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Insurer's Failure to Settle

*John L. Heaslip**

WHEN ONE PURCHASES a liability insurance policy he is contracting with the insurer for the insurer to stand in his place and to pay all liability claims brought against the insured for which the insured is legally liable. In essence, the risk of financial loss is transferred from the shoulders of the insured to those of the insurer, to the extent of the policy limits. The rights and duties of the parties created by a typical automobile liability policy are clearly stated in the policy. The insurer usually incurs the duty:

. . . To pay on behalf of the insured all sums which the insured shall become legally obligated to pay as damages because of bodily injury and/or property damage.

. . . To defend any suit alleging such bodily injury or property damage and seeking damages . . ., even if any of the allegations of the suit are groundless, false or fraudulent.

But the insurer reserves the right:

. . . To make such investigation and settlement of any claim or suit as *it deems expedient*.

The insured agrees:

. . . To cooperate with the company and, upon the company's request, attend hearings and trials and assist in making settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of any legal proceedings.

. . . The insured shall not, except at his own cost, voluntarily make any payment, assume any obligation or incur any expense other than for such immediate medical and surgical relief to others as shall be imperative at the time of accident.¹

These typical agreements preclude the insured from handling any claims or suits brought against him, and place the insurer in complete control and direction of the defense or compromise of suits or claims. But there seems to be universal agreement in all the courts that the insurer may not execute its

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¹ American States Automobile Excel Ins. Policy, form 9-ax (Nov. 1959); 30 Ohio Jur. 2d 585 at Sec. 646.

duties solely as "it deems expedient" for its own welfare. Rather, the courts recognize a duty on the part of the insurer, in considering settlement offers, to act in such a manner that will display adequate consideration for the interests of the insured.²

Assume that an insurer issues a liability insurance policy with limits of \$5,000 for each person injured, and that the claimant alleges that through the insured's negligence he incurred injuries and claims damages in a suit against the insured in the amount of \$25,000. Prior to trial the claimant offers to settle the case for \$4,500, but the insurer declines to settle. Judgment is awarded in the claimant-versus-insured suit for \$15,000, and the insured institutes suit against the insurer for the excess judgment of \$10,000, claiming that the insurer should be liable for failure to settle.

In deciding cases of this nature the courts must take into consideration several issues of law:

1. Is the insurer under any duty to the insured to accept the compromise offer, and if it is, what is the nature and the extent of that duty?
2. Must the insured pay the excess judgment in order to claim any damages?
3. Who, if anyone, besides the insured, can maintain such an action against the insurer?

Insurer's Duty to Settle

In the earlier cases the courts, in considering this issue, took the position that the policy was clear and unambiguous; that just because the insurer reserved the privilege of settling, this did not place a corresponding duty on him to settle.³ But surely, in our day, such an attitude cannot be allowed to prevail. It is true that the policy definitely gives to the insurer the power to settle as it deems expedient. Yet it would seem that this is so provided chiefly because the insurer is in a better position to evaluate the worth of a claim than is the insured. But by what rational process can it be held to be justifiable for an insurer to have the absolute *right* to deliberately *abuse* this power given

² 30 Ohio Jur. 2d 593 at Sec. 649 (The rights and duties to settle); 29a Am. Jur. 556 at Sec. 1444 (Duty to exercise good faith or due care); 40 A. L. R. 2d 170 at Sec. 2. See, Keeton, Liability Insurance and Responsibility for Settlement, 67 Harv. L. R. 1136 (1954).

³ 40 A. L. R. 2d 174 at Sec. 3 (Absolute Discretion).

by the insured? As the insurer has the power, through the control of settlement, to adversely affect the insured's interests, it must necessarily bear a legal responsibility for the proper exercise of that power.⁴ As early as 1932, in the landmark case of *American Mutual Liability Insurance Co. v. Cooper*,⁵ Judge Bryan of the Fifth Circuit Court of Appeals made it clear that the "absolute discretion" theory was no longer acceptable:

. . . It is well settled in cases of limited liability insurance that the insurer may so conduct itself as to be liable for the entire judgment recovered against the insured, although that judgment exceeds the amount of the liability named in the policy. But the courts that have considered the question are not in agreement as to the nature and kind of proof which it is incumbent upon the insured to make in an action against the insurer for the excess which the insured has been compelled to pay over the amount named in the policy. Some of the cases hold that the insured is entitled to recover upon proof that the insurer in refusing to settle a claim for damages covered by the policy was guilty of negligence. Other decisions impose a heavier burden upon the insured, and deny recovery unless he can show that the insurer in refusing to make a settlement acted in bad faith.

