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Insurance - Settlement - Extent of Insurer's Liability for Wrongful Refusal to Settle When Subsequent Judgment Exceeds Policy Limits

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INSURANCE—SETTLEMENT—EXTENT OF INSURER'S LIABILITY FOR WRONGFUL REFUSAL TO SETTLE WHEN SUBSEQUENT JUDGMENT EXCEEDS POLICY LIMITS—The insured, while driving a borrowed truck, injured plaintiff and his wife. Defendant, insurer on a policy which contained liability limits of \$10,000 per person and \$20,000 per accident, was notified of the accident but refused to defend the subsequent suit against the insured on the ground that plaintiff's claim was not covered by the policy. Defendant refused an offer to settle the claim for \$4,000 solely on the basis of its belief as to coverage, though it was aware that the insured was financially unable to effect his own settlement. A judgment of \$25,000 for a plaintiff and \$1,250 for his wife was rendered against the insured. After plaintiff recovered \$10,000 in a suit against the defendant,¹ the insured assigned all his rights against the defendant to plaintiff who brought this suit to recover that portion of the initial judgment in excess of the policy limits. Judgment was entered for the insurer, notwithstanding a jury verdict for the plaintiff. On appeal, *held*, reversed. An insurer who wrongfully, though perhaps with foundation, denies coverage and refuses to accept a reasonable offer of settlement subjects itself to liability for the full judgment against the insured. *Comunale v. Traders & General Ins. Co.*, (Cal. 1958) 328 P. (2d) 198.

The usual contract of insurance imposes upon the insurer the duty to defend the insured against all claims covered by the policy and to satisfy subsequent judgments up to policy limits. The insurer also is generally given the exclusive right to effect settlements of all claims against the insured.² This right, however, may not be exercised at the whim of the insurer. Upon receipt of an offer of settlement, the insurer must consider the insured's interests.³ If the offer is reasonable, a refusal to accept will constitute negligence or bad faith,⁴ subjecting the insurer to full liability for a subsequent judgment.⁵ However, the duty to defend

¹ *Comunale v. Traders & General Ins. Co.*, 116 Cal. App. (2d) 198, 253 P. (2d) 495 (1953), which established defendant-insurer's liability under the policy.

² Whether the insurer defends or not, the insured may settle the uninsured portion of the claim. *General Accident, Fire & Life Assurance Co. v. Louisville Home Telephone Co.*, 175 Ky. 96, 193 S.W. 1031 (1917).

³ The consideration is sometimes stated as that which the insurer would give if it were liable for any excess. *American Casualty Co. v. Howard*, (4th Cir. 1951) 187 F. (2d) 322.

⁴ Exhaustive literature has been devoted to defining negligence and bad faith in this area. In the great majority of the cases there seems to be little distinction between the two. See generally Keeton, "Liability Insurance and Responsibility for Settlement," 67 HARV. L. REV. 1136 (1954); 8 APPLEMAN, INSURANCE LAW AND PRACTICE §§4681-4714 (1942).

⁵ This liability is usually said to arise in tort. The cases treating it as a breach of an implied contract to act in good faith still require a showing of tortious conduct for breach. Compare *American Fidelity & Casualty Co. v. All American Bus Lines*, (10th Cir. 1951) 190 F. (2d) 234 (tort), with *Tyger River Pine Co. v. Maryland Casualty Co.*, 170 S.C. 286, 170 S.E. 346 (1933) (tort or contract).

and the duty to satisfy judgments are generally considered to be correlative so that the absence of one necessarily negates the other.⁶ A fortiori, if the insurer has no duty to satisfy a subsequent judgment, all offers of settlement may be refused with impunity. Where there is only a wrongful refusal to defend without opportunity to settle, the insurer is liable whether its determination that the claim was not covered is reasonable or unreasonable, but only to the extent of the policy limits.⁷ On the other hand, where a refusal to accept a settlement offer is based solely on the insurer's denial of coverage, the courts have denied excess liability on the insurer's part where there is a showing of good faith regarding the refusal to settle.⁸ This in turn has depended on whether the insurer's denial of coverage was reasonable. Thus, if the insurer's interpretation of the policy was reasonable, though erroneous, excess recovery has been denied.⁹ Undoubtedly this is an attempt to relieve the insurer from the seemingly illogical position of having to effect a final settlement when reasonable investigation indicated no liability on its part for the claim. The principal case in this situation makes the insurer's reasonable belief as to coverage no defense if in fact it is erroneous.

Those courts which require a showing of negligence or bad faith to impose liability for refusal to settle would seem to be overly protective of the insurer, but the extreme position taken by the California court does not appear to be the answer to the problem. When the insurer refuses to defend, the insured is released from his promise to abstain from making his own settlement.¹⁰ Moreover, he will be able to recover from the insurer that sum within the policy limits expended in making a reasonable settlement.¹¹ Yet these factors, as well as the insured's financial position, were apparently not considered by the court in the principal case. Acceptance of the offer of settlement by the insured will give him a means

⁶ See 8 APPLEMAN, *INSURANCE LAW AND PRACTICE* §4684 (1942). The duty to defend was held to be independent in *City Poultry & Egg Co. v. Hawkeye Casualty Co.*, 297 Mich. 509, 298 N.W. 114 (1941); but see *Duval v. Aetna Casualty & Surety Co.*, 304 Mich. 397, 8 N.W. (2d) 112 (1943).

⁷ This is true even if the judgment is in excess of the policy limits, the theory being that the insured can obtain his own attorney and thus there is no reason to conclude that the result of the trial would have been different if the insurer had defended. *Mannheimer Brothers v. Kansas Casualty & Surety Co.*, 149 Minn. 482, 184 N.W. 189 (1921).

