INSURER'S REFUSAL TO SETTLE—A PROPOSAL FOR IMPOSITION OF LIABILITY ABOVE POLICY LIMITS

LIABILITY insurance policies reserve to the insurance company absolute control of the defense to any claims against the insured. The company may settle or litigate as it pleases.[1] If the case goes to trial and results in a judgment which exceeds the policy's limits, the insured will be personally liable for the excess. Whenever an insurer refuses an injured person's offer to settle for an amount below the policy limit, the insurance company, in effect, will be gambling with the insured's money.[2] Therefore the policy-holder

Section 8(d) further provides that "the duties so imposed shall not be construed as requiring either party to discuss or agree to any modification of the terms and conditions contained in a contract for a fixed period, if such modification is to become effective before such terms and conditions can be reopened under the provisions of the contract." In Allied Mills, Inc., 82 N.L.R.B. 854 (1949), the Board adopted the trial examiner's statement that this portion of 8(d) "refers to terms and conditions which have been integrated and embodied into a writing . . . . with respect to unwritten terms dealing with 'wages, hours, and other terms and conditions of employment,' the obligation remains on both parties to bargain continuously." This interpretation was reaffirmed by the Board in Tide Water Associated Oil Co., 85 N.L.R.B. 1096 (1949), and was followed by the Steel Industry Board appointed by the President in July 1949. STEEL INDUSTRY BOARD, REPORT TO THE PRESIDENT OF THE UNITED STATES ON THE LABOR DISPUTE IN THE BASIC STEEL INDUSTRY 76-8 (1949). The recent case of Jacobs Mfg. Co., 28 LAB. REL. REP. (Labor-Management) 1162 (1951), however, may indicate a slight shift in the Board's position. In the *Jacobs* case, a 3 to 1 majority of the Board held that a party must bargain during the life of a contract on issues which were not discussed during pre-contract negotiations and are not mentioned in the contract itself. But the Board split 2-2 on the question whether a party must bargain during the contract period on subjects which are not mentioned in the contract but which were discussed during pre-contract negotiations. Regardless of how the Board ultimately decides this issue, however, it should not affect the problem of amending an existing contract to cover new conditions brought about by a shift in parties. By hypothesis, the terms of the existing agreement are not applicable; therefore the addition of new terms should not be regarded as a "modification."

1. The standard policy provides that "the company shall (a) defend in his name and behalf any suit against the insured alleging such injury or destruction and seeking damages in amount thereof, even if such suit is groundless, false or fraudulent; but the company shall have the right to make such investigation, negotiation and settlement of any claim or suit as may be deemed expedient by the company." For a full discussion see SAWYER, AUTOMOBILE LIABILITY INSURANCE (1936).

The insurance company's exclusive control over the settlement applies only to claims for an amount less than the policy limit. To the extent that claims exceed the policy coverage, however, the insured may compromise his own possible liability. Gen'l Accident Fire and Assur. Corp. v. Louisville Home Telephone Co., 175 Ky. 96, 193 S. W. 1031 (1917); *see* City of Wakefield v. Globe Indemnity Co., 246 Mich. 645, 648-50, 225 N. W. 643, 644 (1929).

2. Insurance companies are in a position to say to the insured, "Heads I win, tails you lose." *Cf.* Tyger River Pine Co. v. Maryland Casualty Co., 170 S. C. 286, 293, 170 S. E. 346, 348 (1933); Georgia Life Ins. Co. v. Mississippi Cent. R. Co., 116 Miss. 114, 135, 76

hopes his insurer will accept any settlement offer below the limit; he has nothing to gain and may well lose by litigation. The company, on the other hand, becomes more inclined to litigate the claim as the settlement offer tends to approximate the amount of the policy.[3]

These conflicting interests are brought into sharp relief when an insured suffers a judgment for an amount above the policy limits and then tries to recover the excess in a suit against his insurer who has declined a settlement offer within the policy limits.[4] In early cases, courts construed the company's contractual obligations narrowly.[5] And they justified the com-

So. 646, 653 (1917) (dissenting opinion) (the company held the insured in the "hollow of its hands").

3. Olympia Fields Country Club v. Banker's Indemnity Ins. Co., 325 Ill. App. 649, 60 N. E. 2d 896 (1945). In this case the insurer, on a $10,000 policy, refused an offer to settle for $3500 before trial. The claimant then recovered a judgment for $20,000. Before appeal the victim offered to settle for $8,000 and was again refused. The judgment was affirmed. Thus ultimately the insurer was gambling the insured's $10,000 against a possible loss (beyond the final settlement offer) of its own $2,000. See also Tyger River Pine Co. v. Maryland Casualty Co., 170 S. C. 286, 170 S. E. 346 (1933).

