N.M. 403, 827 P.2d 118 (1992).

<sup>188</sup> N.M. U.J.I. 13-1718, See *Jessen v. National Excess Ins. Co.*, 108 N.M. 625, 776 P.2d 1244, 1246 (1989) overruled on other grounds.

<sup>189</sup> See N.M. U.J.I. 13-1827, committee comment (New Mexico's courts do not distinguish between pure tort and contract in the application of punitive damages).



relationships and because of concerns about the unequal bargaining positions of insurers and their insureds.<sup>190</sup>

In a typical breach of contract action, punitive damages are recoverable only “when the conduct of the wrongdoer may be said to be maliciously intentional, fraudulent, oppressive, or committed recklessly or with a wanton disregard of the Plaintiff’s rights.”<sup>191</sup> Even when the claim involves an insurance contract, a finding of negligence or even gross negligence is not enough to support an award of punitive damages.<sup>192</sup> There must be evidence the breaching party acted with at least reckless disregard for the interest of the non-breaching party.<sup>193</sup> Unless the insurer’s conduct rises to the level of recklessness or bad faith, an insured who sues the insurer for breach of contract is limited to seeking damages that arise out of the breach of contract.<sup>194</sup> The standard of conduct is the same for general tort cases.<sup>195</sup>

At one time, grossly negligent behavior supported a finding of bad faith and an award of punitive damages. For example, in *United Nuclear Corp. V. Allendale Mut. Ins.*,<sup>196</sup> the court held that a showing of an insurer’s “unfounded” or “frivolous” refusal to pay proceeds supported a finding of bad faith and a jury instruction on punitive damages.

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<sup>190</sup> *Romero V. Mervyn’s*, 109 N.M. 249, 255 784 P.2d 992 n. 3 (1989). See also *Cafeteria Operators, L.P. v. Coronado—Santa Fe Associates, L.P.*, WL 809222 (Ct. App. 1997) (citing *Paiz v. State Farm Fire & Cas. Co.*, 118 N.M. 203, 210 880 P.2d 300, 307 (1994) (in a breach of contract case, punitive damages must be predicated on a showing of bad faith, or a showing that the breaching party acted with reckless disregard for the interests of the non-breaching party)

<sup>191</sup> See *United Nuclear Corp. v Allendale Mut. Ins. Co.*, 103 N.M. 480, 485, 709 P.2d 649, 654 (1985).

<sup>192</sup> *Paiz v. State Farm Fire & Cas. Co.* 118 N.M. 203, 880 P.2d 300 (1994).

<sup>193</sup> *Id.* at 210, 880 P.2d 307 (a party acts with reckless disregard when it knows of potential harm to the interests of the plaintiff but nonetheless ‘utterly fails to exercise care’ to avoid the harm).

<sup>194</sup> *Id.* (citing *Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co.*, 102 N.M. 28-31, 690 P.2d 1022, 1023-25 (1984)).

<sup>195</sup> *Hinger v. Parker & Parsley Petroleum Co.* 120 N.M. 430, 902 P.2d 1033 (Ct. App. 1995).

<sup>196</sup> 103 N.M. 480, 485, 709 P.2d 649, 654 (1985).

However, in that case the court determined that the insurer had a legitimate basis to deny coverage and had not acted in bad faith.<sup>197</sup>

Judge Bivins, whose concurrence was necessary for a majority, thought that punitive damages in bad faith actions should only be allowed where there is either a showing of “intention to harm” or “recklessness.”<sup>198</sup> Thus, Judge Bivins argued that upon a determination of bad faith, punitive damages should only be allowed where the insurer’s conduct rises to the level of reckless disregard.<sup>199</sup>

The construction of bad faith as a “frivolous or unfounded” refusal to pay under the terms of the policy was affirmed in *Jessen v. National Excess Ins. Co.*<sup>200</sup> The *Jessen* court broaden the definition of bad faith to include delay in paying a claim for frivolous or unfounded reasons.<sup>201</sup> In that case, the court clarified that a finding of either gross negligence or reckless disregard for the interests of the insured would support an award of punitive damages in a breach of contract claim against an insurer.<sup>202</sup> In 1992, the standard for first-party bad faith changed. In *Jackson National Life Ins. Co. v. Receconi*,<sup>203</sup> the New Mexico Supreme Court held an award of punitive damages would be awarded in a bad faith action only when the insurer’s “frivolous” or “unfounded” refusal to pay constituted a “reckless disregard” of the insured’s interests.

