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Insurance—Liability of Insurer Beyond Policy Limits—The Danger of Strict Liability

A, the owner of a 10,000 dollars liability insurance policy with company *X*, is sued by *B*. Pursuant to the insurance contract, the company undertakes the defense of the lawsuit, controlling all aspects of the litigation including the right to settle. An offer to settle the case for the policy limits is made, which the insurer rejects. At the trial the jury awards the plaintiff a verdict of 100,000 dollars. After company *X* pays its 10,000 dollars, the defendant *A* is liable for the remainder of the judgment. *A* brings an action against the company for wrongful refusal to settle within the policy limits.

This fact situation, presented to the California Supreme Court in *Crisci v. Security Insurance Co.*,[1] confronts the parties to the insurance contract with an inherent conflict of interests. Since under the terms of the policy the insurer reserves the exclusive right to settle claims, an offer by the plaintiff at or near the policy limits gives rise to conflicting desires. "The insurer is interested in settling the claim at the lowest amount within the policy limit, while the insured desires to avoid any liability for the excess."[2] In affirming an award for the excess judgment and for 25,000 dollars for the insured's mental suffering,[3] the California court carefully considered the arguments for a strict liability rule in this area.[4] Simply stated, a strict liability rule would provide that "whenever an insurer receives an offer to settle within the policy limits and rejects it, the insurer should be liable in every case for the amount of any final judgment whether or not within policy limits."[5] After considering arguments for this proposed rule, the court declined "to determine whether there might be some countervailing considerations . . . because . . . the evidence[6] is clearly sufficient to support the determination [under the

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[1] 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

[2] Terrell v. Western Cas & Sur. Co., 427 S.W.2d 827-28 (Ky. 1968).

[3] The award of 25,000 dollars for mental suffering raises an interesting question of whether damages for wrongful refusal to settle are to sound in contract or tort. Discussion of this point, however, is not within the scope of this note. See generally Note, *Excess Recovery—Liability Insurer Who Refused Settlement Within Policy Limits Held Liable for Excess Recovery and Mental Damages*, 43 N.Y.U.L. Rev. 199 (1968); Note, *Refusal to Settle Claim Below Policy Limits —Damages for Mental Suffering*, 22 Sw. L.J. 374, 377-79 (1968).

[4] There were a large number of *amicus curiae* briefs filed supporting the proposed rule.

[5] 66 Cal. 2d at 430, 426 P.2d at 177, 58 Cal. Rptr. at 17.

[6] The evidence was that the insurer knew that there was a strong likelihood

bad faith doctrine]."[7]

The California court is apparently the first court to give a strong indication that it might promulgate a strict liability rule in the excess judgment context.[8] While all courts hold that an insurance carrier will be liable for a wrongful refusal to settle under certain conditions,[9] the basic split heretofore has involved the question of whether the company is liable for mere negligence[10] in refusing to settle or solely for a bad faith[11] refusal. The central issue under either standard concerns the weight the carrier must give to the interests of the insured in determining not to settle. "The predominant majority rule is that the insurer must accord the interest of the insured the same faithful consideration it gives its own interests . . . ."[12] Although the tests will vary in terminology, most writers agree that the distinction between the negligence and bad faith standards is minimal,[13] for the insurer, as a professional in insurance litigation, is often held to a higher standard than the average practitioner.[14] Consequently, mere negligence by the average defender might constitute bad faith by the skilled insurer.[15]

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of a large excess judgment. Its only hope of a favorable verdict was proof of the injured party's prior mental history. "Security was putting blind faith in the power of its psychiatrists to convince the jury when it knew that the accident could have caused the psychosis. . . ." *Id.* at 432, 426 P.2d at 178, 58 Cal. Rptr. at 18.

[7] *Id.* at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17 (footnote added). These arguments will be discussed later in the note. See generally Comment, *Liability of Insurer for Judgment in Excess of Policy Limits,* 48 MICH. L. REV. 95 (1949); Comment, *Crisci's Dicta of Strict Liability for Insurer's Failure to Settle: A Move Toward Rational Settlement Behavior,* 43 WASH. L. REV. 799 (1968); Note, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule,* 18 STAN. L. REV. 475 (1966); Note, *Liability Insurer's Duty to Settle,* 13 U. CHI. L. REV. 105 (1945).