4. One theory of recovery is based upon agency principles. The rule is fundamental that a person may not act as the agent of another where his interests are adverse to those of his principal, without the full knowledge and consent of the principal. MECHEM, OUTLINES OF AGENCY § 167 (2d ed. 1903). However, holding the insurer the agent of the insured does not violate this rule since the insured knows of the adverse interest and consents to the continuation of the relationship. But despite the principal's knowledge and consent, the conduct of the agent is subjected to close scrutiny to determine whether he has acted in bad faith or negligently toward the principal. Traders and General Ins. Co. v. Rudco Oil and Gas Co., 129 F.2d 621 (10th Cir. 1942); Christian v. Preferred Accident Insurance Co., 89 F. Supp. 888 (N. D. Cal. 1950); Stowers Furniture Co. v. American Indemnity Co., 15 S. W. 2d 544 (Tex. Comm. App. 1929); MECHEM, OUTLINES OF AGENCY § 178 (2d ed. 1903). *But cf.* Foremost Dairies v. Campbell Coal Co., 57 Ga. App. 500, 196 S. E. 279 (1938) (in negotiating settlements the insurer acts as an independent contractor rather than as an agent).

The second theory is couched in contractual terms. Here the insurer's refusal to settle is often held to be a breach of the obligation to assume the insured's liability to the extent of the policy coverage. The underwriter is regarded as having "contracted to take charge of the defense of the claim," so that the contract "created a relation out of which grew the duty to use due care when action was taken." Douglas v. United States Fidelity and Guaranty Co., 81 N. H. 371, 376, 127 Atl. 708, 711 (1924).

5. This inflexible doctrine arose almost exclusively from employer liability insurance cases. The injured employee would offer to settle; the insurer would refuse; and an excess judgment would follow. The insured would assert that the refusal to settle, ipso facto, placed the burden of any subsequent judgment upon the insurer. But the courts generally held that such unlimited liability could not be read into a limited liability contract. *See* St. Joseph Transfer and Storage Co. v. Employer's Indemnity Corp., 224 Mo. App. 221, 231, 23 S.W.2d 215, 220 (1930) (insurer is under no duty except that for which he has expressly contracted); *accord,* Rumford Falls Paper Co. v. Fidelity and Casualty Co., 92 Me. 574, 43 Atl. 503 (1889); Georgia Casualty Co. v. Cotton Mills Products Co., 159 Miss. 396, 132 So. 73 (1931); Best Building Corp. v. Employers' Liability Assur. Corp., 247 N.Y. 451, 160 N.E. 911 (1928); Wisconsin Zinc. Co. v. Fidelity and Deposit Co., 162 Wis. 39, 52, 155 N.W. 1081, 1087 (1916).

pany's exclusive control of the defense on the likelihood that the insured would otherwise always accept any compromise offer below the policy limit.[6]

Gradually, however, courts began to recognize that in some cases the insurer should be liable. Abuse of the policy-holder's helplessness led to the setting up of certain judicial standards for measuring the company's conduct during negotiations for settlement.

The first standard of conduct evolved was that of good faith. In order to win reimbursement, the policy holder must sustain the burden of proving that the company intentionally disregarded his financial interests in dealing with a liability claimant.[7] Jurisdictions following the good faith rule require some evidence on which a jury could base a finding that the insurance company rejected a settlement offer (within the policy limits) which the company itself considered reasonable.[8] Thus, advising an insured to place his property beyond reach of an anticipated excess judgment,[9] setting up a reserve to cover possible liability to the policy-holder,[10] refusing to accept a settlement

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For a realistic discussion which recognizes the inferior bargaining position of most policy-holders, see the dissenting opinion in Georgia Life Ins. Co. v. Mississippi Cent. R. Co., 116 Miss. 114, 76 So. 646 (1917). Here the insured was a railroad corporation. Because of its ability to bargain on an equal footing with the insurer, it secured a policy providing that if the insurer refused a settlement offer below the maximum coverage of the policy, the policy limit would be doubled.