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<sup>197</sup> *Id.*

<sup>198</sup> *Id.* at 489.

<sup>199</sup> *Id.*

<sup>200</sup> *Jessen v. National Excess Ins. Co.*, 108 N.M. 625, 776 P.2d 1244 (1989) overruled on other grounds.

<sup>201</sup> *Id.*

<sup>202</sup> *Id.* at 628, 776 P.2d at 1247; However, also See *Paiz v. State Farm Fire & Cas. Co.*, 118 N.M. 203, 880 P.2d 300 (1994)(in breach of contract case, including one involving insurance contract, punitive damages may not be predicated solely on gross negligence, but on a showing of bad faith or reckless disregard).

<sup>203</sup> 113 N.M. 403, P.2d 118 (1992).

Although no New Mexico court has considered whether a gross negligence standard will support a claim for bad faith in the third-party context, it will be interesting to see how the courts deal with the insurer's failure to defend. To support a finding of bad faith, must the evidence show that the insurer's failure to defend was done in reckless disregard of the insured's interests? Is this standard consistent with the current law surrounding the duty to defend?

## VI. AFFIRMATIVE DEFENSES IN BAD FAITH ACTIONS

Not surprisingly, insurers have attempted to prevent bad faith claims by developing preventive measures and workable defenses. An insurer may raise a number of defenses including the statute of limitations and failure to state a claim upon which relief can be granted.<sup>204</sup> However, this paper explores three emerging and somewhat controversial defenses: comparative bad faith, comparative fault, and ERISA Preemption.

### A. Comparative Bad Faith

The duty of good faith and fair dealing is owed by both the insurer and the insured.<sup>205</sup> An insurer who has acted in bad faith may seek relief for an insured's breach of the implied covenant of good faith and fair dealing.<sup>206</sup> For example, a comparative bad faith defense may be raised by counsel for the insurance company when the insured fails to comply with his or her duties, such as misrepresenting requested information or making a fraudulent claim. The idea of the comparative bad faith defense is that the insurer should not be subjected to bad faith liability if the insured has also engaged in

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<sup>204</sup> See Richmond, *supra*, at 116.

<sup>205</sup> *Modisette v. Foundation Reserves, Ins. Co.*, 77 N.M. 661, 427 P.2d 21 (1967).

misconduct. Generally, however, an insurer cannot raise the defense of comparative bad faith when the insured merely breached the insurance contract.<sup>207</sup>

The concept of comparative bad faith first surfaced in *Fleming v. Safeco Ins. Co. of America, Inc.*<sup>208</sup> In that case, the plaintiff was severely injured when the car she was traveling in was struck by a stolen vehicle. At the time of the accident, Safeco was the plaintiff's uninsured motorist carrier. Although the policy limits were \$15,000, Safeco only offered the plaintiff \$10,000 to settle her claim. The plaintiff eventually sued Safeco for bad faith. At trial, the jury returned a verdict in the plaintiff's favor, but determined that twenty-six percent of the plaintiff's compensatory damages were attributable to her bad faith and seventy-four percent were attributable to Safeco's bad faith.<sup>209</sup>

Although a number of jurisdictions now allow some form of comparative bad faith principles as viable defenses for insurers, the comparative bad faith theory remains relatively untested.<sup>210</sup> Furthermore, the duty of good faith and fair dealing toward the insurance company remains roughly undefined.<sup>211</sup> Much of the existing law is from California, where the theory of comparative bad faith is used as both an affirmative defense and as a separate cause of action referred to as "reverse bad faith".<sup>212</sup>

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<sup>206</sup> *Id.*

<sup>207</sup> Douglas Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?* 77 Marq. L. Rev. 41, 54 (1993).

<sup>208</sup> 206 Cal. Rpt. 313 (Cal. Ct. App. 1984).

<sup>209</sup> *Fleming*, at 315.

<sup>210</sup> Barry R. Ostrager & Thomas R. Newman, *Bad Faith and Wrongful Refusal to Settle: Liability in Excess of Policy Limits*, 518 PLI/Lit 233, 287 (1995). Marjie D. Barrows, *Reverse Bad Faith: Is the Duty of Good Faith and Fair Dealing Really a Two Way Street?*, In *Recurring Issues in Insurance Disputes*, 327 (David L. Leitner, ed. 1996).

<sup>211</sup> Ostrager & Newman, *supra*, at 287.

