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PRIMARY AND EXCESS INSURERS AND THEIR COMMON INSURED: THE TRIANGULAR RELATIONSHIP WITH NO LOVE LOST

The development of liability insurance involved the formation of primary and excess insurance carriers to fully protect the insured's interests. This Note examines the evolution of the insurer-insured relationship, the movement away from imposing an implied covenant of good faith on the insurer and toward applying a strict liability standard, the insured's duty of good faith to his or her insurance company, and the nature of the primary-excess insurer relationship. This Note concludes that the imposition of the good faith doctrine characteristic of the insured-insurer context is inapposite to the primary-excess insurer context and that a new, independent duty of care between the excess and primary insurers should be applied.

INTRODUCTION

LIABILITY INSURANCE originated as a device to protect an individual from financial hardship or ruin due to an adverse liability judgment. Purchasing insurance transferred the risk of a debilitating judgment to the insurance company in exchange for the insured's payment of regular policy premiums.¹

The development of the insured-insurer relationship led to the imposition of a duty of good faith and fair dealing on the insurer to protect the rights of the less powerful individual policyholder.² An insured who sought greater protection from the risk of potentially large adverse judgments could insure against that risk through the mechanism of excess insurance. This supplemental insurance protected the insured from liability exceeding the primary insurance policy limits.³

This Note analyzes the triangular relationship between the excess and primary insurers and their common insured. This triangular relationship is discussed in light of the situation which arises when the primary insurer refuses to settle or defend a claim against its insured, thereby exposing the insured to an excess liability judgment.⁴ The Note further examines the repercussions of the primary insurer's faulty decisionmaking which result in legal

1. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136, 1177 n.99 (1954).

2. See *infra* notes 30-31 and accompanying text.

3. See *infra* notes 167-68 and accompanying text.

4. See *infra* note 171 and accompanying text.

liability to both the insured⁵ and the excess insurer⁶ for judgment exceeding primary policy limits.

This Note first examines the judicial development of the insured-insurer relationship from its inception⁷ to present treatment.⁸ The current view shuns strict contract formalities⁹ and recognizes that the insurer's "power to affect the interests of insured as well as its own interests should be accompanied by responsibility for its exercise, regardless of the fact that such responsibility is not expressed in the policy."¹⁰ This modern consumer-oriented approach recognizes that the basic purpose of insurance is to provide the insured with "peace of mind."¹¹ To further this purpose, the insurer must be compelled to provide a standard of service which will further such goals.¹²

Second, this Note considers the creation of a fiduciary duty between the insurer and its insured and its effect on the insurance industry. The development of this duty from the early establishment of the implied covenant of good faith and fair dealing to the recent move toward strict liability for insurers for improper handling of the insured's interests is then examined.¹³

The third section of this Note examines the extent to which an insured owes a duty of good faith to his or her insurance company.¹⁴ This section concludes that while it is inappropriate to impose on the insured a reciprocal duty of good faith to his or her insurer, the insured should not be permitted to ignore the insurer's legitimate interests with impunity.¹⁵

Finally, in light of the development of the insured-insurer relationship and the duty of good faith, this Note examines the nature of the primary-excess insurer relationship to determine whether either the primary or excess insurer may benefit from a doctrine similar to the insurer's established duty to deal fairly with the in-

5. See *infra* notes 53-90 and accompanying text.

6. See *infra* notes 191-209 and accompanying text.

7. See *infra* notes 19-24 and accompanying text.

8. See *infra* notes 25-31 and accompanying text.

9. See *infra* notes 25-26 and accompanying text.

10. Keeton, *supra* note 1, at 1138.

11. Note, *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CAL. W.L. REV. 358, 358 (1977).

12. Parks, *Recovery of Extra-Contract Damages in Suits on Insurance Policies*, 9 FORUM 43, 55 (1973). A reasonable standard of service includes a sum equal to the insured's policy limits available to settle claims against the insured.

13. See *infra* notes 25-115 and accompanying text.

14. See *infra* notes 131-60 and accompanying text.

15. See *infra* notes 158-65 and accompanying text.

terests of its insureds.¹⁶ This Note concludes that application of either the equitable subrogation or good faith doctrines is inappropriate in the primary-excess insurer context.¹⁷ While both primary and excess insurers have legitimate interests in their relationship to a common insured, application of standards designed to protect the insured will not effectively protect insurance companies. Instead, this Note recommends the creation of a new, independent duty of care between the excess and primary insurance carriers.¹⁸

I. DEVELOPMENT OF THE INSURED-INSURER RELATIONSHIP

A. *Early View Favors Insurers*

Early twentieth century courts have adhered to strict contract theories favoring the insurer.¹⁹ The insurer and insured were viewed traditionally as equal parties to a contract.²⁰ This view severely curtailed the insured's ability to recover in excess of the policy limits.²¹ Insurers rarely would settle claims against their insureds when the probable liability approached the policy limits. Since an insurer's maximum obligation was the policy limit, insurers would ignore settlement prospects and risk trial—in effect gambling with the insured's money.²² The insured's only recourse was to allege negligence in the insurer's conduct of the trial.²³ As one commentator has observed, “[T]he insurance industry enjoyed almost total immunity. In the early part of the twentieth century many courts took the position that the insurer was free to settle or

