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INSURER'S LIABILITY IN EXCESS OF COVERAGE

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Millions of dollars are paid in premiums every year for liability insurance coverage. Yet, very few policy holders have any conception of the provisions, terms and conditions of the policy for which they pay. For example, the standard liability policy contains the following language:

> With respect to such insurance as is afforded by this policy for bodily injury liability and property damage liability, the company shall:
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> (a) defend any suit against the insured alleging such injury . . . and seeking damages on account thereof, even if such suit is groundless, false, or fraudulent; but the company may make such investigation and settlement of any claim or suit as it deems expedient . . .[1]

This places upon the company the duty to defend any action brought against the policy holder, but the policy holder is sometimes astounded to learn that this same clause gives the company the absolute right to pay or settle any claim made against him without regard to his culpability and even over his strenuous objections. In some respects, the insured is thus at the complete mercy of the insurer. He is provided with counsel chosen by the company. He can neither direct nor interfere in the investigation. He may not settle directly with the claimant, nor even insist that settlement be made by the company. However, during every stage of the proceedings he must give full aid and cooperation to the company. This does not become particularly burdensome to the insured, nor cause him any great concern, until such time as he is sued for damages in an amount in excess of his protection under his liability policy. If the claim is settled within the maximum limits of the insured's coverage, the company has fulfilled its obligations and the insured has nothing to worry about. What happens, however, if the company either fails or refuses to settle the claim within the policy limits?

This problem is not new to the law, but, with the passing of time, it has become more complex. This is due in part to the fantastic increase in the manufacture and ownership of instrumentalities of injury with resulting liability. It is also due to the almost universal education of the public by insurance companies to an awareness of the need for insurance. Whether or not these same companies could foretell the seriousness of the situation they fostered is a matter of conjecture. Certainly the early interpretations of these liability policies by the courts uniformly favored the insurer. But this, as we shall see, has all changed.

One of the first cases to construe the duty to defend clause of an insurance policy was that of *Rumford Falls Paper Co. v. Fidelity and Cas. Co.*[2] in 1899. The court, in ruling in favor of the insurance

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1 Patterson and Young, Cases on Insurance 698 (4th ed. 1961).

2 92 Me. 574, 45 Atl. 503 (1899).

company, held that the terms of the policy were controlling—that they were clear and concise in their meaning—and that the company could not, under any condition, be liable for any amount over and above that stated in the policy.

For several years thereafter, this rule was followed with even more stringency. In New York, the courts adopted a buyer beware attitude, holding that the policy gave the company an absolute right to settle or not settle, to pay or not pay, which the insured knew in accepting the policy, and, in the absence of fraudulent concealment, the company could not be held liable for refusing to settle a claim which resulted in a judgment being entered against the insured in excess of his coverage under the policy.[3]

Other jurisdictions were committed to the same theory—that the policy itself gave the company the right of control;[4] that the insurer could contest an action if it chose, without responsibility

3 Auerbach v. Maryland Cas. Co., 236 N.Y. 247, 140 N.E. 577 (1923).
4 Schmidt & Sons Brewing Co. v. Travelers Ins. Co., 244 Pa. 286, 90 Atl. 653 (1914).

for the outcome;[5] and while the insurer had an obligation to refrain from doing anything prejudicial to the insured, they were not required to prejudice their own interests. If a conflict appeared, the rights of the insured must give way.[6]

A minor revolution to this obvious injustice arose in the late 1920s, when policy holders throughout the county tried to enforce upon the insurance companies a duty to either settle the claims within the limits of their policies or become strictly liable for any excess judgments. This, of course, was rejected,[7] but it did result in a more equitable approach to the matter by a majority of the courts, and two rules of construction were adopted—one of negligence and the other of bad faith.

A. The Negligence Rule

Prevalent in any negligence case is the prudent person, the average man, and/or the reasonable man, and the degree of care expected of him. This same standard of care has been applied with regard to insurance companies in negotiating and settling claims under the negligence rule. Thus, if the company refuses or fails to settle a claim within the policy limits, but does so in a reasonable, prudent manner, it will not be held liable for a judgment in excess of its liability under the policy.

