A Critical Element of Proper Claims Handling

By Mark D. LoGalbo and Kevin T. Merriman

The Duty to Settle Third-Party Claims

Most third-party liability policies give the insurer full control over both the defense and settlement of a claim. Consequently, even if the insured has a strong interest in settling a claim to avoid an exposure in excess of its policy limits, it is reliant on the insurer to protect this interest. On the other hand, an insurer, which controls the defense and settlement of a claim, may have an incentive to "roll the dice" by not settling a claim, knowing that its exposure is capped at policy limits.

Recognizing this tension, courts have found that an insurer has a duty of good faith to give equal consideration to its insured's interests. *See State Farm Mut. Auto. Ins. Co. v. Skaggs*, 251 F.2d 356, 358-59 (10th Cir. 1957) ("Where an insurance company, under the terms of its liability policy has the duty to defend an action brought against its insured and the right to control the defense of the action and determine whether a compromise of the claim shall be made, and the insurance company assumes such defense, while it may properly give consideration to its own interests, it must in good faith give equal consideration to the interests of the insured and if it fails to do so, it acts in bad faith."); *Pinto v. Allstate Ins. Co.*, 221 F.3d 394, 398 (2d Cir. 2000) ("Because an insurance company has exclusive control over a claim against its insured once it assumes defense of the suit, it has a duty under New York law to act in 'good faith' when deciding whether to settle such a claim, and it may be held liable for breach of that duty. The insurer acts in good faith when it gives equal consideration to its insured's interest in avoiding liability in excess of the policy limit as it does to its own interests when considering plaintiff's demand to settle a lawsuit."). As a result, most courts impose on insurers a duty to respond in good faith to all reasonable settlement offers. This duty is commonly referred to as the "duty to settle."

Origins of the Duty

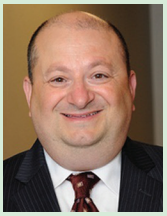
The duty to settle has regulatory, statutory, and common law roots. The National Association of Insurance Commissioners drafted the Unfair Claims Settlement Practices Act, which has been adopted in most states and requires specific conduct and claims handling by insurance adjusters. States also have enacted statutes concerning unfair settlement practices, which require insurers to attempt in good faith to reach prompt and fair settlements of claims against their insured where liability is reasonably clear. *See, e.g.*, Cal. Ins. Code §790.03(h)(5) ("The following are hereby defined as unfair methods of competition and unfair and deceptive acts or practices in the business of insurance. … Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear."); 40 Pa. Stat. §1171.5(10)(vi) ("Any of the following acts if committed or performed with such frequency as to indicate a business practice shall constitute unfair claim settlement or compromise practices. … Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which the company's liability under the policy has become reasonably clear.").

The duty to settle also can be found in the common law. For example, in *Alford v. Textile Ins. Co.,* 103 S.E.2d 8, 12 (N.C. 1958), the court declared:

> The law imposes on the insurer the duty of carrying out in good faith its contract of insurance… It is a matter of common knowledge that fair and reasonable settlements can generally be made at much less than the financial burden imposed in litigating claims. It is for this reason that courts have consistently held that an insurer owes a duty to its insured to act diligently and in good faith in effecting settlements within policy limits, and if necessary to accomplish that purpose, to pay the full amount of the policy. Liability has been repeatedly imposed upon insurance companies because of their failure to act diligently and in good faith in effectuating settlements with claimants.

Courts have held that the duty to settle in good faith is implied from the terms of the policy itself. In *Alt v. Am. Family Mut. Ins. Co.*, 237 N.W.2d 706, 711 (Wis. 1976), the court explained:

> [T]he duty of the insurer to exercise good faith toward the insured in determining whether or not settlement should be undertaken by the insurer arises from the provisions of the insurance contract which give the insurer absolute control of the defense of any claim against the insured and which exclude the insured from any settlement negotiations on his own.



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Whether the Duty Requires the Insurer to Initiate Settlement

Courts are not in agreement as to whether the insurer has a duty to initiate settlement discussions.