16. See *infra* notes 167-237 and accompanying text.

17. See *infra* notes 221-24 and accompanying text.

18. See *infra* notes 238-48 and accompanying text.

19. See, e.g., *Auerbach v. Maryland Casualty Co.*, 236 N.Y. 247, 140 N.E. 577 (1923). The court ruled that nothing in the policy obligated the insurer to settle a claim. The insurer was “under no legal obligation, either express or implied, to compromise or settle the claims prior to trial.” *Id.* at 252, 140 N.E. at 579.

20. See, e.g., *Rumford Falls Paper Co. v. Fidelity & Casualty Co.*, 92 Me. 574, 586, 43 A. 503, 506 (1899).

21. The insured's damages were limited under the contract to the “amount due” (the policy amount) plus interest. See Note, *The Tort of Bad Faith: A Perspective Look at the Insurer's Expanding Liability*, 8 CUM. L. REV. 241, 242 (1977).

22. See Brittle, *Avoiding Insurer's Excess Liability*, 28 FED'N INS. COUNS. Q. 298 (1978). “The essential implication was that the insurance company could write its own contract and establish its own level of conduct.” *Id.* at 301.

23. See *Dumas v. Hartford Accident & Indem. Co.*, 92 N.H. 140, 26 A.2d 361 (1942), where the court held that a cause of action for excess liability is a negligence action in which the insured must show injury. The court would find no actual injury until the insured had paid the excess judgment “or at least until his financial status is such that the excess judgment is sure to be collected.” *Id.* at 141, 26 A.2d at 362.

not as it saw fit. The insurance company was only obliged to defend and pay within the policy."²⁴

B. *Modern View*

Modern courts, with few exceptions,²⁵ have rejected the narrow contractual approach. One writer has stated, "[A]n insurer's absolute right to settle or not to settle a claim, which left the insured completely at the mercy of the insurer, has been abandoned in every jurisdiction that has ruled on the subject."²⁶

Insurance policies now are regarded as agreements whereby the insurer promises to "stand in the shoes" of the insured in a loss covered by the policy.²⁷ The insurer still controls the claim and decides whether to settle or defend.²⁸ Strong public policy considerations support vesting this control in the insurer.

The obvious reason for the policy provision giving [a] company such exclusive control over the settlement decision is to keep down claims costs. . . . [There is a] fundamental premise that the liability insurance system will work more effectively if [the] company controls the defense and settlement than if either of these matters is left to insured.²⁹

Vesting such complete control in the insurer occasionally may sacrifice the insured's interests.³⁰ Thus, modern courts require that this exclusive authority be exercised in good faith. From this mandate springs the implied covenant of good faith and fair dealing which courts now read into all insurance contracts.³¹

24. Miller, *Living With Bad Faith*, 46 INS. COUNS. J. 34, 34 (1979).

25. One of the few modern cases which still protects the insurer is *Gordon v. Nationwide Mut. Ins. Co.*, 30 N.Y.2d 427, 285 N.E.2d 849, 334 N.Y.S.2d 601 (1972). *But see* Miller, *supra* note 24, at 35: "*Gordon* seems to be the last of its kind."

26. P. MAGARICK, EXCESS LIABILITY, DUTIES AND RESPONSIBILITIES OF THE INSURER 139 (1976).

27. *See* Note, *In California Excess Liability Cases, Does "Bad Faith" in Law Equal "Strict Liability" in Practice?*, 4 PEPPERDINE L. REV. 115, 119 (1976).

28. *Id.* The basic decision process the insurer follows has not changed. If a lawsuit is filed against the insured, the insurer must determine whether to settle the claim or defend the insured. If the insurer decides to litigate and the insured is found liable, the insurer will satisfy the claim up to the monetary limit of the insured's policy. The difference under the modern approach is the ramifications of the insurer's decision to either settle or defend.

29. Keeton, *supra* note 1, at 1166.

30. For example, "[e]fforts to protect the solvency of the insurance fund for policyholders as a group might occasionally result in unfair treatment to an individual policyholder." Note, *supra* note 27, at 119.