This poses an interesting question. On the one hand we have the reasonable insurance company working on its own money, and on the other hand we have the reasonable insurance company working on the money of its insured. It doesn't take much imagination to envision that if the limits of the policy are $5,000.00, the claim $50,000.00 and the offer of settlement $4,500.00, no reasonable man would risk losing $45,000.00 in order to save $4,500.00. It is quite possible, however, if the company were assured its exposure would be no greater than $5,000.00 in any event, that it would be reasonable to risk the $500.00 in order to reduce the $4,500.00 offer of settlement, or even eliminate it entirely.

In *Dumas v. Hartford Acc. & Indem. Co.*,[8] which was decided on the basis of the negligence doctrine, in ruling against the insurer, the court said: "In deciding whether to settle, the insurer must be as quick to compromise and dispose of the claim as if it itself were liable for the excess verdict."[9]

In jurisdictions where the negligence rule is followed, the courts have refused to extend it to define the reasonably prudent man as one who is going to make settlement or pay the claim with someone else's money.[10]

Kansas and Texas are the only two states which seem to adhere to the minority negligence rule, the others applying negligence as a form of bad faith. Even in these states, the question is held to be one of fact for the jury, as in other tort actions.[11]

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5 Mears Mining Co. v. Maryland Cas. Co., 162 Mo. App. 178, 144 S.W. 883 (1912).

6 Blue Bird Taxi Corp. v. American Fid. & Cas. Co., 26 F. Supp. 808 (E.D. S.C. 1938); St. Joseph's Transfer and Storage Co. v. Employers Indem. Co., 244 Mo. App. 221, 23 S.W.2d 215 (1930).

7 Georgia Cas. Co. v. Cotton Mills Prod. Co., 159 Miss. 396, 90 Atl. 653 (1931).

8 94 N.H. 484, 56 A.2d 57 (1947).

9 *Id.* at 487, 56 A.2d at 60.

10 Highway Ins. Underwriters v. Lufkin-Beaumont Motor Coaches, Inc., 215 S.W.2d 904 (Tex. 1948).

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

B. Bad Faith

A majority of the courts have refused to accept the negligence rule in imposing liability on the insurer for judgments in excess of the policy limits, preferring to adopt the equally nebulous theory of bad faith. Perhaps this is an effort to retain the contractual aspects, because it is almost always employed in an action for damages for breach of the duty owed to the insured. Thus, the insurer who collects the premium and assumes full control over the claim itself, as well as the litigation, also assumes the correlative duty to act in utmost good faith. As in other contract cases, the breach of that duty forms the basis for an action in damages by the insured. However, interestingly enough, the courts uniformly hold that the action against the insurer is founded in tort and not in contract.[12]

In some jurisdictions, the term negligence is used interchangeably with the term bad faith.[13] In others, negligence is said to be an element of bad faith.[14]

The term bad faith is probably as elusive of definition as the time worn "reasonable man." However, in setting out the factual situation which is determinative of good or bad faith, the jury is not called upon to decide which is more reasonable, but only whether the insurer has demonstrated a lack of good faith. In this respect it is preferable from the standpoint of the insurer.

In *Burnham v. Commercial Cas. Ins. Co.*,[15] it was held that a mistake of judgment is not bad faith.

Several excellent opinions hold that the insurer has a duty to consider the rights and the pocketbook of the insured in the same manner as it does its own, in negotiating settlement, and failure to do so is bad faith.[16]

In *Tyger River Pine Co. v. Maryland Cas. Co.*,[17] the South Carolina court went one step further in holding that good faith required the insurer to sacrifice its own interests for those of its insured if there was a conflict of interests. The court said that to hold otherwise would render an indemnity policy a "delusion and a snare," because when a conflict arose the company would always give preference to its own interests no matter what the cost to the insured. The recent case of *Smoot v. State Farm Mut. Auto. Ins. Co.*,[18] holds