[8] Some courts have considered the doctrine and have rejected it. *E.g.,* Kaudern v. Allstate Ins. Co., 277 F. Supp. 83 (D.N.J. 1967).

[9] *See generally* Brown v. United States Fid. & Guar. Co., 314 F.2d 675 (2d Cir. 1963): 7A J. APPLEMAN, INSURANCE LAW AND PRACTICE §§ 4712-13 (1962, Supp. 1968) [hereinafter cited as APPLEMAN]; Annot., 40 A.L.R.2d 168 (1955); Keeton, *Liability Insurance and Responsibility for Settlement,* 67 HARV. L. REV. 1136 (1954) [hereinafter cited as Keeton]; Note, *Insurer's Liability for Refusal to Settle,* 42 ST. JOHNS L. REV. 544 (1968).

[10] *E.g.,* Smith v. Transit Cas. Co., 281 F. Supp. 661 (E.D. Tex. 1968).

[11] *E.g.,* Bowers v. Camden Fire Ins. Ass'n, 51 N.J. 62, 237 A.2d 857 (1968).

[12] Cowden v. Aetna Cas. & Sur. Co., 389 Pa. 459, 470, 134 A.2d 223, 228 (1957).

[13] *See* 7A APPLEMAN § 4712; Annot., *supra* note 9; Keeton.

[14] State Farm Mut. Auto. Ins. Co. v. Marcum, 420 S.W.2d 113, 120 (Ky. 1967); *accord,* Bowers v. Camden Fire Ins. Ass'n, 51 N.J. 62, 237 A.2d 857 (1968).

[15] 7A APPLEMAN § 4712. Following this reasoning one court has stated that "[T]he insurer is simply held to a standard of reasonable conduct and avoidance

An analysis of case law reveals that under both the good faith and negligence standards, no one factor is determinative of liability. A listing of relevant considerations includes the following:

> (1) the strength of the injured claimant's case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to the settlement; (3) failure of the insurer to properly investigate the circumstances involved in the accident, which would result in its inability to effectively weigh the evidence against the insured; (4) the insurer's rejection of advice of its own attorney or agent; (5) failure of the insurer to inform the insured of the compromise offer; (6) the amount of financial risk to which each party is exposed in the event of a refusal to settle; and (7) the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts.[16]

Although it has been held that the insurer has no duty to initiate settlement negotiation,[17] the fact that no offer was made within policy limits is merely one factor to be considered in determining bad faith.[18] "It has been similarly established that an insurer's refusal to settle a case within maximum policy limits . . . does not render the insurer liable per se to its assured . . . ."[19] In view of the above considerations,[20] perhaps the insurer's best approach is to treat the settlement situation as though there were no policy limits.[21]

North Carolina is in accord with the majority of states in holding the insurer to a standard of good faith.[22] Its statute provides: "The insurance carrier shall have the right to settle any claim covered by the policy, and if such settlement is made in good faith, the amount thereof shall be deductible from the limits. . . ."[23] Prior to the passage of this statute, the

of fraud, negligence, and/or bad faith. . . ." Powell v. Prudence Mut. Cas. Co., 88 Ill. App. 2d 343, 348, 232 N.E.2d 155, 158 (1967).

[16] Kaudern v. Allstate Ins. Co., 277 F. Supp. 83, 88-89 (D.N.J. 1967), *quoting from* Brown v. Guarantee Ins. Co., 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

[17] Oda v. Highway Ins. Co., 44 Ill. App. 2d 235, 194 N.E.2d 489 (1963).

[18] State Auto. Ins. Co. v. Rowland, —— Tenn. ——, 427 S.W.2d 30 (1968); *accord*, Cernocky v. Indemnity Ins. Co. of N. America, 69 Ill. App. 2d 196, 216 N.E.2d 198 (1966).

