

# WHITE AND STEELE, P.C.

ATTORNEYS AT LAW

## Summary of Colorado Bad Faith Law

By:

**Robin L. Bowers, Esq.**

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### **I. General Law Surrounding Bad Faith Claims**

Colorado imposes a duty of good faith and fair dealing in every contract, which if breached, generally provides the injured party with remedies under contract law and not tort law.<sup>1</sup> However, because of the special nature of the relationship which exists between an insurer and an insured, the breach of the duty of good faith and fair dealing in the insurance context will give rise to tort liability.<sup>2</sup> Such a tort claim is separate and independent from any claim made under the policy itself.<sup>3</sup> Further, due to the special relationship between an insurer and an insured, the duty of good faith and fair dealing is non-delegable.<sup>4</sup> Colorado has also imposed the duty of good faith and fair dealing upon claim administrators who perform actions similar to those generally performed by insurers.<sup>5</sup> This same duty is also imposed upon worker's compensation insurers, independent claims adjusting companies, surety companies and insurance vendors.<sup>6</sup>

There are two types of insurance bad faith claims in Colorado: first party claims and third-party claims. When an insurer refuses to pay or delays paying the insured under an insurance policy, the insured may bring a claim for first party bad faith. When an insurer acts unreasonably in investigating, settling or defending a claim made against the insured, the insured may bring a claim for third party bad faith. Colorado does not recognize a claim by a third-party claimant

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<sup>1</sup> Goodson v. American Standard Insurance Co., 89 P.3d 409, 414 (Colo. 2004).

<sup>2</sup> Goodson, 89 P.3d at 414.

<sup>3</sup> Flickinger v. Ninth District Production Credit Ass'n of Wichita, 824 P.2d 19, 24 (Colo. 1991).

<sup>4</sup> Cary v. United of Omaha Life Insurance Co., 68 P.3d 462,, 466 (Colo. 2003).

<sup>5</sup> See Cary, 68 P.3d at 466 and at 469 holding a third-party administrator may be subject to bad faith. "When the actions of a defendant are similar enough to those typically performed by an insurance company in claim administration and disposition, we have found the existence of a special relationship sufficient for imposition of a duty of good faith and tort liability for its breach – even when there is no contractual privity between the defendant and the plaintiff." Id.

<sup>6</sup> See also Travelers Insurance Co. v. Savio, 706 P.2d 1258 (Colo. 1985) indicating worker's compensation insurers owe a duty to an employer's employees; Scott Wetzel Services Inc. v. Johnson, 821 P.2d 804 (Colo. 1991) holding that independent claims adjusting companies for self-insured employers owe a duty of good faith and fair dealing to injured employees; Transamerica Premier Insurance Co. v. Brighton School District 27J, 940 P.2d 348 (Colo. 1997) holding that privity requirements are not necessary for bad faith actions relating to surety contracts; and Rederscheid v. Compicare, Inc., 667 P.2d 766 (Colo. App. 1983) holding an insurance vendor is also subject to bad faith.

against an insurer for bad faith.<sup>7</sup> "Whether an insurer has acted reasonably in denying or delaying approval of a claim will be determined on an objective basis, and generally requires proof of the standards of conduct in the industry."<sup>8</sup> However, at least in the first-party context, expert testimony concerning the insurer's standard of care may not be required if the standard is within the knowledge or experience of an average juror and when a statute such as the Unfair Claims Practices Act sets forth such standard.<sup>9</sup>

It should be noted that even though the insurance relationship is ongoing, the continued relationship will not generally provide a basis for tolling the statute of limitations applicable to claims for bad faith.<sup>10</sup> Further, any time limitations for bringing claims contained in the applicable policy do not apply to tort claims for bad faith breach against insurers.<sup>11</sup> It should also be noted that because claims for bad faith are torts, claims against a government entity are generally barred by sovereign immunity.<sup>12</sup>