Affirmative Duty to Initiate Settlement

Some courts have held that an insurer is obligated to initiate settlement discussion. For example, in *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 323 A.2d 495 (N.J. 1974), the court held that an insurer has an affirmative duty to initiate settlement negotiations, unless there is no realistic possibility of settlement within the policy limits and the insured will not contribute to a settlement figure above the policy limits. Otherwise, the court reasoned, the insurer, who contractually has full control over settlement of claims against the insured, might be tempted to gamble on the outcome of a trial, because its exposure would not be considerably affected by a verdict in excess of the policy limits, whereas the insured's would. *See also U.S. Fire Ins. Co. v. Royal Ins. Co.*, 759 F.2d 306 (3d Cir. 1985).

Conditional Duty to Initiate Settlement

Other courts have rejected the idea that an insurer has an affirmative duty to initiate settlement, but have made an exception where liability is clear and the claimant's likely damages would exceed the policy limits. *See Westchester Fire Ins. Co. v. Mid-Continent Cas. Co.*, 954 F. Supp. 2d 1374, 1381 (S.D. Fla. 2013), *rev'd on other grounds*, 569 Fed. Appx. 753 (11th Cir. 2014) (holding that where liability is clear and injuries are so serious that a judgment in excess of the policy limits is likely, an insurer has an affirmative duty to initiate settlement negotiations, as "the crux of a bad faith claim is the self-serving delay caused by the insurer's failure to adjust the claim in a timely manner, which exposes its insured to an excess judgment."); *Fulton v. Woodford*, 545 P.2d 979, 984 (Ariz. Ct. App. 1976) ("We therefore hold, in the absence of a demand or request to settle within policy limits or within the limits of the insured's financial ability, plus policy limits, that a conflict of interest would give rise to a duty on behalf of the insurer to give equal consideration to the interest of its insured where there is a high potential of claimant recovery and a high probability that such a recovery will exceed policy limits."); *Haddick v. Valor Ins. Co.*, 763 N.E.2d 299, 304 (Ill. 2001) ("The duty does not arise at the time the parties enter into the insurance contract, nor does it depend on whether or not a lawsuit has been filed. The duty of an insurance provider to settle arises when a claim has been made against the insured and there is a reasonable probability of recovery in excess of policy limits and a reasonable probability of a finding of liability against the insured.").

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Per this exception, the insurer does not generally have a duty to settle if there is no reasonable possibility of a judgment greater than the policy limits. *See, e.g., Milroy v. Allstate Ins. Co.*, 151 P.3d 922 (Okla. Civ. App. 2006) (holding that since the insured was not in jeopardy of having a judgment entered against her in excess of the policy limit, insurer could not have breached a duty to settle); *Messersmith v. Mid-Century Ins. Co.*, 43 Cal. Rptr. 2d 871, 881 (Ct. App. 1995) ("[T]here is no duty even to negotiate let alone settle when the demand is less than the policy limits.").

Must the Claimant Make the First Move?

Some courts do not impose a duty to settle until the claimant makes a demand within policy limits. In *Am. Physicians Ins. Exch. v. Garcia*, 876 S.W.2d 842, (Tex. 1994), for example, the insurer's policy limits were $500,000. The underlying plaintiffs first demanded $600,000, and then increased their demand to $1.1 million to settle the underlying claim. The insurer responded that the applicable insurance policy only provided $500,000 in coverage. The plaintiffs, again, increased their demand to $1.6 million, to which no response was made. The case went to trial and resulted in a verdict of more than $2.2 million against the insured.

The trial court found that the insurer breached its duty to settle and entered judgment against the insurer. On appeal, the Texas Supreme Court reversed the trial court's ruling, holding that there was no breach of the duty to settle, because the insurer had never received a settlement demand within its policy limits. The court explained that a rule that did not require a settlement demand within policy limits "would require the insurer to bid against itself in the absence of a commitment by the claimant that the case can be settled within policy limits." *Garcia,* 876 S.W.2d at 851. The court also observed that "[r]equiring the claimant to make settlement demands tends to encourage earlier settlements" because the claimant "stands to benefit substantially and increase the assets available to satisfy any judgment by committing to settle for a reasonable amount within policy limits if the insurer rejects the demand." *Id.*, at n. 18.