31. *See* *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

C. *Development of Case Law in the Insured-Insurer Relationship*

*Brassil v. Maryland Casualty Company*³² is an early example of this good faith doctrine. The controversy arose when an insurer failed to appeal an adverse judgment against its insured. The insured successfully appealed and subsequently sued the insurer for attorneys' fees and costs. Ironically, the insurance company first claimed that the insured was not dealing "fairly and in good faith."³³ The court found, however, that the insurer had a "correlative obligation" to exercise similar good faith.³⁴

The development of the good faith and fair dealing doctrine is characterized by confused terminologies and legal theories.³⁵ An action against an insurer has been characterized as sounding in both contract and tort,³⁶ and an insurer's violation of its good faith duty is often called "bad faith."³⁷ One court defined bad faith as "an *intentional* disregard of the financial interests of [the] insured, in the hope of escaping full liability imposed . . . by [the] contract of insurance."³⁸ Another court adopted a less stringent standard for imposing liability on the insurer: "[F]ailure to consider the interests of the insured, or the possibility of an excess verdict, [is] to be considered as bad faith."³⁹ Thus, it appears that while one court would impose liability for reckless, possibly even

32. 210 N.Y. 235, 104 N.E. 622 (1914).

33. *Id.* at 242, 104 N.E. at 624.

34. *Id.*

35. The majority of courts will use a bad faith rationale to impose excess liability on the insurer, a shorthand method of stating that a duty of good faith and fair dealing has been violated. P. MAGARICK, *supra* note 26, at 139. Courts have been especially prone to confuse bad faith with negligence. For a definition of bad faith relying on negligence terminology, see *Coca-Cola Bottling Co. v. Maryland Casualty Co.*, 325 F. Supp. 204, 206 (W.D.N.C. 1971). Other courts reach a middle ground, using negligence as a factor in determining bad faith. *See, e.g., Tully v. Travelers Ins. Co.*, 118 F. Supp. 506, 571 (N.D. Fla. 1954).

36. "Although wrongful refusal to settle has generally been treated as a tort . . . , it is the rule that where a case sounds both in contract and tort the plaintiff will ordinarily have freedom of election." *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 663, 328 P.2d 198, 203 (1958).

37. Due to the "elusive nature of the concepts of negligence and bad faith and their many analytical similarities, the courts have shown a natural tendency to interchange the principles and their theoretical bases. The result has been a coalescence of the standards . . . combining a requirement of ordinary care in investigation with good faith in the decision not to settle" Brittle, *supra* note 22, at 304.

38. *Tennessee Farmers Mut. Ins. Co. v. Wood*, 277 F.2d 21, 34 (6th Cir. 1960) (emphasis added).

39. P. MAGARICK, *supra* note 26, at 140 (citing *Henke v. Iowa Home Mut. Casualty Co.*, 250 Iowa 1123, 97 N.W.2d 168 (1959)).

negligent, conduct by the insurer, another court would require a showing of intentional conduct.

The landmark decision establishing the implied covenant of good faith and fair dealing in insurance contracts is *Brown v. Guarantee Insurance Co.*⁴⁰ In *Brown*, the insurer refused to settle because the claimant's demand approached the insured's policy limit.⁴¹ The court found that "the relationship between the insured and the insurer under such circumstances closely approximates that of principal and agent or beneficiary and trustee."⁴² Thus, the court read an implied covenant into the contract that neither party act in a manner which would injure the others' rights.⁴³

The insurer also may be subject to a bad faith claim for "unreasonably" refusing to accept a settlement offer within the insured's policy limit.⁴⁴ Courts apply divergent standards in determining whether an insurer has violated its good faith duty by refusing to settle. The prevailing standard requires the insurer to give equal consideration to the insured's interests.⁴⁵

The interpretation of "equal consideration" has provoked substantial controversy.⁴⁶ One commentator stated that equal consideration "with rare exceptions, does not require an insurer to give more weight to the interests of an insured than it does to its own. It requires only that the same degree of consideration be given to the interests of both parties."⁴⁷ This interpretation of equal consideration causes confusion, since either decision an insurer makes—to settle or to litigate—sacrifices one party's interests.

Professor Keeton advocates the better view of identifying equality of consideration with impartiality—as if the insurer were one person holding two competing interests.⁴⁸ In a case which adopted a variation of Keeton's standard, a California appellate court stated, "[t]he fairest method of balancing the interests [of

40. 155 Cal. App. 2d 679, 319 P.2d 69 (1957).

41. For a discussion of this type of conduct by the insured, see *supra* notes 19-24 and accompanying text.

42. 155 Cal. App. 2d at 687, 319 P.2d at 74.

43. *Id.* at 684, 319 P.2d at 72-73. This principle was articulated in *Brown v. Superior Court*, 34 Cal. 2d 559, 212 P.2d 878 (1949).

44. Note, *supra* note 21, at 242.

45. *Ivy v. Pacific Auto. Ins. Co.*, 156 Cal. App. 2d 652, 320 P.2d 140 (1958). See Keeton, *Ancillary Rights of Insured Against Liability Insurer*, 13 VAND. L. REV. 827 (1960).

46. Brittle states that "the courts and commentators are far from agreement on what weight should be given the insured's interest." Brittle, *supra* note 22, at 302.