## II. First Party Bad Faith

If a claim is made directly by an insured against his or her own insurer, such a claim is considered a first party claim. First party claims involve an insurer's refusal to pay or delay in paying the insured under insurance policies such as life, health, disability, property, fire or no-fault auto insurance policies.<sup>13</sup> The duty of good faith and fair dealing in the first party context is broad and wide-ranging "extending to 'everything pertaining' to the provision of insurance services to the public."<sup>14</sup> In a first party context, an insured has not ceded his interests to the insurer for representation and thus Colorado has not found a fiduciary relationship to exist.<sup>15</sup> For this reason, in a first party claim the insurer's conduct is not judged on a negligence standard, rather, "...an insurer will be held liable for a bad faith refusal to settle a claim only if it is shown that the insurer's conduct was unreasonable and that the insurer knew that such conduct was unreasonable or acted with a reckless disregard of its unreasonableness."<sup>16</sup> Thus, a determination of bad faith conduct in the first party context looks at two elements including proof of unreasonable conduct and knowledge of the unreasonableness.<sup>17</sup>

### A. Unreasonable Conduct

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<sup>7</sup> Schnacker v. State Farm Mut. Auto. Ins. Co., 843 P.2d 102 (Colo. App. 1992).

<sup>8</sup> Travelers Insurance Co. v. Savio, 706 P.2d 1258, 1275 (Colo. 1983).

<sup>9</sup> American Family Mutual Insurance Co. v. Allen, 102 P.3d 333 (Colo. 2004).

<sup>10</sup> Harmon v. Fred S. James & Co., 899 P.2d 258, 261 (Colo. App. 1994).

<sup>11</sup> Flickinger, 824 P.2d at 24-25; Emenyonu v. State Farm Fire and Casualty Co., 885 P.2d 320 (Colo. App. 1994).

<sup>12</sup> Jordan v. City of Aurora, 876 P.2d 38 (Colo. App. 1993).

<sup>13</sup> Goodson, 89 P.3d at 414.

<sup>14</sup> Ballow v. Phico Ins. Co., 875 P.2d 1354, 1363 (Colo. 1993).

<sup>15</sup> Goodson, 89 P.3d at 415.

<sup>16</sup> Tozer v. Scott Wetzel Services, Inc., 883 P.2d 496, 498 (Colo. App. 1994); Savio, 706 P.2d at 1275; Farmers Group, Inc. v. Williams, 805 P.2d 419, 421 (Colo. 1991); Goodson, 89 P.3d at 415.

<sup>17</sup> Savio, 706 P.2d at 1272.

The question of reasonableness of an insurer's actions is a question for the court and not for the lay fact finders.<sup>18</sup> Reasonableness "depends upon whether the actions were predicated on a rational argument based on law or fact."<sup>19</sup> The determination of reasonableness is made objectively, and must be "based on proof of industry standards" which may require expert witnesses to establish evidence of such standards.<sup>20</sup> Note that Colorado has refused to place the burden on the insured to prove a lack of any arguable reason for denying the claim and thus, it would appear that the burden is on the insurer to prove it had a rational argument based on law or fact.<sup>21</sup> A determination as to reasonableness of a decision to deny benefits "must be evaluated based on the information before the insurer at the time of that decision."<sup>22</sup>

If the basis for an insurer's actions is an open question of law, Colorado has found a reasonable and rational basis for an insurer's actions.<sup>23</sup> Likewise, if the insurer's actions lack substantial justification and have no rational argument based upon either the law or the evidence, they will be found to be unreasonable and in bad faith.<sup>24</sup> Note the "substantial justification" test has been found to be unduly limiting and will not govern all first party bad faith claims.<sup>25</sup>

Finally, while the duty of good faith and fair dealing continues for the life of the insurance relationship, the obligation to negotiate with the insured may be temporarily suspended due to special circumstances.<sup>26</sup> For example, an insurer has been found to have had no obligation to continue settlement negotiations when there is a disagreement about the amount of compensable damages and when the insured has demanded arbitration.<sup>27</sup>

## **B. Knowledge**

The second element in a first party bad faith claim requires knowledge, which reflects a balance between "... the right of an insurance carrier to reject a non-compensable claim submitted by its insured and the obligation of such carrier to investigate and ultimately approve a valid claim of its insured."<sup>28</sup> In fact, it has been recognized that both the insurer and the insured have equal duties to protect their own interests due to the contractual nature of the relationship.<sup>29</sup> The Court noted that "[t]he insurer has a right to protect its own interests along with those of the insured, and these interests run parallel to each other, neither being superior."<sup>30</sup> For this reason, in the

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<sup>18</sup> Tozer, 883 P.2d at 499.