Similarly, in *Reid v. Mercury Ins. Co.*, 220 Cal. App. 4th 262, (2013), a case that arose out of an automobile accident, the claimant's attorney requested disclosure of the policy limits, and the defendant provided it. The claimant's attorney, however, never issued a demand for an amount within those limits. While the carrier ultimately offered policy limits, the offer was rejected. The case went to trial and the claimant obtained a judgment for more than $5.9 million.

In the subsequent bad-faith action, the claimant contended that the insurer breached its duty to settle by, among other things, failing to make a reasonable settlement offer within a reasonable time. The court of appeals ruled for the insurer, concluding that there was no liability for failing to settle a case within policy limits without a demand within those limits, or some other notice to the carrier that the

injured party was interested in settlement. The court reasoned that "nothing in California law supports the proposition that bad faith liability for failure to settle may attach if an insurer fails to initiate settlement discussions, or offer its policy limits, as soon as an insured's liability in excess of policy limits has become clear. Nor will this court make such a rule of law, for which neither precedent nor sound policy considerations have been offered." *Reid,* 220 Cal. App. 4th at 277. *See also Haddick,* 763 N.E.2d at 304-05 ("Since Illinois law generally does not require an insurance provider to initiate settlement negotiations, this duty does not arise until a third party demands settlement within policy limits.")

Other courts have taken a contrary view, concluding that a settlement demand within policy limits is not a prerequisite to triggering the duty to settle. For example, in *State Auto Ins. Co. v. Rowland*, 427 S.W.2d 30 (Tenn. 1968), the insurer contended that it could not be liable for bad faith for failure to settle because there was no settlement demand within the limits of the applicable insurance policy. The court rejected that argument, stating that the requirement of a settlement demand within limits "could most certainly lead to inequitable results." *Rowland,* 427 S.W.2d at 35. The court explained that under such a holding, there would be nothing "to prevent an insurance company, in a case where liability is certain and injury great, to simply decline negotiations with the injured party and later assert that there was no offer within the policy limits." *Id.; see also Badillo v. Mid Century Ins. Co.*, 121 P.3d 1080, 1095 (Okla. 2005) (holding that "a legally binding, unconditional offer of settlement from the claimant is not a prerequisite to maintaining an action of this type where the insured has been exposed to an excess verdict."); *State Farm Mut. Auto. Ins. Co. v. Jackson*, 346 F.2d 484 (8th Cir. 1965) (explaining that no demand by the insured is required particularly where the policy gives the insurer the irrevocable power to decide whether a settlement offer should be accepted or rejected within policy limits).

The Fiduciary-Like Relationship Underlying the Duty to Settle

Many courts view the insurance policy as creating a fiduciary-like relationship between the insurer and the insured. In *Tynes v. Bankers Life Co.*, 730 P.2d 1115 (Mont. 1986), for example, the Montana Supreme Court reviewed case law from other jurisdictions regarding the nature of the relationship between insurers and their insured, and held that a special relationship exists between them, which can be described as "fiduciary in nature." *See also Van Noy v. State Farm Mut. Auto. Ins. Co.*, 16 P.3d 574 (Wash. 2001) (holding that an insurer owes a fiduciary duty to its insured). In *Progressive West Ins. Co. v. Yolo Cnty. Superior Court*, 37 Cal. Rptr. 3d 434 (Ct. App. 2005), the court explained the purpose behind the heightened good faith obligation placed upon insurers, which is "to avoid or discourage conduct which would thus frustrate realization of the contract's principal benefit (*i.e.*, peace of mind)." *Progressive West,* 37 Cal. Rptr. 3d at 446.The special "fiduciary-like" duties arise because of the unique nature of the insurance contract. *Id.*

Such a fiduciary relationship exposes an insurer to tort liability if it acts in bad faith.

Such a fiduciary relationship exposes an insurer to tort liability if it acts in bad faith. "Bad faith in this context would occur if an excess judgment were obtained under circumstances when the insurer failed 'to exercise intelligence, good faith, and honest and conscientious fidelity to the common interest of the insured as well as the insurer and to give at least equal consideration to the interest of the insured.'" *Herrig v. Herrig*, 844 P.2d 487, 490 (Wyo. 1992) (quoting *Western Cas. and Sur. Co. v. Fowler*, 390 P.2d 602, 606 [Wyo. 1964]).