As of 1955 almost all of the courts passing on the issue held to the "good faith" doctrine.⁶ In checking the more recent cases that doctrine was found still to be the majority view,⁷ with a

⁴ *Harris v. Standard Accident and Ins. Co.*, 191 F. Supp. 538, 540 (D. C. S. D. N. Y. 1961).

⁵ 61 F. 2d 446, 447 (5th Cir., Ala. 1932).

⁶ 40 A. L. R. 2d 178 (Cases are cited by states following the good faith doctrine and those following the negligence theory).

⁷ *Hart v. Republic Mutual Ins. Co.*, 152 Ohio St. 185, 87 N. E. 2d 347 (1949); *Ross v. Stricker*, 85 Ohio App. 56, 88 N. E. 2d 80 (1949); *J. Spang Baking Co. v. Trinity Universal Ins. Co.*, 45 Ohio L. Abs. 577, 68 N. E. 2d 122 (1946); *Cleveland Wire Spring Co. v. General Acc. Fire and Life Ass. Corp., Ltd.*, 6 Ohio App. 345 (1917); *Southern Farm Bureau Cas. Ins. Co. v. Parker*, 341 S. W. 2d 36 (Ark. 1960); *Supra*, n. 4; *Davey v. Public Natl. Ins. Co.*, 5 Cal. Rpt. 488, 188 Cal. App. 2d 387 (1960); *Maroney v. Allstate Ins. Co.*, 12 Wis. 2d 197, 107 N. W. 2d 261 (1961); *Radio Taxi Service Inc. v. Lincoln Mutual Ins. Co.*, 31 N. J. 299, 157 A. 2d 319 (1959); *Bentley v. Farmers Ins. Exchange*, 289 F. 2d 59 (C. A. Mich. 1961); *Bell v. Commercial Ins. Co. of Newark, N. J.*, 280 F. 2d 514 (C. A. 3rd Cir. Pa. 1960); *American Fidelity and Cas. Co. v. Nicholis*, 173 F. 2d 830 (C. A. 10th Cir. Okla. 1949); *McGarry v. Rhode Island Mutual Ins. Co.*, 158 A. 2d 156 (R. I. 1960); *Peerless Cas. Co. v. Cole*, 121 Vt., 258, 155 A. 2d 866 (1960); *Tennessee Farmers Mutual Ins. Co. v. Wood*, 277 F. 2d 21 (C. A. 6th Cir. Tenn. 1960); *American Fidelity and Cas. Co. v. Greyhound Corp.*, 258 F. 2d 709 (C. A. 5th Cir. Fla. 1958); *Henke v. Iowa Home Mutual Cas. Co.*, 250 Ia. 1123, 97 N. W. 2d 168 (1959); *Boerger v. American Ins. Co. of Minn.*, 257 Minn. 72, 100 N. W. 2d

(Continued on next page)

small minority holding to the "strict negligence" theory.⁸ There is a substantial minority of cases which seem to say that either theory is applicable.⁹

Good Faith Doctrine

Those states that follow the good faith theory take the position that, as the carrier has the power to accept or reject the settlement offer, to the possible detriment of both, it stands in a fiduciary relationship to the insured, with the resulting duties that grow out of such a relationship.¹⁰ It is not enough to show that the insurer acted negligently in deciding to litigate rather than to settle the case, but rather, that it is guilty of bad faith, which is a species of fraud, that must be proved by clear, satisfactory, and convincing evidence.¹¹ Good faith implies honesty, fair dealing and full revelation, while bad faith implies dishonesty, fraud, and concealment.¹² It is the insurer's duty to consider, in good faith, the insured's interest as well as its own when making the decision as to settlement. A recent case pointed out that:

. . . The insurer must accord the interest of its insured the same faithful consideration it gives its own interest in handling the defense of an action: since the interest of one or the other may be imperiled at the instant of decision, the fairest method of balancing the interests is for the insurer to treat the claim as if it alone were liable for the entire amount.¹³

(Continued from preceding page)

133 (1959); *Fidelity Cas. Co. of N. Y. v. Rabb*, 267 F. 2d 473 (C. A. 5th Cir. Tex. 1959); *Prickett v. Hawkeye Security Ins. Co.*, 282 F. 2d 294 (C. A. 10th Cir. Kan. 1960); *Perry v. U. S. Fid. & Guar. Co.*, 359 S. W. 2d 1 (Tenn. App. 1962).