6. *See* Douglas v. United States Fidelity and Guaranty Co., 81 N.H. 371, 377, 127 Atl. 708, 711 (1924); Tyger River Pine Co. v. Maryland Casualty Co., 170 S.C. 286, 288, 170 S.E. 346, 348 (1933); Hilker v. Western Automobile Ins. Co., 204 Wis. 1, 4, 235 N.W. 413, 415 (1931). *But cf.* Traders and General Ins. Co. v Rudco Oil and Gas Co., 129 F.2d 621, 627 (10th Cir. 1942). See also Note, 8 MINN. L.REV. 151 (1924).

7. Johnson v. Hardware Mutual Casualty Co., 109 Vt. 481, 491, 1 A.2d 817 (1938).

Yet no "intentional disregard" was found in many cases where an outrageous disparity between the settlement offer and the judgment existed. *E.g.,* McDonald v. Royal Indemnity Ins. Co., 109 N.J.L. 308, 162 Atl. 620 (1932) (insurance company refused offer of $2,000; verdict of $20,000); Best Building Co. v. Employers' Liability Assur. Corp., 247 N. Y. 451, 160 N.E. 911 (1928) (offer of $8,500 refused; verdict $16,000). Johnson v. Hardware Mutual Casualty Co., *supra* (offer of $5,500 refused; verdict $14,000); Burnham v. Commercial Casualty Ins. Co., 10 Wash.2d 624, 117 P.2d 644 (1941) (offer of $3,500 refused; verdict $21,400).

8. This rule requires a showing of conduct approaching fraud. An honest error of judgment is not bad faith; nor is the failure to prejudge, within a degree of certainty, the outcome of a lawsuit. It is not sufficient that hindsight reveals that a settlement would have been wiser, nor even that foresight suggests it to some extent. "The gift of prophecy has never been bestowed on ordinary mortals. . . ." Georgia Casualty Co. v. Mann, 242 Ky. 447, 454, 46 S.W.2d 777, 779 (1932). *Cf.* Noshey v. American Automobile Ins. Co., 68 F.2d 808 (6th Cir. 1934); Wilson v. Aetna Casualty and Surety Co., 76 A.2d 111 (Me. 1950); City of Wakefield v. Globe Indemnity Co., 246 Mich. 645, 225 N.W. 643 (1929).

9. Noshey v. American Automobile Ins. Co., 68 F.2d 808 (6th Cir. 1934).

10. Lanferman v. Maryland Casualty Co., 222 Wis. 406, 267 N. W. 300 (1936).

offer recommended by its adjustor or counsel,[11] and rejecting a settlement offer because the insured would not assume a part of its own contractual liability,[12] have all supported findings of bad faith. However, an intentional disregard of the insured's interests is ordinarily so hard to prove that policy-holders seldom recover under this rule.[13]

An alternative standard upon which some courts base a finding of liability is negligence[14]—rejecting an offer of settlement which an ordinarily prudent businessman would have taken.[15] Negligence has been found in the refusal

11. Maryland Casualty Co. v. Elmira Coal Co., 69 F.2d 616 (8th Cir. 1934); American Mutual Ins. Co. v. Cooper, 61 F.2d 446 (5th Cir. 1932), *cert. denied*, 289 U. S. 736 (1933); Johnson v. Hardware Mutual Casualty Co., 109 Vt. 481, 1 A.2d 817 (1938).

12. Boling v. New Amsterdam Casualty Co., 173 Okla. 160, 46 P.2d 916 (1935).

13. To escape liability the insurance company can always show some justification for its decision to litigate rather than settle. Of course, the insurer's conduct is seldom patently fraudulent, since any company which consistently ignored the interests of its policy-holders would lose business quickly. But in at least one case an insurance company has escaped liability even after apparently coercing a policy holder into contributing to a settlement. Neuberger v. Preferred Accident Ins. Co., 18 Ala. App. 72, 89 So. 90 (1921). See Note, 7 MINN. L.REV. 337, 340 (1923) spelling out the contractual theory which absolved such insurers from liability.

In a few cases the injured party has tried to collect the excess from the insurer, but generally without success. Kleinschmit v. Farmers Mutual Hail Ins. Assn., 101 F.2d 987 (8th Cir. 1939); Bartlett v. Travelers Insurance Co., 117 Conn. 147, 167 Atl. 180 (1933); Duncan v. Lumbermen's Mutual Casualty Co., 91 N. H. 349, 23 A.2d 325 (1941). *But cf.* Auto Mutual Indemnity Co. v. Shaw, 134 Fla. 815, 184 So. 852 (1938).