<sup>19</sup> Diversified Veterans Corporate Center v. Hewuse, 942 P.2d 1312, 1313 (Colo. App. 1997).

<sup>20</sup> Goodson, 89 P.3d at 415. *But see Allen*, 102 P.3d 333, *supra*.

<sup>21</sup> *See, e.g. Herod v. Colorado Farm Bureau Mutual Insurance Co.*, 928 P.2d 834, 836 (Colo. App. 1996).

<sup>22</sup> Peiffer v. State Farm Mutual Automobile Insurance Co., 940 P.2d 967, 970 (Colo. App. 1996).

<sup>23</sup> Tozer, 883 P.2d at 499.

<sup>24</sup> American Guarantee and Liability Insurance Co. v. King, 97 P.3d 161, 168 (Colo. App. 2003) citing Tozer, 883 P.2d at 499.

<sup>25</sup> *See King*, 97 P.3d at 168-69 where the court found that maintenance of a suit out of dislike for a claimant, without investigation, disregarding information provided to it, and then attempting to hide such evidence is sufficient for bad faith.

<sup>26</sup> Bucholtz v. Safeco Insurance Co. of America, 773 P.2d 590, 592 (Colo. App. 1988).

<sup>27</sup> Bucholtz, 773 P.2d at 593.

<sup>28</sup> Savio, 706 P.2d at 1275.

<sup>29</sup> Bailey v. Allstate Insurance Co., 844 P.2d 1336, 1339 (Colo. App. 1992).

<sup>30</sup> Bailey, 844 P.2d at 1339.

first party context where the relationship between insurer and insured is adversarial, it is impossible for the insurer to be a fiduciary for the insured.<sup>31</sup>

Additionally, in instances where the insured is seeking reformation of a contract for extended or enhanced PIP benefits, Colorado has found that additional benefits are not due until after reformation, and thus failure to pay enhanced PIP benefits prior to reformation has been found insufficient for a claim of bad faith.<sup>32</sup> The Court noted that "[a]n insurer may challenge claims which are fairly debatable. If as here, an insurer maintains a mistaken belief that the claim is not compensable, it may be within the scope of permissible challenge even if its belief is incorrect."<sup>33</sup>

### III. Third Party Bad Faith

A third party claim for bad faith is a claim by an insured against his or her insurer for unreasonably failing to settle, defend or investigate a claim brought against the insured by a third-person.<sup>34</sup> Like the first party claim context, Colorado imposes upon insurers a duty of good faith and fair dealing in the third party claim context.<sup>35</sup> However, unlike in the first party context, when a third-party brings a claim against an insured, the insurer retains control of the defense and the insured may not interfere with such defense, investigation or settlement.<sup>36</sup> For this reason, Colorado has found a quasi-fiduciary relationship between the insured and insurer in the third-party context.<sup>37</sup> Further, unlike the first party bad faith context, third party bad faith claims are judged under a negligence standard.<sup>38</sup>

The quasi-fiduciary relationship between the insured and the insurer results in a duty being placed upon the insurer to exercise reasonable care in settling and defending claims.<sup>39</sup> The purpose of purchasing insurance is to obtain protection against calamity, which purpose is defeated when an insurer refuses without justification to pay valid claims.<sup>40</sup> However, the duty to settle does not extend to settling to protect the insured from punitive damages since such damages cannot be covered by insurance in accordance with the public policy of Colorado.<sup>41</sup>

For an insured to have a claim against its insurer for bad faith in a third-party context, the facts plead must show an absence of any reasonable basis for the insurers actions.<sup>42</sup> The question is one of reasonableness examining whether a reasonable insurer would "have denied or delayed payment of the claim under the facts and circumstances."<sup>43</sup>

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<sup>31</sup> Bailey, 844 P.2d at 1339.