12 Ivy v. Pacific Auto Ins. Co., 156 Cal. App. 2d 652, 320 Ins. L.J. 483 (1957).
13 7A Appleman, Insurance Law and Parctice 562 (1962).
14 St. Paul-Mercury Indem. Co. v. Martin, 190 F.2d 455 (10th Cir. 1951).
15 10 Wash. 624, 117 P.2d 644 (1941).
16 American Fid. & Cas. Co. v. All American Bus Lines, Inc., 190 F.2d 234 (10th Cir. 1951); American Fid. & Cas. Co., Inc. v. G. A. Nichols Co., 173 F.2d 830 (10th Cir. 1949); American Mut. Liab. Ins. Co. v. Cooper, 61 F.2d 446 (5th Cir. 1932); Southern Fire & Cas. Co. v. Norris, 35 Tenn. App. 657, 250 S.W.2d 785 (1951).
17 Supra note 11.
18 299 F.2d 525 (5th Cir. 1962).

that the insurer may consider its own interest but may never forget that of its insured.

Where the adjustor neglected to tell his company that a verdict in excess was probable, failure of the company to settle within the policy limits was held to be bad faith in *Johnson v. Hardware Mut. Cas. Co.*[19] The court held that the adjustor, after all, was an agent of the company and that such action was an "intentional disregard of the financial interests of the [insured] in the hope of escaping the full responsibility imposed upon [the insurer] by [its] policy."[20]

In *Klefbeck v. Dous*,[21] the insurer discovered, after investigation, that the claim was not within the policy. The court held that the company should have disclaimed and withdrawn at that point, but having failed to do so, it was liable.

Failure of the company to properly investigate the case and to prepare for trial, and the further failure to have lay and medical witnesses available was held to be an improper defense of the interests of the insured, and evidence of bad faith, in *Augustin v. General Acc. Fire and Life Assur. Corp., Ltd.*[22] Bad faith is presumed where the insurer has notice of witnesses which it fails to interrogate,[23] and where the investigation conducted by the insurer is so slipshod as to prevent it from intellingently protecting the insured in offers of settlement.[24]

The insurer may not ignore the recommendations of settlement made by its attorneys and adjustors,[25] nor may it escape liability on the sole ground that it accepted and acted upon advise of counsel.[26] If the insurer has an opportunity to settle within the policy limits after judgment in excess of the limits, and fails or refuses to do so, it is evidence of bad faith.[27]

The tendency to gamble with the insured's money is usually held to be bad faith. This is true where the insurer's liability is clear and unequivocal,[28] where there is less than a 50-50 chance of winning the case[29] or of holding the verdict below the policy limits,[30] or where the insurer delays settlement until the shadow of the court house looms in the foreground, even though liability is strong.[31]

If the insurer underestimates the value of the case because of the color, race or religion of the claimant, this discriminatory lack of foresight is tantamount to bad faith.[32]

The insurer may not demand contribution from the insured before accepting an offer of settlement within its own policy limits,[33] nor may the insurer advise the insured to go south or dispose

19 109 Vt. 481, 1 A.2d 817 (1938).
20 *Id.* at 484, 1 A.2d at 820.
21 302 Mass. 383, 19 N.E.2d 338 (1939).
22 283 F.2d 82 (7th Cir. 1960).
23 American Mut. Liab. Ins. Co., *supra* note 16.
24 Southern Fire & Cas. Co. v. Norris, 35 Tenn. App. 657, 250 S.W.2d 785 (1952).
25 Royal Transit, Inc. v. Central Sur. & Ins. Corp., 168 F.2d 345 (7th Cir. 1948).
26 Dumas, *supra* note 8.
27 Roberts v. American Fire & Cas. Co., 89 F. Supp. 827 (1950); *aff'd* 186 F.2d 921 (1951).
28 American Fid. & Cas. Co., *supra* note 16.
29 Attleboro Mfg. Co. v. Frankfort Marine & Plate Glass Ins. Co., 240 Fed. 573 (1917).
30 Maryland Cas. Co. v. Cook-O'Brien Constr. Co., 69 F.2d 462 (8th Cir. 1934).
31 Vanderbilt Univ. v. Hartford Acc. & Indem. Co., 119 F. Supp. 565 (S.D. Tenn. 1952).
32 Roberts v. American Fire & Cas. Co., 89 F. Supp. 827 (N.D. Tenn. 1950); *aff'd* 186 F.2d 921 (1951).
33 Milbank Mut. Ins. Co. v. Schmidt, 304 F.2d 640 (8th Cir. 1962).