47. P. MAGARICK, *supra* note 26, at 141.

48. R. KEETON, BASIC TEXT ON INSURANCE LAW 511 (1971).

both parties] is for the insurer to treat the claim as if it were alone liable for the entire amount."⁴⁹

Case law differs widely on this issue. Some courts hold that the insured's interest must have equal consideration throughout the settlement process.⁵⁰ Other courts require equal consideration until a conflict arises. When a conflict exists, the insurer is allowed to subordinate the insured's interest.⁵¹ There also is a minority view requiring the insured's interest in avoiding personal liability always to be preferred.⁵² These varied interpretations of equal consideration are prevalent in bad faith actions against the insurer and produce inconsistent decisions.

1. *Insurer's Duty to Settle*

In applying the equal consideration test, it is unclear whether an insurer may reasonably and in good faith refuse to accept a settlement offer within the insured's policy limit. The problem is created by the inherent conflict of interest which exists in the insured-insurer relationship. This conflict is most apparent when the insurer is negotiating a settlement. If liability exceeding the policy limits is likely, the insurer usually will settle. Settlement under such circumstances saves the insurer the costs of litigation and avoids the possibility that the insured will be personally liable for amounts exceeding the policy limits.⁵³ The normal remedy for conflict of interest is separate counsel for both parties.⁵⁴ This solution is unworkable in the insurance context, however, since the insured's counsel does not have settlement authority. The insured's attorney only may offer advice to the insurer.⁵⁵

49. *Merritt v. Reserve Ins. Co.*, 34 Cal. App. 3d 858, 110 Cal. Rptr. 511 (1973). *But see* Note, *supra* note 27, at 131, where the author observes:

The court [in *Merritt*] considered the bad faith issue as it related to a conflict of interest between the insurance company and the insured. The court determined that as long as settlement within policy limits was not feasible the interests of the insured and the company were the same. It is to be noted that *Merritt* would not be cited for the proposition that an insurer does not have a duty to promote settlements. The facts of this case present a rare situation.

50. *See, e.g.*, *Young v. American Casualty Co.*, 416 F.2d 906 (2d Cir. 1969), *cert. dismissed*, 396 U.S. 997 (1970).

51. *See, e.g.*, *Schmidt & Sons Brewing Co. v. Travelers' Ins. Co.*, 244 Pa. 286, 90 A. 653 (1914).

52. *See, e.g.*, *American Casualty Co. v. Howard*, 187 F.2d 322 (4th Cir. 1951); *American Mut. Liab. Ins. Co. v. Cooper*, 61 F.2d 446 (5th Cir.), *cert. denied*, 289 U.S. 736 (1932).

53. *See* Brittle, *supra* note 22, at 300.

54. *Merritt v. Reserve Ins. Co.*, 110 Cal. Rptr. 511, 519, 34 Cal. App. 3d 858, 870 (1973).

55. One author comments facetiously that since "separate legal representation is ineffective in third-party excess liability actions, the courts have 'improvised' a workable solu-

Choosing an appropriate course of action when the insurer believes its insured's potential liability will not exceed the policy limit has created a dilemma. One commentator advocates the following view:

[M]ost courts hold . . . that if an insurer honestly and reasonably believes, after proper investigation, that it can defeat an action, or hold a judgment within the limits of its policy, its refusal to settle for an amount within those limits cannot be held to be bad faith, even though its decision may have been mistaken.⁵⁶

Later decisions, especially by California courts,⁵⁷ reject the contention that an insurer is never liable for a "good faith" mistaken judgment.⁵⁸ These later decisions hold that if an insurer refuses to settle, then it will be liable for all damages which may be awarded, including damages exceeding policy limits. The ineluctable conclusion reached by one commentator is that the "equitable justification for applying this theory of recovery [the good faith doctrine] to a refusal to settle is the unavailability of a realistic alternative theory of recovery in a situation which cries out for redress."⁵⁹

2. *Insurer's Duty to Defend*

In addition to the duty to settle, an insurer has a duty to defend its insured against third party claims. A traditional tort law standard requiring the insurer to exercise ordinary care when defending on behalf of the insured is applied in duty to defend cases.⁶⁰ This proposition has not been disputed widely. It is unclear, however, what consequences might flow from an insurer's refusal to defend its insured.

This issue of an insurer's liability for refusing to defend its in-

tion: If the insurer rejects a settlement offer in bad faith, it will be held liable for the entire judgment against the insured." Note, *supra* note 11, at 366-67.

56. P. MAGARICK, *supra* note 26, at 141-42. See also *Defenber & Townsend v. American Universal Ins. Co.*, 372 F.2d 50 (6th Cir. 1967); *Christian v. Preferred Accid. Ins. Co.*, 89 F. Supp. 888 (N.D. Cal. 1950). These cases state that in the settlement context, insurers are not expected to be "prophets" making correct judgments in every case.

57. "The California experience will, to the extent not prohibited by statute, spread to other jurisdictions." Parks, *supra* note 12, at 59.

58. See *infra* note 66 and accompanying text.

59. Parks, *supra* note 12, at 59. Brittle apparently has reached the same conclusion: "What has become abundantly clear from the cases is that the critical consideration is not the standard the court purportedly uses, but rather the equities involved in a particular fact situation." Brittle, *supra* note 22, at 305.

