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Liability of Insurance Company for Failure to Settle

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COMMENT

LIABILITY OF INSURANCE COMPANY FOR FAILURE TO SETTLE

Where an insurance company has the opportunity and fails to settle a claim against its insured within the limits of a liability or indemnity policy, or in excess of the policy limits where the insured agrees to supply the excess, and a verdict and judgment are subsequently rendered in excess of the proposed settlement amount, does the insured have any rights against the insurer? The purpose of this Comment is to analyze this question in light of Pennsylvania law and to resolve what the basis or bases for determining liability should be.

The problem is illustrated by the leading case, *Cowden v. Aetna Cas. & Sur. Co.*,[1] involving a truck of the insured which caught fire. When the driver stopped on the highway to attempt to extinguish the fire, an automobile driven by Latham crashed into the truck. Phillips, a passenger in Latham's automobile who was injured in the crash, claimed he had warned Latham of the stopped truck. An action instituted by Phillips was tried three times. The first resulted in a mistrial before all the evidence was presented. At the second trial, a verdict of $100,000 was rendered against Latham and the insured jointly, which verdict was set aside and a new trial granted. During the third trial the insured's personal counsel had an opportunity to settle the claim for $45,000, which amount he felt could be supplied in the following manner: $10,000, that being Latham's insurance coverage; $10,000, which the insured would contribute; and $25,000, which represented the policy limit of insured's coverage. The company rejected the proposal because it felt that any negligence of its insured was not the proximate cause of the accident. The final trial ended with a $90,000 verdict which the insured settled for $80,000.

Relying *solely* on bad faith,[2] the insured then brought an action against his insurer for the loss which he had suffered because of the latter's refusal to settle. He received a verdict for the full amount claimed, which was nullified by a judgment n.o.v. for the defendant company. The court held that the evidence was insufficient to justify a finding of *bad faith* on the part of the insurer for its refusal to settle the claim against the insured.

There are two principal tests which are applied to determine an insurer's liability in such a case: the "bad faith" test and the "negligence"

1. 389 Pa. 459, 134 A.2d 224 (1957).
2. *Id.* at 462, 134 A.2d at 224.

test.[3] Although *Cowden* would seem to suggest that Pennsylvania imposes the more difficult burden of proving bad faith on the part of the insurer in failing to settle,[4] the fact is that the Pennsylvania courts have never had an opportunity to choose between the two tests. *Cowden* was a case of first impression,[5] yet the insured, for some unknown reason, chose to rest his entire case on a theory of bad faith on the part of the insurer. Agreeing with the lower court that the plaintiff had simply failed to prove his allegation of bad faith, the supreme court was careful to point out that it was not adopting this test as the rule of decision in Pennsylvania. The court stated: "Nor is it without presently material significance that the plaintiff does not assert that the defendant's conduct was fraudulent or even negligent; and, of course, bad judgment, if alleged, would not have been actionable."[6]

In order to evaluate the respective merits of the bad faith and negligence tests, it becomes necessary to determine the relationship between the insurer and the insured. The answers to such questions as the following all depend on the nature of the relationship. To what degree should the insurer consider the interests of the insured? Must the insurer always give the insured's interests paramount consideration? To what extent will the actions of the insurer in dealings affecting the insured be subjected to scrutiny? Should there be an absolute duty to settle?

In the *Cowden* case, the Pennsylvania Supreme Court stated:

> While the contract is primarily one of indemnity, it operates at the same time to create an agency relationship in its provision for the insurer's exercise of control over the disposition of claims against the insured (within the policy's limits) whether that be by settlement or litigation.[7]

The opinion also mentions that even though the interests of insurer and insured may be substantially hostile, especially in situations where neither settlement nor verdict can lie within policy limits, the fiduciary obligations of the insurer remain undiminished. In fact, in such cases, the insurer is obligated to exercise the utmost good faith in handling claims against the insured. It has been recognized that Pennsylvania courts impose a high degree of good faith upon the insurer's counsel. This is especially true in defense work.[8] In the

3. See annot., 40 A.L.R.2d 168 (1955).

4. Indeed, in APPLEMAN, INSURANCE LAW AND PRACTICE § 4712, at 564 (1962), the *Cowden* case is the sole authority for the author's assertion that Pennsylvania has adopted the bad faith test in this situation.