of all of his property,[34] without exposing itself to the dangers of bad faith. In some instances, failure to keep the insured informed of offers of settlement, or risk to the insured in excess of the policy limits, may be an element of bad faith,[35] but it does not shift the burden of defense to the insured.[36]

The illustrations given were confined to cases in which there was only one claimant. What happens where the policy limits are $10,000.00 for any one person, $20,000.00 for any one accident and $5,000.00 property damage?

This problem was considered in the very interesting and recent case of *Brown v. United States Fid. & Guar. Co.*[37] The U.S.F. & G. had issued an automobile liability policy in favor of Brown with limits of 10/20/5. Brown was involved in an accident with another automobile and four claims were made against him, one by the passenger in his own car, one by the driver of the other car, and two by the passengers in the other car. The attorney representing the two passengers offered to settle those two claims within the $20,000.00 with the other two claimants, if such an arrangement could be effected. While this offer was still outstanding, one company adjustor settled the claim of Brown's passenger for $6,000.00, despite the fact he probably would have come under the limitations of the guest statute. This left only $14,000.00 for the other three. At approximately the same time, another company adjustor settled the claim of the driver of the other car for $8,000.00, without even considering the very real defense of contributory negligence on his part. This now left only $6,000.00 to be shared by the two passen-

34 Maryland Cas. Co., *supra* note 30.
35 Springer v. Citizens Cas. Co. of N.Y., 246 F.2d 123 (5th Cir. 1957).
36 Smoot, *supra* note 18.
37 314 F.2d 675 (2d Cir. 1963).

gers, who were manifestly the only ones to be seriously considered and who, additionally, had serious injuries. Realizing the futility of a reasonable settlement, the two passengers sued Brown and recovered judgments in excess of $45,000.00. The Circuit Court of Appeals for the Second District of New York held this to be a very real demonstration of bad faith on the part of the insurer, and Brown received judgment against the company for the full amount.

There are other cases as interesting and informative from many jurisdictions. Unfortunately, the question has not been decided by the Supreme Court of Colorado. One comparable case has been decided by the Colorado Supreme Court. In *Kesinger v. Commercial Standard Ins. Co.*,[38] the insured was faced with a claim which he obviously thought had merit. The company was advised of the claim by the insured, and by the attorney for the claimant, in an attempt at settlement. The company replied that it "was not interested." Thereupon the insured undertook to settle the claim himself, and then sued his insurance company for the amount he had paid. The Colorado Supreme Court held that the insured could not settle the claim himself and then hold the company liable. It further held that even though the company may not have been "interested" in the claim or in settling it, this was not a refusal to defend, nor was there anything to defend inasmuch as suit had not been filed.

The opposite result was reached in *Traders & Gen. Ins. Co. v. Rudco Oil & Gas Co.*,[39] and in *Evans v. Continental Cas. Co.*,[40] where settlement was effected by the insured after the insurer, in both cases, refused to make settlement, and in spite of the fact that the policies provided that no acion could be mainained against the insurers until the insureds' losses had been determined by final judgment.

Correlative to the main issue here is (1) whether the judgment creditor may maintain the action for the excess, and (2) whether the insured must pay the excess judgment before instituting his action against the insurer. Because of the importance of these factors in their relation to the primary litigation against the insurer, they will be briefly discussed.