60. Keeton, *supra* note 45, at 851.

sured arose in *Comunale v. Traders & General Insurance Co.*⁶¹ where the insured, a truck driver, struck the Comunales at a crosswalk. The insurance company refused to defend its insured,⁶² claiming that its policy did not provide coverage since the insured was not driving his own vehicle.⁶³ After trial, damages exceeding the policy limit were assessed against the insured.⁶⁴ By way of settlement, the insured assigned his "refusal to defend" claim against the insurance company to the Comunales.⁶⁵ In an attempt to clarify past confusion regarding an insurer's duty to settle and defend, the court asserted:

We do not agree with the cases that hold there is no liability in excess of the policy limits where the insurer, believing there is no coverage, wrongfully refuses to defend and without justification refuses to settle the claim. . . . An insurer who denies coverage does so at its own risk, and, although its position may not have been entirely groundless, if the denial is found to be wrongful . . . [the insurer] is liable for the full amount . . .⁶⁶

The court's attempt to forge a more workable standard of conduct⁶⁷ for insurers has drawn heavy criticism. The *Comunale* decision expands the insurer's implied duty of good faith to instances where the insurer has "wrongfully" refused to defend its insured or accept "reasonable" settlement offers. The ruling offers little guidance for determining when an insurer's refusal to settle or defend constitutes "wrongful" behavior.⁶⁸ When contemplating settlement, the insurer at least must equate the insured's interest with its own.⁶⁹ While *Comunale* closed the definitional gap between negligence and bad faith, the court's definition of "reasonableness" has "merely substituted one nebulous concept for another."⁷⁰ Since *Comunale* blurs the distinction between negligence—or even mistaken judgment, i.e., innocence—and bad faith, there are few situations where an insurer can negligently re-

61. 50 Cal. 2d 654, 328 P.2d 198 (1958).

62. *Id.* at 657, 328 P.2d at 200.

63. *Id.*

64. *Id.*

65. *Id.* at 658, 328 P.2d at 200.

66. *Id.* at 660, 328 P.2d at 201-02.

67. See Brittle, *supra* note 22, at 304.

68. "[T]his case discusses good faith in terms of the 'most reasonable manner of disposing of the claim.' It also contains language suggesting that the insurer may be liable on a straight breach of contract theory, rendering the reasonableness of the company's actions irrelevant." *Id.* at 305 (quoting *Comunale*, 50 Cal. 2d at 659, 328 P.2d at 201).

69. 50 Cal. 2d at 659, 328 P.2d at 201.

70. Note, *Applying the Bad Faith Doctrine to the Primary and Excess Insurance Carrier Relationship in California*, 7 *LOY. L.A. L.REV.* 277, 284 (1974).

fuse to settle or defend without being held liable under a bad faith rationale.⁷¹ Thus, *Comunale* establishes that no insurer may escape its duty of good faith and fair dealing by claiming that its insured is not covered under the policy.⁷² Such a claim invites a judgment of bad faith.

In the wake of *Comunale*, commentators accused California courts of reordering the economics of the insurance industry, making it nearly impossible for insurers to exercise business judgment—whether in good faith or not. It has been observed:

[The court] tempered the inherent conflict between the insurer's economic interests and those of the assured by relegating to the insurer the arduous task of preassessing the reasonableness of its treatment of the assured. Misassessment could expose the insurer to liability for the entire adverse judgment, even for amounts exceeding the policy limits.⁷³

This criticism reflects a misunderstanding of the role of insurance in society. The key issue is whether insureds will benefit collectively from judicial imposition of a more rigorous duty on the insurer in settlements. The insurance industry probably would raise premiums to meet an increased number of claims alleging bad faith. The pivotal issue is whether the increased protection for all insureds is worth the increase in premiums.⁷⁴

Critics also claim that *Comunale* and similar decisions essentially are imposing strict liability on insurance companies for failure to settle or defend on behalf of insureds.⁷⁵ While California has not explicitly adopted strict liability, the tables have been turned against insurers. Instead of gambling with an insured's money, the insurer now must gamble with its own funds when refusing to defend an action or settle a claim which probably will result in an excess judgment.

71. *Id.* at 281.

72. "The implied duty of good faith does not gain its existence from the insurer's right to control the litigation, but is inherent in every contract so long as that contract remains in existence." Note, *supra* note 21, at 247.

73. Note, *supra* note 70, at 284.

74. See *infra* notes 106-07 and accompanying text.

75. See, e.g., Kircher, *Insurer's Mistaken Judgement—A New Tort?*, 59 MARQ. L. REV. 775 (1976). "What the California Courts are telling insurers operating in the state is that they will be absolutely liable for insureds' consequential damages if an honest mistake in judgment results in the failure to pay a claim, which, upon hindsight, should have been paid." *Id.* at 785.