> By way of explication, an insurer's right to control settlement and litigation under a policy of liability insurance creates a fiduciary relationship between insurer and insured. Concomitantly, an insurer owes a duty to exercise good faith in evaluating and negotiating third party claims against its insured and may be held liable in tort (commonly referred to as the tort of bad faith) by its insured for a third party judgment in excess of the policy limits in the event it fails to exercise good faith in the performance of its fiduciary obligation. It is the existence of this fiduciary relationship between insurer and insured under a policy of liability insurance, beyond and apart from any subsisting implied covenant of good faith and fair dealing on the part of an insurer under a policy of insurance, which exposes an insurer to liability in tort for failure to exercise good faith in evaluating and negotiating third party claims against an insured.

Duncan v. Andrew County Mut. Ins. Co., 665 S.W.2d 13, 18-19 (Mo. Ct. App. 1983). Another court explained the fiduciary-like relationship:

> In an action for failure to settle within the policy limits, the insurance company is charged with acting in a fiduciary capacity as an attorney in fact representing the insured's interest in litigation. The company's interest comes into conflict with that of the insured's while representing him; and, arguably, acting in its own interests to the detriment of the insured's interest while acting in such a fiduciary capacity is a tort.

Mesmer v. Md. Auto. Ins. Fund, 725 A.2d 1053, 1063 (Md. 1999) (quoting *Farris v. U.S. Fid. and Guar. Co.*, 587 P.2d 1015, 1018-19 (Or. 1978)).

The Standard for Breach of Duty to Settle

Jurisdictions are split in determining the standard for liability for breaching the duty to settle. In some states, insurers are held to a standard of reasonable conduct (*i.e.*, the negligence standard). This negligence standard requires the insurer to accept a policy limits settlement offer if a person of ordinary prudence, in the exercise of that degree of care which such a person would use in the management of his affairs, would accept the settlement offer.

The court in *Hartford Cas. Ins. Co. v. New Hampshire Ins. Co.*, 628 N.E.2d 14 (Mass. 1994), applied the negligence standard to determine whether an insurer breached its

duty to settle an underlying lawsuit. However, the court also required the insured to prove that the plaintiff in the underlying action would have settled the claim within policy limits and that no reasonable insurer would have refused the settlement offer. Other jurisdictions apply the negligence standard as well. *See, e.g., Bollinger v. Nuss*, 449 P.2d 502 (Kan. 1969) (insurer in acting on offers of settlement within policy limits must conduct itself with that degree of care that would be used by ordinarily prudent person in the management of his or her own business, with no policy limits applicable to the claim); *Aetna Cas. & Sur. Co. v. Kornbluth*, 471 P.2d 609 (Colo. Ct. App. 1970) (in deciding whether to settle, an insurer must exercise that degree of care and diligence that a reasonably prudent person would use under the same or similar circumstances).

Other states employ a "bad faith" standard for liability, which is a higher standard than negligence. *See, e.g., Hadenfeldt v. State Farm Mut. Auto. Ins. Co.*, 239 N.W.2d 499, 502 (Neb. 1976) ("The liability of an insurer to pay in excess of the face of the policy accrues when the insurer, having exclusive control of settlement, in bad faith refuses to compromise a claim for an amount within the policy limit.") (quotation omitted). Accordingly, to establish a claim for breach of the duty to settle, plaintiffs must allege the following elements: (1) the insurer's assumption of control over negotiation and settlement and legal proceedings brought against the insured; (2) a demand by the insured that the insurer settle the claim; (3) the insurer's refusal to settle the claim within the liability limits of the policy, and (4) proof that the insurer acted in bad faith, rather than negligently. *Tobin v. Leader Nat'l Ins. Co.*, 58 S.W.3d 590, 598 (Mo. Ct. App. 2001). An insurer's duty to its insured in responding to settlement offers is often expressed in terms of good faith, rather than due care. Ashley, Stephen S., Bad Faith Actions Liability & Damages §2:5 (2d ed.); *see also, Zoppo v. Homestead Ins. Co.*, 644 N.E.2d 397, 400 (1994) ("[A]n insurer fails to exercise good faith in the processing of a claim of its insured where its refusal to pay the claim is not predicated upon circumstances that furnish reasonable justification therefor.") (quotations omitted).