A. Action by Judgment Creditors

A split of authority exists as to whether the plaintiff in the original action may maintain an action directly against the defendant's insurer, in the absence of assignment. Some policies provide that if an execution against the insured for a final judgment is unsatisfied, the judgment creditor may garnishee the debtor's insurance carrier. Presumably this carries with it the same right which the insured has against the insurer for the excess over the policy limits when the insurer has refused or failed to settle within the policy limits, in bad faith.[41]

If there is no assignment and the policy makes no provision for such action, it is clear from a majority of the decisions that the judgment creditor may not maintain an action directly against

38 101 Colo. 109, 70 P.2d 776 (1937).
39 129 F.2d 621 (10th Cir. 1958).
40 40 Wash. 2d 614, 245 P.2d 470 (1952).
41 Kleinschmit v. Farmers Mut. Hail Ins. Ass'n, 101 F.2d 987 (8th Cir. 1939); Auto Mut. Indem. Co. v. Shaw, 134 Fla. 815, 184 So. 852 (1938).

the insurer for the excess.[42] This would seem to be the correct rule, because there is no contractual relationship between the claimant and the insurer, and thus no duty to settle.

B. Necessity for Payment Prior to Suit

Very few jurisdictions require the insured to pay the full amount of the judgment before bringing an action against the insurer for the excess over the policy limits, where there has been a lack of good faith on the part of the insurer in settling within the limits of the policy coverage. This is based on the theory that when judgment is entered against the insured, he has been damaged to that extent and his liability is fixed.[43] While there are no cases directly in point, it can be assumed that Colorado would follow the majority of other jurisdictions in this respect.

The concern once borne solely by the insured, as a result of the decisions in the early cases, is now shared by the insurer. In some instances companies are pitted one against the other in an effort to escape the blame.[44] Insurance companies have been and are making desperate attempts to stem the tide of the decisions adverse to the once sacred right they held—to absolutely control litigation without responsibility.

In *American Fid. & Cas. Co., Inc. v. G. A. Nichols Co.*,[45] the company caused to be inserted in its standard policy the following clause:

> No action shall lie against the Company for penalty because of the refusal or failure of the Company to pay or satisfy any demands or offers of settlement—even though such demands or offers of settlement be within the Limits of Liability of the policy. . . .

Admittedly clever! However, the United States Court of Appeals for the Tenth Circuit gave little credance to the effectiveness of the clause. The court held that it would be contrary to public policy under Oklahoma law. In any event, such a clause would not bar recovery for actual damages suffered from a breach of duty.

Liability of the company for excess over the policy limits, for failure to settle within the policy limits, should be called the "hidden protection clause," in view of the recent decisions. It doesn't appear in the policy—not even in the fine print—but it's there just the same. By judicial fiat, the equities have been restored.[46]

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42 Wessing v. American Indem. Co. of Galveston, Tex., 127 F. Supp. 775 (D. Miss. 1955); Canal Ins. Co. of Greenville, S.C. v. Surgis, 114 So.2d 469 (Fla. 1959); Duncan v. Lumberman's Mut. Cas. Co., 91 N.H. 349, 23 A.2d 325 (1941); Murray v. Mossman, et. al., 355 P.2d 985 (Wash. 1962).

43 Southern Farm Bureau Cas. Ins. Co. v. Mitchell, 312 F.2d 485 (8th Cir. 1963); Comunalt v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 328 P.2d 198 (1958).

44. Hawkeye Security Ins. Co. v. Indemnity Ins. Co. of No. Am., 250 F.2d 361 (10th Cir. 1962).

45 *Supra* note 16.

46 Author's Note: Many articles have been written, and authorities quoted, on this subject. The author, with good reason, has been limited as to scope and space, so that some of the more exhaustive treatises have been deleted. They are cited here for the benefit of the reader:

40 A.L.R. 2d 220.
68 A.L.R. 2d 883.
38 Am. Jur. *Negligence* § 20 (1941).
45 C.J.S. *Insurance* § 936 (1946).
O'Brien, *Liability Beyond the Policy Limit*, 20 Ins. L. J. 525 (1955).
Keeton, *Ancillary Rights of the Insured Against His Liability Insurer*, 28 Ins. L. J. 395 (1961).
Wymore, *Safeguarding Against Claims in Excess of Policy Limits*, 28 Ins. L. J. 44 (1961).
Keeton, *Liability Insurance and Responsibility For Settlement*, 67 Harv. L. Rev. 1136 (1954)