[19] Powell v. Prudence Mut. Cas. Co., 88 Ill. App. 2d 343, 347-48, 232 N.E.2d 155, 158 (1967).

[20] The considerations mentioned are by no means intended to be an exhaustive listing of all relevant factors. See generally 7A APPLEMAN §§ 4712-13; Keeton.

[21] Crisci v. Security Ins. Co., 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

[22] Annot., *supra* note 9.

[23] N.C. GEN. STAT. § 20-279.21(f)(3) (1953). See Bradford v. Kelly, 260 N.C. 382, 132 S.E.2d 886 (1963). Consider also the impact of the UNIFORM COMMERCIAL CODE which states that "the obligations of good faith, diligence, reason-

North Carolina Supreme Court had consistently followed the good faith test;[24] since its passage, the court has continued to follow it,[25] although on one occasion it specifically refused to decide whether the insurer was liable for negligence.[26] The most recent case dealing with North Carolina's standard is *Abernathy v. Utica Mutual Insurance Co.*[27] In this case the Fourth Circuit Court of Appeals reversed a nonsuit in the district court, and held that the mere refusal by the company to entertain an offer of settlement before trial was sufficient to carry the case to the jury on the issue of bad faith.[28] The court pointed out that all cases have at least a "nuisance" value and that the flat refusal to negotiate should be considered by the jury.[29] The practical effect of this decision is to give the insured a strong bargaining point in further negotiations with the insurer, since it is common knowledge that juries favor those suing insurance companies.[30]

In analyzing the case law, it becomes apparent that there are strong arguments both for and against the trend[31] towards a strict liability rule.

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ableness and care prescribed by this chapter may not be disclaimed by agreement. . . ." N.C. GEN. STAT. § 25-1-102(3) (1965).

[24] Wynnewood Lumber Co. v. Travelers' Ins. Co., 173 N.C. 269, 91 S.E. 946 (1917); *accord*, State Auto. Mut. Ins. Co. v. York, 104 F.2d 730 (4th Cir. 1939).

[25] Henry v. Nationwide Ins. Co., 139 F. Supp. 806 (E.D.N.C. 1956); Bradford v. Kelly, 260 N.C. 382, 132 S.E.2d 886 (1963); Alford v. Textile Ins. Co., 248 N.C. 224, 103 S.E.2d 8 (1958).

[26] Alford v. Textile Ins. Co., 248 N.C. 224, 103 S.E.2d 8 (1958). The court has stated, however, that the carrier, when wrongfully refusing to defend, is liable only for a reasonable amount of the consent judgment in excess of limits. Nixon v. Liberty Mut. Ins. Co., 255 N.C. 106, 120 S.E.2d 430 (1961).

[27] 373 F.2d 565 (4th Cir. 1967).

[28] This case is quite interesting on its facts. Insured held a policy with 30,000 dollars maximum limit. Insured's car ran into the rear of another car which had previously hit a van in the rear. There were four fatalities and one serious injury. The main issue was whether the second accident was the proximate cause of any or all injuries sustained in the adverse party's car. Two wrongful death actions were consolidated for trial and the jury returned a verdict for the insured which was affirmed on appeal. Lawing v. Landis, 256 N.C. 677, 124 S.E.2d 877 (1962). The second suit was by the injured occupant, and the jury gave a 10,000 dollar verdict against the insured, which was also affirmed on appeal. Punch v. Landis, 258 N.C. 114, 128 S.E.2d 224 (1962). This left 20,000 dollars in insurance coverage. There was an offer to settle the last two wrongful death actions for 15,000 dollars. The company refused, and at the trial the injured passenger testified for the first time that he remembered all the occupants being alive after the first wreck, a critical issue. The judge advised insured's attorney that he should settle to which he replied that he did not have 50 dollars authority. 373 F.2d at 568.

[29] 373 F.2d at 569.

[30] It should be pointed out that the case was eventually settled for a substantial figure.

