

## Washington Court Rejects Bad Faith Coverage by Estoppel Because Insured Was Insulated from Liability

This week, the Division I Washington Court of Appeals granted partial relief to an insurer and held that if an insured is legally insulated from any exposure to a tort victim, the presumption of harm in a bad faith claim against the insurer is rebutted and there is no coverage by estoppel. *Mutual of Enumclaw Ins. Co. v. Day*, No. 75633-8-I (Dec. 12, 2016).

Mutual of Enumclaw (MOE) defended Day, subject to a reservation of rights, in a liquor liability case. This case arose when a teenager purchased alcohol at Myong Suk Day's grocery store and shared it with his underage friends. Two pedestrians, who were injured when the teenagers were racing their vehicles through Point Defiance Park, sued Day. Day then contacted her independent insurance agent, Michael Huh. Day alleges that she asked for liquor liability coverage when she first purchased the policy years before the accident and that Huh told her she had insurance applicable to the claims in the lawsuit. Huh, on behalf of Day, tendered the claim to MOE. MOE reserved rights, agreed to defend Day, and stated that it might bring a declaratory judgment action to determine its obligations under the policy.

MOE's policy did not include liquor liability coverage. Day asserted the policy should have included liquor liability coverage, and asserted MOE failed to investigate her assertion. The MOE claims adjuster had no explanation for why MOE did not interview Day about the coverage issue or ask Day why she thought she had liquor liability coverage. Additionally, MOE did not tell Day that agent Huh claimed she declined liquor liability coverage at the time the policy was requested.

MOE filed a declaratory judgment action to determine its obligation to defend or indemnify Day. In her answer, Day sought reformation of the insurance contract to include liquor liability coverage or otherwise provide Day with insurance coverage and alleged bad faith, Consumer Protection Act (CPA) and Insurance Fair Conduct Act (IFCA) violations, and coverage by estoppel.

In June 2011, the parties in the personal injury lawsuit reached a settlement agreement and Day agreed to an entry of judgments for the pedestrians against Day for \$7,986,222. The pedestrians agreed not to execute on the agreed judgments, except as to Day's claims against insurance agent Huh. Day assigned the pedestrians all rights, privileges, claims, and causes of action that she may have against Huh, but Day retained her claims against MOE. The settlement agreement included an obligation to fully satisfy the judgments against Day once the claims against Huh concluded. The pedestrians reached a settlement with Huh three years later, and the trial court entered an order finding the settlement reasonable. Thus, under the 2011 settlement agreement, because the claim against Huh had been resolved, the agreed judgments against Day were fully satisfied.

In the coverage case, the trial court denied Day's claim to reform the insurance contract but applied coverage by estoppel to award Day a judgment against MOE in the amount of the agreed judgments for the pedestrians, with interest. The jury found that MOE's bad faith caused Day emotional distress damages in the amount of \$300,000, and the trial court then applied the IFCA multiplier, resulting in an award of an additional \$600,000 in damages. The court also awarded attorney fees to Day. MOE appealed and Day cross-appealed.

In a traditional covenant judgment, the tort victim takes an agreed judgment against the insured in exchange for a covenant not to execute on any of the insured's assets except the insured's claims against its own insurer, and the insured assigns those claims to the tort victim. The insured is not released from liability, but recovery is limited to a specific asset — the proceeds of the insurance policy and the rights owed by the insurer to the insured.

Washington case law holds that if the insurer has engaged in bad faith while defending the tort



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victim's personal injury claim under a reservation of rights, the tort victim pursuing the assigned bad faith claim against the insurer is entitled to a presumption of harm and coverage by estoppel. If the settlement reached is reasonable, the amount of the agreed judgment is the tort victim's presumptive recovery on the assigned bad faith claim.

Under the facts here, however, the Court of Appeals held that coverage by estoppel was precluded because Day was insulated from liability. The court compared the case to *Werlinger v. Clarendon National Insurance Co.*, 129 Wn. App. 804 (2005), noting that where the insured is protected from personal liability, the presumption of harm is rebutted. The insured in *Werlinger* was protected from personal liability due to a discharge in bankruptcy, which meant there was no injury to the insured.

The court held that Day's insulation from liability is equivalent to the insured's bankruptcy in *Werlinger*. The court noted that when the judgments were entered against Day in 2014, the claim against Huh had been resolved and thus, under the 2011 settlement agreement, Day was entitled to a full satisfaction of those judgments. Furthermore, unlike the rights created in a traditional covenant judgment, Day's right to full satisfaction of the agreed judgments is unrelated to the resolution of any claims (retained or assigned) against Day's insurer. As a result, Day was legally insulated from any exposure based on the agreed judgments, which meant there was no injury to Day. The court concluded that even assuming that a presumption of harm applies, the presumption is rebutted, precluding any application of coverage by estoppel.

The court declined to address MOE's argument that the emotional distress damages are not "actual damages" subject to trebling under IFCA because MOE did not preserve the issue for appeal. And the court affirmed the trial court's award of attorney fees under IFCA and awarded Day her reasonable fees on appeal on the issue she prevailed upon.

This case illustrates the need to evaluate the terms of each settlement, but also to be wary that in Washington, bad faith and IFCA claims can proceed to an adverse verdict even in the absence of an indemnity obligation.

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**To discuss any questions you may have regarding the issues discussed in this Alert, or how they may apply to your particular circumstances, please contact William F. Knowles at [wknowles@cozen.com](mailto:wknowles@cozen.com) or (206) 224-1289 or Katie M. Sluss at [kssluss@cozen.com](mailto:kssluss@cozen.com) or (206) 373-7208.**