5. 389 Pa. at 468, 134 A.2d at 227.

6. *Id.* at 472, 134 A.2d at 229.

7. *Id.* at 469-70, 134 A.2d at 228.

8. See Weiner v. Targan, 100 Pa. Super. 278 (1930); see also Perkoski v. Wilson, 371 Pa. 553, 92 A.2d 189 (1952); Malley v. American Indem. Co., 297 Pa. 216, 146 Atl. 571 (1929).

case of *Malley v. American Indem. Co.*,[9] the court specifically mentioned that this duty is placed upon the company in order to prevent an insurer from "play[ing] fast and loose, taking a chance in the hope of winning . . . ."[10]

Notwithstanding these generalizations intended to emphasize the insurer's fiduciary obligations to its insured, the Pennsylvania Supreme Court has clearly indicated that there is no absolute duty placed upon the insurer to settle claims against the insured. In *Schmidt v. Travelers Ins. Co.*,[11] the court said that "the insurer was under no obligation to pay in advance of trial and the decision whether to settle or to try was left to its discretion."[12] However, this does not mean that the company is permitted to act unreasonably or arbitrarily with respect to the interests of the insured. In the case of *American Fid. & Cas. Co. v. G. A. Nichols Co.*,[13] recovery was permitted under the bad faith rule, even where the company provided in its policy that

> 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, whether made before or after judgment, even though such demands or offers of settlement be within the Limits of Liability provided herein.[14]

The cases which have adopted the negligence approach, while realizing that the company is a party to the contract in addition to being a mere agent, nevertheless fix a duty on the insurer to employ the ordinary care of a prudent man in all its actions which involve the insured.[15] Dictum in the *Cowden* case suggests that, whenever the interests of the insured and insurer become substantially hostile, "it becomes all the more apparent that the insurer must act with the utmost good faith toward the insured in dis-

9. *Supra* note 8.

10. *Id.* at 224, 146 Atl. at 573.

11. 244 Pa. 286, 90 Atl. 653 (1914).

12. *Id.* at 289, 90 Atl. at 654; *accord*, Noshey v. American Auto. Ins. Co., 68 F.2d 808, 809-10 (6th Cir. 1934), wherein the court stated:

> Nor within the policy limits has the insurer any contract obligation to effect settlement, as the policy contains no promise that it will do so under any and all conditions or circumstances, and none is to be implied, and beyond the policy limits the insurer has of course no authority to bind the assured by compromise in any amount whatsoever.

The rejection of an implied contract to settle seems proper, since such a term was not agreed to or bargained for as a part of the contract. Even though the law favors settlement, a policy agreement should be accepted as an integrated contract, and such a provision should not be read into it.

13. 173 F.2d 830 (10th Cir. 1949).

14. *Id.* at 833. The court interpreted "penalty," as used in the exculpatory provision, to mean some sort of extraordinary liability as distinguished from compensation.

15. See Weymer v. Belle Plaine Broom Co., 151 Iowa 541, 132 N.W. 27 (1911); *but cf.* Smith v. Fidelity & Columbia Trust Co., 227 Ky. 120, 12 S.W.2d 276 (1928) (mistaken judgment is not negligence).

posing of claims against the latter."[16] It would seem that a standard of "utmost good faith" would lend itself to a theory of recovery based on negligence; as yet, however, no standard of ordinary prudence or due care has been imposed upon an insurer in Pennsylvania for a failure to settle. Should such a standard be espoused? This question cannot be intelligently approached without an understanding of the evolution of the bad faith test.