<sup>212</sup> *Id.*

Consequently, under a comparative bad faith defense, if the insured has dealt with the insurance company dishonestly about a material fact, or with the intent to deceive, he or she may be prevented from recovering under the bad faith claim.<sup>213</sup> New Mexico has not determined whether it will allow such a defense in a bad faith action. In *Jessen v. National Excess Ins. Co.*,<sup>214</sup> the New Mexico Supreme Court affirmed the trial court's refusal to submit a comparative bad faith instruction, cautiously stating that it was not deciding "whether such an instruction necessarily would be inappropriate in another case."<sup>215</sup> In determining whether the comparative bad faith defense is an appropriate defense in New Mexico, the court should consider the significance, if any, of the absence of anything owed by the insured to the insurer that resembles a fiduciary duty.<sup>216</sup>

In *Stephens v. Safeco Ins. Co. of America*,<sup>217</sup> the Montana Supreme court specifically rejected the comparative fault defense in a bad faith action. In that case, the court reasoned that bad faith is a tort only when the parties have a special relationship.<sup>218</sup> While the insured shares a special relationship with the insurer, the reverse is not true.<sup>219</sup> The insurer's superior economic position frees it from the fear of oppression and the risk of financial harm as is true of the insured.<sup>220</sup> Therefore, comparing the parties respective causes of action and remedies is like comparing "apples to oranges."<sup>221</sup>

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<sup>213</sup> Marjie Barrows, at 327.

<sup>214</sup> 108 N.M. 625, 776 P.2d 1244 (1989).

<sup>215</sup> *Id.* at 1249

<sup>216</sup> Jerry, II, *supra*, at 162.

<sup>217</sup> 852 P.2d 565 (Mont. 1993).

<sup>218</sup> *Id.* at 567.

<sup>219</sup> *Id.* at 568.

<sup>220</sup> *Id.*

<sup>221</sup> *Id.* at 569.

## B. Comparative Fault

In recent years, courts have also begun to allow insurers to claim comparative fault as a defense to bad faith actions.<sup>222</sup> The concept of comparative fault has evolved from a basic principle that a party may not recover for injuring him or herself, and allows the court to reduce the amount of damages relative to the fault of the injured party.<sup>223</sup> Unlike reverse bad faith, the comparative fault defense is only a partial defense, reducing damages--not entirely precluding them.

An insurer may seek to avoid its obligations under a policy by claiming the insured materially breached policy provisions. However, the insurance company must demonstrate substantial prejudice as a result of the insured's breach.<sup>224</sup> In most cases, whether the insured acted fairly or whether the insurer was substantially prejudiced by the actions of the insured are questions for the jury.<sup>225</sup>

The problem with the comparative fault defense is that it allows the trier of fact to compare the insured's negligence with the insurer's bad faith or reckless misconduct. Although New Mexico has recognized comparative negligence since *Bartless v. New Mexico Welding Supply*,<sup>226</sup> it has not decided whether a comparative fault jury instruction

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<sup>222</sup> Ronald S. Range *The Setup Defense and the Comparative Fault Defense: New Wrinkles in Bad Faith Claims Against Insurers*. 45 Wash. & Lee. L. Rev. 321 (1988).

<sup>223</sup> *Id.* at 347.

<sup>224</sup> *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 684 P.2d 524 (Ct. App.), cert. denied, 101 N.M. 362, 683 P.2d 44 (1984) overruled on other grounds.

<sup>225</sup> *Id.*

<sup>226</sup> 98 N.M. 152, 646 P.2d 579 (Ct. App.), cert. denied, 98 N.M. 336, 648 P.2d 794 (1982).

would be appropriate as a defense to a bad faith claim.<sup>227</sup> To date, only California has officially adopted comparative fault as an affirmative defense in bad faith litigation.<sup>228</sup>

A comparative fault defense gets further complicated under circumstances where the insurance company breaches its duty to defend the insured. An insurer who fails to defend loses the right to claim that the insured breached policy provisions, including the policy provisions requiring the insured to forward suit papers.<sup>229</sup> The insurer also loses the right to claim that the insured did not cooperate, the right to claim the insured settled without its consent, and becomes liable for any reasonable good faith settlement entered into by the insured.<sup>230</sup> In this situation, it is possible that an insurer who fails to defend may also waive its right to raise a comparative fault defense.