14. Most jurisdictions hold that negligence is a question for the jury. *E.g.*, Tyger River Pine Co. v. Maryland Casualty Co., 170 S. C. 286, 170 S. E. 346 (1933). See 8 APPLEMAN, INSURANCE LAW AND PRACTICE §§ 4712-13 (1942).

In determining whether or not the insurance company was negligent in its duty to the insured, the jury may consider the manner of conducting investigations, statements obtained by agents, correspondence between the insurer and its attorneys, settlement negotiations, conduct of the trial and pre-trial preparations, and general reports and recommendations. Anderson v. Southern Surety Co., 107 Kan. 375, 191 Pac. 583 (1920); Mendota Electric Co. v. N. Y. Indemnity Co., 169 Minn. 377, 211 N. W. 317 (1926); Dumas v. Hartford Accident and Indemnity Co., 94 N. H. 484, 56 A.2d 57 (1947); Pacific Coast Cement Co. v. Metropolitan Casualty Ins. Co., 173 Wash. 534, 23 P.2d 890 (1933).

However, for a recent illustration of the difficulty of proving negligence, see Wilson v. Aetna Casualty & Surety Co., 76 A.2d 111 (Me. 1950).

15. In Dumas v. Hartford Accident Indemnity Co., 94 N. H. 484, 56 A.2d 57 (1947), the insurer had an opportunity to settle the claim for $4,000, this being $1,000 less than the policy limit. The subsequent recovery was $12,000. The court felt that in consideration of the permanence of the victim's injuries, the size of her out of pocket expenses, and the overwhelming evidence of the driver's negligence, the prudent businessman would have taken the settlement offer.

See also Traders and General Ins. Co. v. Rudco Oil and Gas Co., 129 F.2d 621 (10th Cir. 1942), where civil actions totalling $63,000 were filed against Rudco which it settled on its own initiative for $17,000 ($7,000 above the policy limit), but the insurer refused to accept the settlement offer. The insurer was found negligent and ordered to reimburse Rudco, even though if it had accepted the offer its maximum loss would have been $10,000.

to act on advice of counsel,[16] acting on the advice of misinformed counsel,[17] ineptitude or delay of local managers or claims agents,[18] and failure to consider the extent of plaintiff's injuries.[19] The negligence test thus differs from that of bad faith in requiring only an accidental, as opposed to an intentional, wrongdoing. Of course, bad faith will suffice for liability under either rule;[20] mere negligence, however, is not bad faith.[21]

But in the vast majority of cases today, the only evidence against the insurance company is a simple refusal to settle. And this by itself amounts to neither negligence nor bad faith.[22] The question remains, though, whether the existing standards of care do not sanction a practice involving deplorably low ethics. For by reserving exclusive control over settlement, the insurer has the policy-holder's interest altogether at its mercy. Reasonably, then, the insurer should be held to the standard of conduct required of a fiduciary. In this view, the company's insistence upon litigating a claim which could be settled within policy limits should be regarded as an act of bad faith.[23] The insured has paid for protection up to a stated amount. When a settlement offer gives the company a chance to afford protection within this amount, why should it be allowed to shift much of the hazard of turning down that chance

16. Lanferman v. Maryland Casualty Co., 222 Wis. 406, 267 N. W. 300 (1936).

17. Dumas v. Hartford Accident & Indemnity Co., 94 N. H. 484, 56 A.2d 57 (1947); Douglas v. U. S. Fidelity and Guaranty Co., 81 N. H. 371, 127 Atl. 708 (1924); Highway Ins. Underwriters v. Lufkin-Beaumont Motor Coaches, Inc., 215 S.W.2d 904 (Tex. Civ. App. 1948).

18. Tyger River Pine Co. v. Maryland Casualty Co., 170 S. C. 286, 170 S. E. 346 (1933).

19. Stowers Furniture Co. v. American Indemnity Co., 15 S.W.2d 544 (Tex. Com. App. 1929).

20. However, it is far easier, both on the law and the facts, to establish negligence on the part of an insurer than it is to establish bad faith or fraud. See Burnham v. Commercial Casualty Ins. Co., 10 Wash.2d 624, 117 P.2d 644 (1941).