⁸ *Chancery v. New Amsterdam Cas. Co.*, 336 S. W. 2d 763 (Tex. Civ. App. 1960); *General Accident Fire and Life Assurance Co.*, 188 F. Supp. 23 (D. C. E. D. Wis. 1959).

⁹ *Lee v. Nationwide Mutual Ins. Co.*, 184 F. Supp. 634 (D. C. 4th Cir. Md. 1961); *Southeastern Fire Ins. Co. v. Hilton*, 192 F. Supp. 441 (D. C. S. D. Ala. 1961); *Moore v. Columbia*, 174 F. Supp. 566 (D. C. Ill. 1960); *Alabama Farm Bureau Mutual Cas. Ins. Co. Inc. v. Dalrymple*, 270 Ala. 119, 116 So. 2d 924 (1959); *Southern Farm Bureau Cas. Ins. Co. v. Parker*, 341 S. W. 2d 36 (Ark. 1960); *Canal Ins. Co. of Greenville v. Sturgis*, 114 So. 2d 469 (Fla. 1960).

¹⁰ *American Fidelity and Casualty Co. v. Nicholis*, 173 F. 2d 830 (10th Cir. Okla. 1949).

¹¹ *Maroney v. Allstate Ins. Co.*, 12 Wis. 2d 197, 107 N. W. 2d 261 (1961).

¹² *Davey v. Public National Ins. Co.*, 188 Cal. App. 2d 514, 515 (3rd Cir. Pa. 1960).

¹³ *Bell v. Commercial Ins. Co. of Newark, N. J.*, 280 F. 2d 514 (D. C. S. D. N. Y. 1961).

A failure to comply with that obligation is generally proved by evidence largely circumstantial in nature. It is most readily inferable when the severity of the claimant's injuries is such that any verdict against the insured is likely to be greatly in excess of the policy limits, and further when the facts in the case indicate that a defendant's verdict on the issue of liability is doubtful. When these two factors coincide, and the insurer still refuses to settle, the inference of bad faith is strong.¹⁴ In other words, the insurer should determine not to settle a claim within policy limits only on the basis of a bona fide belief that there is a real likelihood of prevailing in the action.¹⁵ To hold the contrary would be to sanction a gamble, and it is bad faith to gamble with the insured's money.¹⁶ Thus it would appear that under the good faith doctrine the question to be answered is whether or not the insurer acted with its own interests too much in mind, with the result of subordinating the insured's interests to its own.¹⁷

Negligence Theory

Repeatedly, in reading decisions of courts following the *good faith* doctrine, one will hear them say that a liability insurance company which reserves the right to settle as it deems expedient, any claim against its insured, is not liable to the insured for mere negligence in settling or refusing to settle a claim. Thus it appears that under the *negligence* theory the insurer is placed under a stricter duty of care for the interests of the insured than is the case under the good faith doctrine. The test applied under the negligence theory is that of reasonable care.¹⁸ The ultimate responsibility of an insurer to its insured, in regard to settlement of a claim, is to exercise such care and diligence as an ordinarily prudent person would exercise in the management of his own business.¹⁹ This, of course, does not mean that merely because

¹⁴ Harris, *supra*, n. 4.

¹⁵ *Id.*, at 544.

¹⁶ Tennessee Farmers Mutual Ins. Co. v. Wood, 277 F. 2d 21 (6th Cir. Tenn. 1960).

¹⁷ Hart v. Republic Mutual Ins. Co., 152 Ohio St. 185, 87 N. E. 2d 347 (1949).

¹⁸ Augustin v. General Accident Fire and Life Assurance Co., 188 F. Supp. 23 (D. C. E. D. Wis. 1959), *affd.* 283 F. 2d 82 (7th Cir. Wis. 1960).

¹⁹ Chancery v. New Amsterdam Casualty Co., 336 S. W. 2d 763 (Tex. Civ. App. 1960).

the decision of the insurer proved to be wrong that it will become liable.

In *Augustin v. General Accident*, the court, following the negligence theory, held the insurer liable because it appeared that it was negligent in the investigation of the claim, with the result that it was not in a position to make a fair appraisal of the value of the case.²⁰ Under the good faith doctrine this negligence or error in judgment does not constitute fraud or bad faith.²¹ Under the good faith doctrine the insured is charged with the duty of making a reasonable investigation. Negligence in not doing this is indicative of bad faith, but negligence alone is not sufficient to render the insurer liable.