[31] At least one federal judge interprets it as a new trend saying that "the reasoning of the California Supreme Court seems to indicate a trend towards requiring insurance companies to act more responsibly towards their customers

The basic theme of the strict liability argument, as announced in *Crisci*, is that the rule would "eliminate the danger that an insurer, faced with a settlement offer at or near policy limits, will reject it and gamble with the insured's money to further its own interests."[32] This argument is seemingly answered, however, in the next sentence of the court's opinion where it states that "it is not entirely clear that the proposed rule would place a burden on insurers substantially greater than that which is present under existing laws."[33] Surely the burden would not be substantially greater if the carrier were truly gambling with the insured's money, due to the existing negligence and bad faith standards. But what of the notion that "a mistake [of judgment], honestly made does not subject the person to legal liability?"[34] Consider further the obvious change in the burden of proof. Absent some affirmative defense such as fraud, an insured would merely be required to prove the rejection of an offer that was within policy limits. Proponents of a strict liability rule argue that it would be simple to apply and would avoid determining whether the insurer's decision was reasonable.[35] This logic would obviate a function that juries regularly perform in simple negligence cases. Perhaps the most attractive argument of the proponents of strict liability is that "where insurer's and insured's interest necessarily conflict, the insurer, which may reap the benefit of its determination not to settle, should also suffer the detriments of its decision."[36] This argument apparently overlooks the fact that the parties to the contract expressly bargained for limited, not absolute, liability. Furthermore, the insurer is granted the right to control settlements.[37] Strict liability would make the insurer absolutely liable for the excess though the company was exercising an express contractual right;[38] where-

with respect to offers of settlement." Kaudern v. Allstate Ins. Co., 277 F. Supp. 83, 89 n.5 (D.N.J. 1967).

[32] 66 Cal. 2d at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17.

[33] *Id.*

[34] Wynnewood Lumber Co. v. Travelers' Ins. Co., 173 N.C. 269, 271, 91 S.E. 946, 947 (1917).

[35] See 66 Cal. 2d at 431, 426 P.2d at 177, 58 Cal. Rptr. at 17 (dictum).

[36] *Id.*

[37] It must be remembered that the insured's cause of action is normally based on the alleged breach of an implied covenant found in this settlement control clause. See Annot., *supra* note 9; Keeton.

[38] While it is true that the insurance contract is not truly an arms length transaction, the insured is normally protected by his state legislature, which condones this clause. *E.g.*, N.C. GEN. STAT. § 20-279.21(f)(3) (1953). As pointed out by one writer, the full impact of the *Crisci* dicta is that it "holds out to liability insureds the prospect that they will have the best of both worlds: absolute contractual liability of the insurer, without necessity of proof other than rejection of an offer within policy limits, plus liability for financial damage, mental suffering, and perhaps other items of damage." Levitt, *The Crisci Case—Something Old, Something New*, 580 INS. L.J. 12, 18 (1968).

as, the insured would be completely protected if the settlement offer had been within policy limits.

An ancillary problem presented by the excess judgment cases is whether the injured party, either as a third party beneficiary or as an assignee of the insured's rights, may sue the insurer. The great weight of authority holds that the injured party is not a third party beneficiary and may not sue for bad faith in a direct action,[39] although an exception has been found in the case of compulsory insurance laws.[40] The concept of allowing the insured to assign his cause of action has received some approval,[41] for it allows the insured to effectuate a settlement of the excess that the company allegedly caused.[42] A strong countervailing argument is that such assignments would breed collusion between the injured person and the insured.[43] It is not difficult to foresee settlement offers being made within the policy limits solely to give rise to a bad faith action, and this danger would be increased by a strict liability rule. Some states effectively preclude such assignments by holding that the insured must make payment on the excess judgment before he has a cause of action against the insurer.[44]

Under present law the liability of the parties to the insurance contract is often uncertain in the settlement situation.[45] Perhaps the best solution, suggested by at least one writer,[46] is to include a provision in the insurance policy to the effect that the liability of the insurer will be double the original limits, should the insurer reject an offer that is within those policy limits. Such a provision would not eliminate all excess judgment actions. It would, however, tend to (1) minimize the risk that

[39] *See, e.g.,* Browdy v. State-Wide Ins. Co., 56 Misc. 2d 610, 289 N.Y.S.2d 711 (Sup. Ct. 1968).