21. Bad faith and negligence could be defined so as to minimize or even do away with any distinction between them. This is neatly illustrated by two Wisconsin cases. In one of them, good faith is defined as "that degree of care and diligence which a man of ordinary care and prudence would exercise in the management of his own business were he investigating and adjusting such claims." Hilker v. Western Automobile Ins. Co., 204 Wis. 1, 10, 231 N.W. 257, 261 (1930). Negligence, on the other hand, is defined as the doing of an act, or omitting to take a precaution, which under the circumstances present, the doer, as an ordinarily prudent person, ought reasonably to foresee "will thereby expose the interests of another to an unreasonable risk of harm." Osborne v. Montgomery, 203 Wis. 223, 242, 234 N.W. 372, 379 (1931). The concept of due care appears to be the controlling element in both definitions.

22. Farm Bureau Mutual Insurance Co. v. Violana, 123 F.2d 692 (2nd Cir.) *cert. denied,* 316 U.S. 672 (1942); Georgia Casualty Co. v. Mann, 242 Ky. 447, 46 S.W.2d 777 (1932); Long v. Union Indemnity Co., 277 Mass. 428, 178 N.E. 737 (1931); Wynnewood Lumber Co. v. Travelers Insurance Co., 173 N.C. 269, 91 S.E. 946 (1917).

23. The duty to defend should include a duty to settle if that be the best defense. *See* Sanders v. Frankfort Marine Insurance Co., 72 N.H. 485, 497, 57 Atl. 655, 658 (1904); Stowers Furniture Co. v. American Indemnity Co., 15 S.W.2d 544, 547 (Tex. Com. App. 1929).

onto the shoulders of the insured? A rule placing this risk on the company would be much fairer. Such a rule would not compel the company to accept all offers of compromise within the policy limits; rather it would only mean that the entire risk of a subsequent judgment exceeding those limits would be on the company.

To reach this new rule, the company's exclusive control of the defense could be construed to include, by implication, an agreement to accept all sub-coverage offers. Failure to settle would afford a conclusive presumption of negligence or bad faith, whichever test the particular jurisdiction uses to impose excess liability. The jury's role in reimbursement suits would then be confined to deciding whether or not there had actually been a non-collusive offer to settle.[24]

The proposed solution would benefit all parties concerned—the injured victim, the policy-holder, the courts, and the company. Insurer liability for the excess should make it easier for the injured claimant to obtain a settlement. The policy-holder would not be burdened with excessive judgments, and litigation for reimbursement would decrease between policy holders and their insurers. Insurance companies would not be measurably damaged since they could, in time, easily shift the increased costs.[25] Nor would the proposal necessarily encourage the purchase of lower policies. For when the size of the tortfeasor's policy is disproportionately small compared to the claim, settlement offers will probably exceed the face value of the policy. Although rejection of settlement offers within policy limits is a minor facet of the total problem of spreading losses due to accidents,[26] shifting excess verdicts to the insurance company would be a step in the right direction.

24. Much criticism has been aimed at the jury's role in this second lawsuit. The usual charge is that in determining negligence or bad faith, intricate questions of law are involved not within the understanding of the jurors. "No jury whatsoever is competent to consider such an issue when even attorneys, expert in the fields of personal injury and insurance law, might well differ upon the questions of due care by or good faith of the insurer in such a situation." Appleman, *Duty of Liability Insurer to Compromise Litigation*, 26 KY. L.J. 100, 111 (1938). *But cf.* Douglas v. United States Fidelity & Guaranty Co., 81 N.H. 371, 374, 127 Atl. 708, 710 (1924).

25. There is a lack of data concerning insurance company allocation of losses to specific causes. However, rates in an area are determined on the basis of gross losses paid. James, *Accident Liability Reconsidered: The Impact of Liability Insurance*, 57 YALE L.J. 549, 552 (1948). See also Douglas, *Vicarious Liability and Administration of Risk*, 38 YALE L.J. 584, 720 (1929); Note, 8 U. OF CHI. L. REV. 729 (1941).

26. As a consequence of the development of the automobile and its widespread use, the problem of adequate compensation for accident victims regardless of fault or financial irresponsibility has caused much concern. A trend is recognizable to permit recovery not only from the actual tortfeasor but also from interested persons who are more likely to be financially responsible. Some of the manifestations of this trend are the "family purpose" doctrine, "consent statutes," and statutes making states and municipalities liable for the torts of their servants even though engaged in a governmental function. Birch v. Abercrombie, 74 Wash. 486, 133 Pac. 1020 (1913); Heyting, *Automobiles and Vicarious Lia-*