### C. ERISA Preemption

A problematic issue in the area of insurance bad faith involves claims arising under the Employee Retirement and Income Security Act ("ERISA").<sup>231</sup> ERISA is a comprehensive and complex statutory regime, the scope of which is beyond the purpose of this paper. However, it is noteworthy to mention it here because of its preemptive effect in common law breach of contract and bad faith actions.

In 1974, Congress passed the Employee Retirement Income Security Act ("ERISA") to protect the interests of participants in employee benefit plans (i.e., welfare and pension ) by requiring disclosure of information, establishing standards of conduct

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<sup>227</sup> See *Jessen v. National Excess Ins. Co.*, 108 N.M. 625, 630, 776 P.2d 1244, 1249 (1989)

<sup>228</sup> Douglas R. Richmond, *Insured's Bad Faith as Shield or Sword: Litigation Relief for Insurers?* 77 Marq. L. Rev. 41, 54 (1993).

<sup>229</sup> *State Farm Fire & Cas. Co. v. Price*, 101 N.M. 438, 684 P.2d 524 (Ct. App.), cert. denied, 101 N.M. 362, 683 P.2d 44 (1984) overruled on other grounds.

<sup>230</sup> *Id.*

<sup>231</sup> 29 U.S.C. §§ 1001 et seq.

for plan administrations, and by providing a federal remedy and forum for the benefit of participants.<sup>232</sup>

ERISA explicitly supersedes “any and all State laws insofar as they may now or hereafter relate to any employee benefit plan.”<sup>233</sup> ERISA preemption is sweeping, superseding common bad faith law with respect to insurance provided as part of an employee benefit plan.<sup>234</sup> For example, in *Lunn v. Time Insurance Co.*<sup>235</sup> the plaintiffs sued their insurance carrier for its alleged breach of an insurance contract and misrepresentation and bad faith in administration of an ERISA plan. The breach of contract claim sought benefits under the plan, and the bad faith and misrepresentation claims related to the plan’s administration. The court determined that because the bad faith claims related to the plan, they were preempted by ERISA.<sup>236</sup>

The preemptive effect of ERISA is substantial because most health insurance, life insurance, and some disability insurance provide benefits in the employment setting.<sup>237</sup> This means that insurers who provide such plans may not be sued for bad faith performance of their obligations under the policies.<sup>238</sup>

It is important to note that the scope of preemption of ERISA is not infinite, and certain claims based on state law in some sense which relates to an ERISA plan are not

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<sup>232</sup> Roger C. Henderson, *The Tort of Bad Faith In First-Party Insurance Transactions After Two Decades*, 37 Ariz. L. Rev. 1153, 1173 (1995).

<sup>233</sup> 29 U.S. C. § 1144(a).

<sup>234</sup> Jerry, II, *supra*, at 158.

<sup>235</sup> 110 N.M. 73, 792 P.2d 405 (1990).

<sup>236</sup> *Id.* at 75, 792 P.2d at 407.

<sup>237</sup> Jerry, II, *supra*, at 158.

<sup>238</sup> *Id.*



preempted.<sup>239</sup> ERISA does not preempt state laws that regulate insurance.<sup>240</sup> Moreover, state laws which affect ERISA plans in a “tenuous, remote or peripheral” manner will not be preempted.<sup>241</sup> Although ERISA provides no equivalent remedy to bad faith, preemption does not necessitate dismissal of the action where the pleadings state a cause of action arising under federal law.<sup>242</sup> The Supreme Court has found that ERISA so completely preempts the field of employee benefit plans that a complaint asserting only state causes of action may state a claim arising under federal law for the purpose of finding federal question jurisdiction under ERISA.<sup>243</sup> In the Tenth Circuit, “[a] state law claim will convert to a federal claim [if] the claim is preempted by ERISA and within the scope of ERISA’s civil enforcement provisions.”<sup>244</sup>

## VII. UNFAIR PRACTICE STATUTES

During the mid 1960s and 1970s, state legislatures began to codify the issues of good faith and fair dealing by enacting unfair claims practices statutes.<sup>245</sup> Often times these statutes and the causes of action they create preempt or supplant common law bad faith actions.<sup>246</sup> This has not been the case in New Mexico.

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<sup>239</sup> See e.g. *Fort Halifax Packaging Co. v. Coyne*, 482 U.S. 1 (1987)(no preemption where state law insures administration of a plan governed by a single set of regulations and to guarantee administrative integrity, issues not addressed under ERISA); *Hospice of Metro Denver, Inc. v. Group Health Ins. of Oklahoma, Inc.*, 944 F.2d 753, 754 (10<sup>th</sup> Cir. 1991)(state laws which affect plans in only a “tenuous, remote or peripheral” manner will not be preempted).