Some recent cases have ignored the California view. See, e.g., *LaRocca v. State Farm Mut. Auto. Ins. Co.*, 329 F. Supp. 163 (W.D. Pa. 1971), *aff'd mem.*, 474 F.2d 1338 (3d Cir. 1973); *Colsh v. Travelers Ins. Co.*, 281 N.E.2d 593 (Mass. 1972).

3. *Defense Against a Bad Faith Claim*

Defense options available to an insurer accused of bad faith are limited severely. Juries have not been overly sympathetic towards the insurers' perspective.⁷⁶ California courts, building on the *Comunale* decision,⁷⁷ have taken the lead in circumscribing insurers' defense strategies. In *Johansen v. California State Automobile Association*,⁷⁸ an insurer's good faith belief in its insured's noncoverage was rejected as a valid defense. The court stated that "an insurer's 'good faith,' though erroneous, belief in noncoverage affords no defense to liability flowing from the insurer's refusal to accept a reasonable settlement offer."⁷⁹ Thus, under *Johansen*, an insurer may entertain a good faith belief in noncoverage, but the insurer assumes the risk that its belief is correct.

An insurer which decides to assert noncoverage of its insured under an insurance policy faces a substantial liability risk if it is determined subsequently that coverage was appropriate. To avoid a potential bad faith claim, the court in *Johansen* suggested that the insurer enter into an agreement with its insured whereby the insurer would reserve the right to assert a noncoverage defense. The insurer then would settle the case to protect the insured.⁸⁰ If the insurer later proves noncoverage, it then may seek reimbursement of the settlement payment from its insured.⁸¹ While the court's solution is perhaps theoretically feasible, "it is questionable as to how many 'insureds' will possess sufficient assets to satisfy claims for reimbursement."⁸² Furthermore, the court's solution to the noncoverage dilemma is contrary to notions of judicial economy, since another court action between the insured and its insurer would be necessary.⁸³

76. One of the few cases holding for the insurer is *Hodges v. Standard Accident Ins. Co.*, 198 Cal. App. 2d 564, 18 Cal. Rptr. 17 (1961). The court found that the insurer's failure to keep the insured informed of settlement offers did not indicate bad faith without further evidence of an overt conflict of interest between the insurer and its insured. This case is regarded as an historical curiosity in California's development of the good faith duty. Note, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule*, 18 STAN. L. REV. 475, 479 (1966).

77. See *supra* notes 61-74 and accompanying text.

78. 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975).

79. *Id.* at 15, 538 P.2d at 748, 123 Cal. Rptr. at 292.

80. *Id.* at 19, 538 P.2d at 750, 123 Cal. Rptr. at 294.

81. *Id.*

82. Note, *supra* note 22, at 129.

83. One author maintains that, even without the *Johansen* court proposal, the way an insured must enforce his or her rights is both cumbersome and time consuming: "Contrary to the general policy favoring judicial economy, current law tends to foster multitudinous

The *Johansen* decision mandates that the insurer's business judgment be exercised in its insured's best interest. The result of the court's decision is that now "the only permissible consideration in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim's injuries and the probable liability of the insured, the ultimate judgment is likely to exceed the amount of the settlement offer."⁸⁴ This standard arguably weakens the insurer's right to control the handling of a claim made against its insured. While the right to control claims is a major premise on which the insurance industry was founded, it must be remembered that the insurer's exclusive control over claims is tempered by the duty to exercise that control in the insured's best interest.⁸⁵

In response to judicial decisions limiting an insurer's defense options, there have been numerous proposals attempting to balance the interests of both the insured and the insurer. One suggestion is that the insurance industry consider adopting a uniform claims analysis system.⁸⁶ Another suggestion, which recognizes the limited possibility of an insurer successfully appealing an excess liability judgment because of juries' bias against insurance companies,⁸⁷ is to remove the bad faith determination from the jury's province.⁸⁸ A third proposal, aimed at avoiding possible collusion between the insured and the injured third party, would prohibit the insured from assigning the bad faith cause of action.⁸⁹ Finally, a proposal examined at length below advocates imposing strict liability on the insurer in its relationship with the insured.⁹⁰

litigation by requiring a second suit in which the insured or an assignee attempts to prove the insurer's bad faith or negligence." Brittle, *supra* note 22, at 307.

84. Note, *supra* note 27, at 129.

85. See *supra* notes 27-29 and accompanying text.

86. See Parks & Neil, *Insurers Beware: "Bad Faith is in Full Bloom,"* 9 FORUM 63 (1973). "It is suggested that what the insurance industry needs, in order to support the reasonableness of a decision to deny benefits, are standardized, industry accepted procedures which should be followed in the processing of various types of claims." *Id.* at 68.

87. Note, *supra* note 76, at 480. "An insurance company doing business in California, in evaluating its chances of upsetting an adverse excess liability judgment on appeal, can only conclude that its chances are minimal."

88. *Id.* at 481. See also Note, *California — In Search of a Solution for Excess Liability Problems*, 8 SANTA CLARA L. REV. 97, 106 (1967).