Negligence and or Bad Faith

To me the more progressive view seems to be that which requires not only good faith but which also holds the insurer liable for negligence. This would seem to eliminate the possible assertion of due care where there was an exercise of bad faith in a state following the strict negligence theory, and the opposite claim of negligence but no bad faith in a state following only the good faith doctrine. In *Southern Farm Bureau v. C. H. Parker*, the court said: "It may be negligence to refuse to settle, even though the negligent person may be acting in good faith. One may in good faith make an honest mistake which hurts another and still be liable for negligence in making the mistake even though no harm was intended."²² In *Lee v. Nationwide Mutual Insurance Co.*, the insurer was free from negligence but took the position that the offer was not technically suitable nor to its liking.²³

Not only does double application of the doctrines close any possible technical loopholes but it forces the insurer to live up to the high standards which every insured reasonably expects when purchasing the policy. It narrows the grounds for grievances between the parties and stems the ever increasing demand for state control of insurance. Only those insurers who are considered to be undesirable in the industry itself would complain

²⁰ *Augustin*, *supra*, n. 18.

²¹ *Davey*, *supra*, n. 12.

²² *Radio Taxi Service Inc. v. Lincoln Mutual Ins. Co.*, 31 N. J. 299, 157 A. 2d 319 (1959).

²³ *Lee v. Nationwide Mutual Ins. Co.*, 286 F. 2d 295 (4th Cir. Md. 1961).

of this dual application, for I believe that it is the policy of most insurers to go beyond the degree of care that is required of them under the two theories.

Must be an Offer to Settle

It appears settled that, as a prerequisite to an action against the insurer, either an offer to settle within policy limits must have been made or that there was an indication of such willingness which the insurer declined to pursue.²⁴ In *Moore v. Columbia*, a 1960 Illinois case, the court held: "Where there is no offer by the injured party to settle within limits there can be no cause of action for bad faith and or negligence."²⁵ And in *Bell v. Commercial Insurance Co.*, a Pennsylvania case, the court ruled that it would be error not to let the question of the insurer's liability go to the jury because there was only an *indication* that the claimant would settle within the policy limits which was not pursued by the insurer.²⁶

This requirement does not take into consideration the cases where the insurer wrongfully refuses to defend, claiming a policy defense. In cases of that nature the courts have ruled that the insurer's wrongful refusal is a breach of the contract and that the insured is no longer obligated by the insuring agreement. The carrier loses its right to control the litigation and is liable for any reasonable settlement arrived at in good faith.²⁷

Insured's Duty to Pay Excess Judgment

A minority of the courts take the attitude that the insured must prove either that he has paid the excess judgment or, at least, that his financial status is such that it is sure to be collected.²⁸ The theory of these cases seems to be that unless such

²⁴ Keeton, Liability Insurance and Responsibility for Settlement, 67 Harv. L. R. 1136 (1954).

²⁵ 174 F. Supp. 566 (D. C. Ill. 1960).

²⁶ *Supra*, n. 13.

²⁷ *Minn. Farm Bureau Service Co. v. American Casualty Co. of Reading, Penna.*, 167 F. Supp. 315 (D. C. D. Minn. 1958); *Neighbours v. Harleysville Mutual Casualty Co.*, 169 F. Supp. 368 (D. C. D. Md. 1959); *Nixon v. Liberty Mutual Ins. Co.*, 255 N. C. 106, 120 S. E. 2d 430 (1961).

²⁸ See Keeton article, *supra*, n. 24 at 1173-75; *State Automobile Mutual Ins. Co. of Columbus, Ohio v. York*, 104 F. 2d 730 (4 Cir. N. C. 1939); *Duncan v. Lumbermen's Mutual Cas. Co.*, 91 N. H. 349, 23 A. 2d 325 (1941); *Dumas v. Hartford Accident and Indemnity*, 92 N. H. 140, 26 A. 2d 361 (1942); *Lee, supra*, n. 23; *Southern Farm Bureau Casualty Ins. Co. v. Parker*, 341 S. W. 2d 36 (Ark. 1960).

proof is made there is no proof of pecuniary loss and therefore there can be no recovery. The majority view is just the opposite, holding that the excess judgment in itself is sufficient.²⁹

While the minority view is logical in the abstract, it serves as a windfall to an insurer fortunate enough to have an insolvent as its insured. It would seem that in following the minority view the courts would be encouraging a breach of trust in those cases where the insured is insolvent, at least the insurer would be less responsive to its trust than in cases where the insured is able to discharge any judgment in excess of the policy limits which may be rendered against him.