<sup>240</sup> *Henderson*, supra, at 1173.

<sup>241</sup> *Hospice of Metro Denver, Inc. v. Group Health Ins. Of Oklahoma Inc.*, 994 F.2d 752, 754 (10<sup>th</sup> Cir. 1991).

<sup>242</sup> *Jerry, II*, supra, at 158.

<sup>243</sup> See *Metropolitan Life Ins. Co. v. Taylor*, 481 U.S. 58, 95 L.Ed 2d 55, 107 S.Ct. 1542 (1987).

<sup>244</sup> *Carland v. Metropolitan Life Ins. Co.*, 935 F.2d 1114, 1119 (10<sup>th</sup> Cir. 1991), cert. denied, 116 L.Ed. 2d 761, 112 S. Ct. 670 (1991).

<sup>245</sup> *Richmond*, supra, at 113.

<sup>246</sup> *Id.*

In 1967, The New Mexico Legislature enacted a comprehensive Unfair Practices Act (“UPA”), Sections 57-12-1 to 57-12-16.<sup>247</sup> This act prohibits unconscionable and unfair or deceptive trade practices. In 1973, the legislature enacted the Unfair Insurance Practices Act which prohibits certain unfair methods of competition and unfair or deceptive acts in the business of insurance. However, this act was repealed in 1984, following the enactment of a comprehensive Insurance Code.<sup>248</sup> The Unfair Insurance Practices Act had the same purpose as the present New Mexico Insurance Code. Under the old Act there was no private right of action for unfair insurance practices. However, the new Code explicitly grants insureds a private right of action for unfair insurance practices.<sup>249</sup> Claims that form the basis of a suit under either bad faith or unfair insurance practices include those where: the insurer misrepresents to insured pertinent facts or policy provisions relating to coverage for the purpose of defeating coverage; the insurer fails to affirm or deny coverage of claims of insured within a reasonable time; the insurer fails to settle in good faith.<sup>250</sup>

To state a cause of action under the Unfair Practices Act, the insured must show that the insurer, while engaged in trade practice, took advantage the insured’s lack of knowledge, ability, experience or capacity to a grossly unfair degree.<sup>251</sup> Thus, where an insured asserts an action for the insurer’s bad faith under the terms of the insurance contract, the insured may alternatively seek relief under the Unfair Practices Act. Under

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<sup>247</sup> NMSA 1978, §§ 57-12-1 to 16.

<sup>248</sup> NMSA 1978, §§ 59A-1-1 to 59A-53-17.

<sup>249</sup> NMSA 1978, § 59A-16-30. (“any person covered by this article... a right to bring an action in district court to recover actual damages.”) This code supersedes the old Insurance code which did not provide a private cause of action. *See* NMSA 1978 § 59-11-9.

<sup>250</sup> Ashley, *supra*, 5-57; NMSA 1978, § 59A-16-1 through 30.

the Unfair Practices Act, the trial judge may, upon a finding of willful engagement in the trade practice, treble the actual damages awarded.<sup>252</sup> However, in the event of a trebling of damages by the trial judge and a verdict for punitive damages based upon a finding of bad faith, the insured will then be required to elect between the two awards so not to duplicate recovery.<sup>253</sup>

#### VIII. CONCLUSION

The law of bad faith was judicially created as a way to deal with increased tension between insurance companies and their insureds. The tort duty of bad faith contemplates that insurers must deal fairly with insureds and conduct their affairs in good faith. Despite the widespread acceptance of the law of bad faith, the concept of bad faith remains somewhat elusive, having no universally accepted definition.

Consequently, courts will continue developing the law of bad faith and the covenant of good faith and fair dealing as standards to test the propriety of insurers' conduct. In particular, future cases may address the requisite standard of care for bad faith duty to defend, and decide whether an insurer has a right to argue issues of coverage once it unjustifiably fails to defend.

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<sup>251</sup> See *Ashlock v. Sunwest Bank of Roswell, N.A.* 107 N.M. 100, 753 P.2d 346 (1988); NMSA 1978, § 57-12-2D.

<sup>252</sup> NMSA 1978, § 57-12-10 (1997).

<sup>253</sup> *Hale v. Basin Motor Co.*, 110 N.M. 314, 759 P.2d 1006 (1990).