One of the leading cases establishing the bad faith test was decided by the New York Court of Appeals in 1928.[17] In that case the defendant was insured against loss which would result if he were held liable for damages accidentally suffered by his employees. In the course of negotiations, it became apparent to the insurer that a settlement could be reached with the injured employee for $8500. The insurer made a settlement offer of $6500. The insured alleged that had he known of this situation, he would have contributed the $2000 difference and the case could have been amicably settled. The court held that if the insurer is to be held liable for not settling such cases, its responsibility should be effected by agreement between insurer and insured or by legislative enactment. In the landmark *Rumford* case[18] generally cited for this same proposition, the Supreme Court of Maine said:

> It must be remembered, in the first place, that this policy of insurance is a contract of indemnity, in which the parties have a legal right to insert any conditions and stipulations which they deem reasonable or necessary, provided no principle of public policy is thereby contravened.[19]

Some of the courts which have adopted the bad faith test hold that only an intentional disregard of the interests of the insured will meet the test.[20] Other courts do not seem to require such a strict standard to be met. Nevertheless, it is recognized that these latter jurisdictions also follow the bad faith test.[21] The courts also appear to apply different standards regarding how closely the insurer should respect the interests of the insured, especially where the interests of insurer and insured become adverse. Should the insurer be permitted to consider its own interests even at the insured's expense? Should the company's actions be judged by the standard that it should dispose of the case as if it alone were to be liable for the entire amount? It has been held that where an insurer does not settle, but decides

16. 389 Pa. at 470, 134 A.2d at 228.
17. Best Building Co. v. Employers' Liab. Assur. Corp., 247 N.Y. 451, 160 N.E. 911 (1928).
18. Rumford Falls Paper Co. v. Fidelity & Cas. Co., 92 Me. 574, 43 Atl. 503 (1899).
19. *Id.* at 585, 43 Atl. at 506.
20. See, *e.g.*, Johnson v. Hardware Mut. Cas. Co., 109 Vt. 481, 1 A.2d 817 (1938).
21. See, *e.g.*, Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 231 N.W. 257 (1939).

to defend, reasonable care must be used in the preparation and conduct of the trial.[22] Although it might be contended that an insurance company, as a named defendant, would be at a decided disadvantage on all jury questions, it should be pointed out that such a situation always obtains when any defendant of substantial means appears in court. Yet, our traditional system has not found this to be such an insurmountable obstacle as to justify denying a remedy where the right is otherwise clear. In addition, the traditional safeguards of motions for directed verdict, judgment n.o.v., and new trial are always available. The courts which require due care in negotiations for settlement and in the conduct of the trial, but look for evidence of bad faith in the company's decision whether or not to settle, have eased considerably the burden of the insured. But why should anything less than reasonable care be the recognized rule at any stage of the game, pre-decision, decision, or trial?

It is submitted that the duty of reasonably prudent conduct should extend to the settlement stage. It would seem that, since the insured has vested such vast discretionary powers in the insurer, the latter should be held to the requirements of due care in any event. The duty to settle would be imposed, not absolutely, but when the circumstances indicate that settlement is reasonable and appropriate. In the case of *Cavanaugh Bros. v. General Acc. Fire & Life Assur. Corp.*,[23] the Supreme Court of New Hampshire stated:

> The question therefore raised . . . is whether [the insurer] . . . owed the plaintiff the duty of settling . . . before suit, if that was the *reasonable* thing to do. As to that there can be no question; for, when the defendant assumed control of the . . . claim, it then and there became its duty to do what the average man would do in a similar situation.[24]

This approach, it is submitted, represents the better reasoning, and should be considered by the Pennsylvania courts at their first opportunity.

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22. Georgia Cas. Co. v. Mann, 242 Ky. 447, 46 S.W.2d 777 (1932).

23. 79 N.H. 186, 106 Atl. 604 (1919).

24. *Id.* at 187, 106 Atl. at 604 (emphasis added); see G. A. Stowers Furniture Co. v. American Indem. Co., 15 S.W.2d 544 (Tex. Civ. App. 1929).

It is true that in the *Cowden* case there was a significant question whether or not the insured's negligence was the proximate cause of the accident and hence whether either insured or insurer was liable. However, it would seem that the company should have appreciated the prophetic significance of the $100,000 jury verdict.