Who May Maintain the Action Against the Insurer

The earlier liability insurance contracts were written in the form of indemnifying agreements, so that the insured had to satisfy the judgment himself before he could be reimbursed under the policy.³⁰ Today, policies make a provision to do away with this requirement: "any person or organization or the legal representative thereof who has secured such judgment or written agreement shall thereafter be entitled to recover under this policy to the extent of the policy limits."³¹ However, it will be noted that this provision allows the claimant himself or the personal representative and the trustee in bankruptcy to bring an action on the policy, but only to the extent of the policy limits. What of actions for excess judgments? It is universally agreed that the claimant is not subrogated to the right of the insured because of the judgment and cannot bring an action under the policy for the excess judgment.³² However, it is agreed that the trustee in bankruptcy can bring the action against the insurer in the insured's name.³³ Most states, like Ohio, have a survival

²⁹ See Keeton article, *supra*, n. 24, at 1173-75; Southern Fire and Casualty Co. v. Norrie, 35 Tenn. App. 657, 250 S. W. 2d 785 (1952); Schwartz v. Norwich Union Indemnity Co., 212 Wis. 593, 250 N. W. 446 (1933); Universal Automobile Ins. Co. v. Culberson, 54 S. W. 2d 1061 (Tex. Civ. App. 1932); Alabama Farm Bureau v. Mutual Casualty Ins. Co. v. Dalrymple, 270 Ala. 119, 116 So. 2d 924 (1960); Harris, *supra*, n. 4; Neighbours, *supra*, n. 27; Murray v. Mossman, 355 P. 2d 985 (Wash. 1960).

³⁰ Aetna Casualty and Surety Co. v. Starrett, 102 Ga. App. 278, 115 S. E. 2d 641 (1960).

³¹ *Supra*, n. 1.

³² 40 A. L. R. 2d 168; Canal Ins. Co. of Greenville v. Sturgis, 140 So. 2d 469 (Fla. 1960); Chittick v. State Farm Mutual Auto Ins. Co., 170 F. Supp. 276 (D. C. D. Del. 1958).

³³ Byrnes v. Phoenix Assurance Co. of N. Y., 178 F. Supp. 488 (D. C. Wis. 1960); 40 A. L. R. 2d 168.

statute that allows the personal representative to maintain the action against the insured.³⁴

Ohio Decisions

An important case reported by the Ohio Supreme Court involving a suit for excess judgment is the case of *Hart v. Republic Mutual Insurance Co.*, decided on July 20th, 1949.³⁵ In this case the trial court charged the jury on both theories, negligence or bad faith. From a verdict for the insured the trial court granted judgment for the insurer notwithstanding the verdict. The judgment was affirmed by the Court of Appeals, but the Supreme Court remanded the case for retrial, pointing out that the trial court erred in giving instructions on both theories. The court said:

. . . A liability insurance company which reserves the right to settle, as it deems expedient, any claim against its insured is not liable to the insured for negligence in settling or refusing to settle a claim. But such company is liable to respond in damages to its insured if it fails to act in *good faith* with respect to the settlement of such a claim.

In the *Hart* case the claimant sustained serious injuries and the liability was questionable. The insurer refused to accept an offer to settle within policy limits even though it was obvious that a verdict for the claimant would surely be in excess of the policy limits. The cumulative effect of these and other circumstances narrated in the record was such as to preclude a holding that there was no evidence tending to show a lack of good faith on the part of the insurer. Thus it would appear that the good faith doctrine is to be applied in Ohio. The *Hart* case serves as a guide to show what facts are necessary to constitute a cause of action.

Conclusion

It would appear that there are four necessary elements to plead and prove in order to make out a proper cause of action for the insurer's failure to settle within the limits of the policy:

1. That the claim of the injured party against the insured arose out of an accident covered by the policy and that it could have been settled within the limits of the policy.

³⁴ Lee, *supra*, n. 23.

³⁵ *Hart v. Republic Mutual Ins. Co.*, 152 Ohio St. 185, 187 N. E. 2d 80 (1949).

2. That the insured made due demand upon the insurer to settle said claim within the limits of the policy prior to the trial of the case, and that the insurer refused or failed to settle.

3. That the insured as a result of the trial was forced to pay to the injured party the amount over the limits of the policy or was obligated to pay.

4. That the action on the part of the insurer in refusing to settle the claim of the claimant within the limits of the policy when requested to do so by the insured was negligence or bad faith, depending on the theory followed by the particular court.³⁶

³⁶ For a detailed presentation of the defense (insurance company) views, well annotated and with forms, see, (pamphlet) *Avoiding Excess Liability*, published by Defense Research Inst., Inc., Syracuse, N. Y. (1962).