89. Note, *supra* note 76, at 481. Although prohibiting assignability may deprive the insured of a possible method of satisfying an injured party's claim, assignability in the insurance context has been condemned as illogical and unjust. "A doctrine or statute permitting claimant to recover the excess from the company is only slightly beneficial to the insured—the one who is the victim of company's wrong." Keeton, *supra* note 1, at 1176-77.

90. See *infra* notes 104-11 and accompanying text.

4. *Movement Toward Strict Liability*

In *Crisci v. Security Insurance Co.*⁹¹ the movement toward strict liability for refusing to settle or defend an insured accelerated. The court held that an insured's recovery on a bad faith claim "may be based on unwarranted rejection of a reasonable settlement offer and that the absence of evidence, circumstantial or direct, showing actual dishonesty, fraud, or concealment [by the insurer] is not fatal to the cause of action."⁹²

Several policy considerations weighed heavily in the decision. The court assumed that whenever excess liability is possible, the insured's interest dictates settlement.⁹³ The court also believed that since an insured purchases a policy for protection, the insured reasonably may expect that a sum equal to the policy limits be available for settlement.⁹⁴ The court concluded:

[T]here is more than a small amount of elementary justice in a rule that would require that, in this situation where the insurer's and the insured's interests necessarily conflict, the insurer, which may reap the benefits of its determination not to settle, should also suffer the detriments of its decision.⁹⁵

While the court proposed a strict liability rule, its holding was predicated on a bad faith refusal to settle, thus precluding the imposition of strict liability.⁹⁶ The court's dicta, advocating strict liability, has caused much debate about the decision's true impact. Some commentators suggest that *Crisci* is an example of the extent to which a court may go to protect the insured.⁹⁷ Others view the case as establishing a definitive standard for insurers in settlement

91. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). In *Crisci*, the plaintiff's tenant (third party claimant) fell through a staircase in plaintiff's apartment house. Plaintiff had a \$10,000 liability policy with defendant insurance company. *Id.* at 427, 426 P.2d at 175, 58 Cal. Rptr. at 15. Defendant rejected tenant's settlement offer of \$9,000, even with the knowledge that should the jury believe tenant's claim of mental suffering, the verdict would approach \$100,000. *Id.* The insured satisfied the adverse verdict which exceeded the policy limits by assigning her cause of action against the insurer to the tenant. *Id.* at 428, 426 P.2d at 176, 58 Cal. Rptr. at 16.

92. *Id.* at 429, 426 P.2d at 177, 58 Cal. Rptr. at 17.

93. *Id.*

94. The court stated that the proposed rule would eliminate the chance that "an insurer, faced with a settlement offer at or near the policy limits, will reject it and gamble with the insured's money to further its own interests." *Id.*

95. *Id.*

96. The *Crisci* court "proposed a strict liability rule but found a bad faith refusal to settle and, thus, did not impose strict liability." Note, *supra* note 11, at 373.

97. "While *Crisci* by no means represents the typical case, it does indicate the potential exposure that the insurance carrier must consider." Brittle, *supra* note 22, at 306.

cases.⁹⁸

The *Crisci* test has been accepted generally as the standard of conduct an insurer should follow in deciding whether to settle claims against its insured.⁹⁹ Under the *Crisci* test, the following standard will be applied to evaluate an insurer's conduct of the settlement: "[W]hether a prudent insurer without policy limits would have accepted the settlement offer."¹⁰⁰ Thus, for the insurer to protect itself from bad faith claims, the contractual limits of its agreement with the insured must be ignored when evaluating settlement offers. The insurer must accept a settlement offer if it is likely that a court will award damages exceeding the insured's policy limits.¹⁰¹ *Crisci*, therefore, supports the view that while the courts have yet to declare strict liability in law, strict liability in fact now prevails.¹⁰²

Imposition of strict liability for an insurer's misjudgment in the settlement process is favored by most commentators.¹⁰³ Those favoring strict liability argue that it will encourage settlements, reduce court congestion, protect the consumer from the risk of personal liability, and deter the abuse of fiduciary responsibilities by insurers.¹⁰⁴ More practically, proponents endorse strict liability as bringing order to chaos: "A predictable standard will stabilize an

98. See, e.g., Note, *supra* note 21, at 248, where the author remarks: "*Crisci*, therefore, appears to finally settle the confusion as to whether the cause of action for failure to settle is based upon a theory of contract or tort—it is based upon both."

99. See *Bowers v. Camden Fire Ins. Ass'n*, 51 N.J. 62, 237 A.2d 857 (1968), where the court stated:

The interests of both the insurer and insured can be served justly only if the insurer treats any settlement offer as if it had full coverage for whatever verdict might be recovered, regardless of policy limits, and makes its decision to settle or to go to trial on that basis. That rule, which we deem to be the appropriate one, has been applied in other jurisdictions in such cases.