<sup>32</sup> *See, e.g. Brennan v. Farmers Alliance Mutual Insurance Co.*, 961 P.2d 550, 556 (Colo. App. 1998).

<sup>33</sup> Brennan, 961 P.2d at 557.

<sup>34</sup> *See Farmers Group, Inc. v. Trimble*, 691 P.2d 1138 (Colo. 1984); and Goodson, 89 P.3d at 414.

<sup>35</sup> Trimble, 691 P.2d at 1141.

<sup>36</sup> Trimble, 691 P.2d at 1141.

<sup>37</sup> Trimble, 691 P.2d at 1142.

<sup>38</sup> Trimble, 691 P.2d at 1142; Wheeler v. Reese, 835 P.2d 572, 578 (Colo. App. 1992)..

<sup>39</sup> Trimble, 691 P.2d at 1142.

<sup>40</sup> Trimble, 691 P.2d at 1141.

<sup>41</sup> Lira v. Shelter Ins. Co., 931 P.2d 514 (Colo. 1996).

<sup>42</sup> Trimble, 691 P.2d at 1142.

<sup>43</sup> Trimble, 691 P.2d at 1142.

#### IV. Damages/Willful and Wanton Conduct

Generally bad faith breach of insurance contract, if proved, entitles the insured to damages under traditional tort principles, including compensatory damages for both economic and non-economic losses.<sup>44</sup> Such damages include a "...complete range of non-economic damages ... so long as the damages are foreseeable at the time of contracting and the damages are a natural and probable result of the breach."<sup>45</sup> While insureds may recover the attorney's fees they incur in attempting to obtain the benefits provided for under the policy, they may not recover the attorney's fees they incur in prosecuting the bad faith claim itself.<sup>46</sup>

Punitive damages are available if an insured establishes that the insurer's breach of contract was "accompanied by circumstances of fraud, malice, or willful and wanton conduct."<sup>47</sup> In the no-fault context, Colorado has determined that willful and wanton conduct is established if "an insurer acts without justification and in disregard of plaintiff's rights."<sup>48</sup> Further, while a finding that an insurer acted willfully and wantonly will also result in a finding of bad faith, the converse is not true; a finding of bad faith will not result in a finding of willful and wanton conduct.<sup>49</sup> This is because while willful and wanton conduct concerns "the refusal to pay insurance benefits when due ... the tort of bad faith breach of an insurance contract encompasses an entire course of conduct and is cumulative."<sup>50</sup> Finally, it has been held that a finding of outrageous conduct by an insurer necessarily implies that the conduct was willful and wanton.<sup>51</sup>

For questions regarding this summary or the law cited therein, please contact Robin L. Bowers, Esq. at [rbowers@wsteele.com](mailto:rbowers@wsteele.com) or (303) 296-2828.

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<sup>44</sup> Goodson, 89 P.3d at 415.

<sup>45</sup> Giampapa v. American Family Mutual Insurance Co., 64 P.3d 230, 238 (Colo. 2003).

<sup>46</sup> Bernhard v. Farmers Ins. Exchange, 885 P.2d 265 (Colo. App. 1994).

<sup>47</sup> Goodson, 89 P.3d at 415.

<sup>48</sup> Dale v. Guaranty Nat'l Insurance Co., 948 P.2d 545, 551 (Colo. 1997).

<sup>49</sup> Dale, 948 P.2d at 551.

<sup>50</sup> Dale, 948 P.2d at 551-52.

<sup>51</sup> Munoz v. State Farm Mutual Automobile Insurance Co., 968 P.2d 126, 129-30 (Colo. App. 1998).