Still other states require a showing of an intentional or reckless disregard of the insured's interests before holding an insurer liable for breach of the duty to settle. *See, e.g., Taylor v. Sentry Group of Cos.* 331 Fed. Appx. 457, 459 (9th Cir. 2009) (applying Washington law and holding that a claim based on a breach of the duty to settle "must be supported by evidence of deception, dishonesty, or intentional disregard for the insured's interest"); *Rinehart v. Shelter Gen. Ins. Co.*, 261 S.W.3d 583, 591 (Mo. Ct. App. 2008) (insurer breaches its good faith duty to settle if the insurer "had intentional disregard of the financial interests of the plaintiff in the hope of escaping the full responsibility imposed upon it by its policy") (quotations omitted).

Consequences for Breach of the Duty

Where an insurer declines the chance to settle a claim within policy limits, the long-standing general rule is that the insurer is liable for any resulting verdict in excess of the policy limits. *See, e.g., Hartford Accident & Indem. Co. v. Aetna Cas. & Sur. Co.*, 792 P.2d 749, 752 (Ariz. 1990) ("If an insurance company fails to settle, and does so in bad faith, it is liable to the insured for the full amount of the judgment. This rule is recognized, in part, because the insurer exercises control over the litigation.") (internal citation omitted); *Hadenfeldt*, *supra*; *Dairyland Ins. Co. v. Herman*, 954 P.2d 56, 61 (N.M. 1997) ("Should an insurer, in violation of its duty of good faith, refuse to accept a reasonable settlement offer within policy limits, it will be liable for the entire judgment against the insured, including the amount in excess of policy limits."); *Trotter v. State Farm Mut. Auto. Ins. Co.*, 377 S.E.2d 343, 349 (S.C. Ct. App. 1988) ("If an insurer undertaking the defense of a suit covered by the policy unreasonably refuses or fails to settle within the policy limits, it is liable to the insured for the amount of the judgment against him in excess of the policy limits."); *State Auto Ins. v. Rowland,* 427 S.W.2d 30, 33 (1968) ("It is well established that an insurer having exclusive control over the investigation and settlement of a claim may be held liable to its insured for an amount in excess of its policy limits if as a result of bad faith it fails to effect a settlement within the policy limits.").

Additionally, some courts have held that the insurer may be liable for punitive damages for breach of its duty to settle. Punitive damages are available if the jurisdiction recognizes bad faith failure to settle as an independent tort. *See, e.g., Canal Indem. Co. v. Greene,* 593 S.E.2d 41, 46 (Ga. Ct. App. 2003) ("A claim for bad-faith failure to settle sounds in tort.") (quotation omitted); *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313, 319 (R.I. 1980) ("An insurer's bad-faith refusal to settle an insurance claim can give rise to an independent tort action that can result upon a proper showing of an award of both compensatory and punitive damages."). If, however, a jurisdiction does not recognize an independent tort of bad faith failure to settle, courts generally will not permit recover of punitive damages. *See, e.g., Bettius & Sanderson, P.C. v. Nat'l Union Fire Ins. Co. of Pittsburgh, PA*, 839 F.2d 1009, 1015 (4th Cir. 1988) (holding that, in Virginia, a bad-faith claim is "nothing more than a breach of contract, for which punitive damages are not recoverable."); *Marquis v. Farm Family Mut. Ins. Co.,* 628 A.2d 644, 652 (Me. 1993) ("We therefore refuse to adopt an independent tort action for an insurer's breach of the implied contractual obligation to act in good faith and deal fairly with an insured, and limit an insured's remedies for breach of the duty to the traditional remedies for breach of contract, and the additional statutory remedies provided in the insurance code.")

Conclusion

Whether imposed by regulation, statute, or common law, many jurisdictions recognize a duty to settle third-party liability claims. As such, it is a critical element of proper claims handling. Insurers must be aware of the duty and all of its contours in each of the jurisdictions where they handle claims, and should fully integrate the duty into their claims handling processes, with due regard to if, when, and how the duty is triggered, and the standards applicable to its breach. This will ensure that insurers' and insureds' interests are placed on equal footing and limit insurers' potential exposure for extra-contractual and punitive damage.