⁸ E.g., *State Farm Mutual Automobile Ins. Co. v. Skaggs*, (10th Cir. 1957) 251 F. (2d) 356; *Ohio Casualty Ins. Co. v. Gordon*, (10th Cir. 1938) 95 F. (2d) 605. Cf. *Farm Bureau Mutual Automobile Ins. Co. v. Violano*, (2d Cir. 1941) 123 F. (2d) 692, cert. den. 316 U.S. 672 (1942); *United States Fidelity & Guaranty Co. v. Canale*, (6th Cir. 1958) 257 F. (2d) 138.

⁹ *State Farm Mutual Automobile Ins. Co. v. Skaggs*, note 8 *supra*; *Ohio Casualty Ins. Co. v. Gordon*, note 8 *supra*. Cf. *Farm Bureau Mutual Automobile Ins. Co. v. Violano*, note 8 *supra*.

¹⁰ *St. Louis Beef Co. v. Casualty Co.*, 201 U.S. 173 (1906).

¹¹ See note 10 *supra*. Cf. *Employers Mutual Liability Ins. Co. of Wisconsin v. Hendrix*, (4th Cir. 1952) 199 F. (2d) 53.

of protecting himself if he is financially able to compromise the claim. In such a situation there seems to be no good reason to hold the insurer liable for the excess judgment when its denial of coverage was reasonable. Recovery of the excess should be allowed, however, when the insured is without the financial means to accept the offer of settlement and thereby avoid any uninsured loss. The insurer has unreservedly promised to defend this claim.¹² Where the insurer refuses to defend or settle and the insured is unable to settle, any judgment against the insured is traceable directly to the insurer's breach of its promise to defend.¹³ In addition, the insurer should be aware of the possibility of a wrongful interpretation of the policy¹⁴ and that an excess judgment might be the result of that error.¹⁵ But this does not have to be looked at in terms of negligence or bad faith since it is at least arguable that such a chain of circumstances was foreseeable at the time the policy was executed.¹⁶ It is axiomatic that contract principles allow recovery for those foreseeable losses, resulting from a breach of the contract, which cannot be reasonably avoided by the claimant.¹⁷ Recovery of the excess should thus be denied where the insured was in a position to avoid this loss but failed to mitigate his damages. Since the bargaining positions of the insurance company and the insured are usually unequal, it seems unduly harsh to place the burden

¹² But since it has not promised to accept all offers of settlement pertaining to that claim, the test of negligence or bad faith has been used to determine liability for a refusal to settle.

¹³ It is hypothesized that the offer of settlement was otherwise reasonable. Had the insurer agreed to defend, it would have been required either to accept the offer or stand liable for any subsequent judgment, since its refusal to accept would be either negligent or in bad faith if the offer was in fact reasonable.

¹⁴ Courts are quite willing to disregard the reasonable interpretation of the insurer if there is a possibility of interpreting the policy so as to protect the insured. See, e.g., *Comunale v. Traders & General Ins. Co.*, note 1 *supra*. The allegations of the injured party's bill will generally determine whether the complaint is within the policy but the insurer should be aware of the possibility that the injured party may amend the original declaration for relief. *Boutwell v. Employers' Liability Assurance Corp.*, (5th Cir. 1949) 175 F. (2d) 597.

¹⁵ The very definition of a "reasonable offer" implies that a judgment will probably exceed the amount of the offer.

¹⁶ See Keeton, "Liability Insurance and Responsibility for Settlement," 67 HARV. L. REV. 1136 at 1157, 1160 (1954).

¹⁷ Will this "sword" cut both ways? Should the insurer, in a situation where the insured could have settled but did not, be allowed to reduce its liability below the policy limits to that figure at which the insured could have settled? Since the purpose of an insurance contract is to provide protection for the insured not only when he actually needs it but whenever the insurer has promised to protect him, the insurer should not be allowed to reduce its liability as considered above. The insurer will be adequately protected as it will be required to pay only that sum which it agreed to pay. See *Ohio Casualty Ins. Co. v. Gordon*, note 8 *supra*, which suggests that the insurer cannot reduce his liability in such a manner. But see *Wilson v. London Guarantee & Accident Co.*, 37 Cal. App. 245, 173 P. 1006 (1918); *Fidelity & Casualty Co. v. Southern Ry. News Co.*, 31 Ky. L. Rep. 55, 101 S.W. 900 (1907).

of the insurer's misinterpretation of its own policy upon the relatively small shoulders of an insured who is financially unable to settle and avoid the excess uninsured loss. This is especially true where as here performance of the contract by the insurer would have avoided such loss.¹⁸ Since the insured in the principal case was in no position to settle, the court's departure from the decisions in other jurisdictions is to be commended.¹⁹ But this result should be limited to those cases where the insured is unable to effect his own settlement.²⁰

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¹⁸ See note 13 *supra*.

¹⁹ Several jurisdictions, not including California, require the insured to satisfy the excess judgment before any recovery of that sum from the insurer will be allowed. Some, but not all, base this result on a distinction between a policy indemnifying against liability and one indemnifying against loss from liability. *State Automobile Ins. Co. v. York*, (4th Cir. 1939) 104 F. (2d) 730 (indemnified against liability). The great weight of authority is to the contrary. See 8 APPLEMAN, *INSURANCE LAW AND PRACTICE* §§4834, 4835 (1942). In the present situation, such a requirement would release the insurer from excess liability in the very situation where its liability should be extended.

²⁰ It should be pointed out that the result of the principal case might possibly be avoided in the future by a clause in the insurance policy which negates liability in excess of the policy limits when the insurer's refusal to settle is based solely on its reasonable belief that the claim is beyond the coverage of the policy, though its interpretation in fact be erroneous.