[40] *Id.* While North Carolina has not passed upon this point, it should be noted that the state does have compulsory liability insurance.

[41] *E.g.,* Terrell v. Western Cas. & Sur. Co., 427 S.W.2d 825 (Ky. 1968). *Contra,* Dillingham v. Tri-State Ins. Co., 214 Tenn. 592, 381 S.W.2d 914 (1964). *See* Annot., 12 A.L.R.3d 1158 (1967).

[42] Annot., 12 A.L.R.3d 1158 (1967).

[43] *Id.*

[44] Universal Auto. Ins. Co. v. Culberson, 126 Tex. 282, 86 S.W.2d 727 (1935). *Contra,* United States Fid. & Guar. Co. v. Evans, 116 Ga. App. 93, 156 S.E.2d 809 (1967). Any effect of this rule on the insured's cause of action has been avoided by means of a declaratory judgment, but the holding still precludes an assignment since the insured must still make some payment before he can sue the insurer. Smith v. Transit Cas. Co., 281 F. Supp. 661 (E.D. Tex. 1968).

[45] For an article making recommendations to insurers on how to avoid this situation, see Snyder, *Defense in Excess of Policy Limit Litigation,* 18 FED. OF INS. COUNSELORS 9 (1968); *see also* O'Brien, *Liability Beyond the Policy Limit,* 391 INS. L.J. 525 (1955).

[46] Keeton 1183-85; see Georgia L. Ins. Co. v. Mississippi C.R. Co., 116 Miss. 114, 76 So. 646 (1917) (policy provided double coverage).

the insurer will gamble with the insured's money, since rejection of an offer within policy limits will expose the carrier to double liability, and (2) would determine the outer limits of the insurer's liability, absent actual bad faith. Such a provision would be more reasonable than court imposition of strict liability, which would frequently impose liability for exercising a contractual right, often one approved by the state legislature.[47] Before such drastic action is taken, the legislature should give its express sanction.

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Labor Law—Innocent Purchaser's Duty to Reinstate Employees

The NLRB, under Section 10(c) of the National Labor Relations Act, has authority to issue a remedial order against an employer who "has engaged in or is engaging in . . . unfair labor practice[s]."[1] The exercise of this authority is unquestioned when the order is directed against the guilty employer. If the guilty employer sells his business before the unfair practice has been remedied, however, the Board must decide whether the order may be directed against the purchaser. If the purchaser is but a "disguised continuance" of the seller[2] or one who has concerted with the guilty employer to evade the order,[3] the Board may properly direct an order against the purchaser. When the purchase is made in good faith, the problems are more acute. An examination of the decisions reveals the Board's difficulties.

Initially, the Board recognized no limitation as to the parties who could be bound by an order under Section 10(c) once an unfair labor practice was discovered. In the 1948 decision of *Alexander Milburn Co.*,[4] a purchaser, who was neither a "disguised continuance" nor an "evader,"

[47] *E.g.*, N.C. GEN. STAT. § 20-279.21(f)(3) (1953).

[1] National Labor Relations Act § 10(c), 29 U.S.C. § 160(c) (1964).

> If . . . the Board shall be of the opinion that any person . . . has engaged in or is engaging in any such unfair labor practice, then the Board . . . shall issue . . . an order requiring such person to cease and desist from such unfair practice, and to take such affirmative action including reinstatement of employees with or without back pay as will effectuate the policies of this Act.

Id.

[2] Regal Knitwear Co. v. NLRB, 324 U.S. 9 (1945); Southport Petro. Co. v. NLRB, 315 U.S. 100 (1942).

[3] Regal Knitwear Co. v. NLRB, 324 U.S. 9 (1945); NLRB v. Ozark Hardwood Co., 282 F.2d 1 (8th Cir. 1960).

[4] 78 N.L.R.B. 747 (1948).