Id. at 71-72. 238 A.2d at 862. See also *Keppic v. Allied Mut. Ins. Co.*, 210 N.W.2d 844, 848 (Iowa 1973): "Modern decisions require the insurer (in the exercise of good faith) to view the settlement situation as if there were no policy limit applicable to the claim. When it does so, it views the claim objectively and renders equal consideration to the interests of itself and the insured"; *Crabb v. National Indem. Co.*, 87 S.D. 222, 205 N.W.2d 633 (1973).

100. *Crisci*, 66 Cal. 2d at 429, 426 P.2d at 176, 58 Cal. Rptr. at 17.

101. The unanswered question may be unanswerable. When does an insurer's good faith decision to litigate become a bad faith decision not to settle? One commentator views the situation this way: "In effect, the [*Crisci*] Court was saying to the insurance company: you were seeking to save your money, not the insured's money. The insured bought the protection of your policy and the peace of mind that comes with the protection of your policy, and you failed. You took the gamble but the insured lost." Miller, *supra* note 24, at 35.

102. Note, *supra* note 27, at 121.

103. See *infra* notes 104-11 and accompanying text.

104. Brittle, *supra* note 22, at 308.

area of the law now plagued with capricious results under the amorphous good faith-reasonableness test."¹⁰⁵

Advocates of strict liability cite furtherance of public policy and consumer protection as major attributes of the rule. Enhanced consumer protection is justified because the insurer controls the decisionmaking process and is "more skilled in evaluating liability and distributing the risk of loss, [such that it] should not be permitted to shift the hazard of its decision to the insured."¹⁰⁶ Strict liability also would provide insureds with better protection since it would reduce the occurrence of multiple actions over a single claim by encouraging insurers to settle before trial. Although policy premiums may increase as more claims are settled, spreading the cost of better protection is consistent with the public policy favoring risk distribution.¹⁰⁷

Advocates of strict liability also contend it will benefit the insurance industry:

It is possible that the insurance industry would save money if a rule of strict liability were imposed. If the insurer settled, it would save the cost of defense and extensive investigation. If it chose to litigate, and suffered an excess judgment, it would pay and save the expense of defending an excess liability action.¹⁰⁸

Proponents of strict liability also deny that the rule would force unwilling insurance carriers to settle. The insurer has the skill and experience to determine when a verdict will be in the insured's favor, and its judgment is usually correct.¹⁰⁹ Thus, the insurer still may rely on its judgment without being compelled to settle un-

105. Kelly, *The Workable Sanction and Solution in Excess Liability Cases: Strict Liability for Insurance Carriers*, 1976 *INS. L.J.* 346, 355. See also Note, *supra* note 88, at 106 (primary advantage of applying strict liability is that it is "consistent, predictable method of determining liability").

106. Note, *supra* note 11, at 380.

107. *Id.*

108. Note, *supra* note 76, at 485. See also Kelly, *supra* note 105, at 355. The author asserts that "the insurance industry can distribute the cost, if any, of the strict liability rule over a vast segment of the populace." He further states:

It is also questionable whether a strict liability rule will result in any additional cost to the insurance industry. It must be remembered that any extra cost will be diluted by the savings in defense and investigation costs that will result where an offer made within the policy limit is accepted. In addition, costs of defense in a second action will be saved.

109. This argument illustrates the disagreement between proponents of strict liability and the insurance industry. The argument that the insurer is "usually correct" in its judgment of how to handle an insured's claim fails to recognize that imposing liability in the comparatively few cases in which the insurer's judgment is mistaken may have a dramatic impact on both the insurance industry and the consumer. See *infra* notes 112-15 and accompanying text.

wisely.¹¹⁰ One commentator, convinced of the benefits of strict liability, recommends that insurers take the initiative and offer their insureds a strict liability clause in the policy.¹¹¹

Opponents of strict liability, however, maintain that the concept is inappropriate in the insurance context. These individuals argue that since the insurance industry is premised on an insurer's exclusive control of claims, strict liability effectively would divest the insurer of that control. This loss of control then would cause a diminution of the claim fund.¹¹² Opponents predict that strict liability also would increase fraudulent claims, force unwise settlements, and raise consumer premiums.¹¹³

A typical objection is that "[t]he company shouldn't be forced to settle claims it believes are fraudulent The costs of insurance would probably go up because the company would bear essentially the same risk regardless of the size of the policy it sold; the limitations imposed by the contract would be rendered virtually meaningless."¹¹⁴ Critics of strict liability condemn this "after-the-fact" *Crisci*-type analysis, which does not require a showing of fault on the insurer's part.¹¹⁵

As noted above, while strict liability has yet to be officially adopted by the courts, the rule now prevails in fact.¹¹⁶ The present trend for courts following California's lead is to operate under strict liability precepts while avoiding explicit acknowledgment that the rule is being applied.¹¹⁷

5. *One Step Further—Insurer's Affirmative Duty*

The insurer's duty of good faith and fair dealing was extended in *Rova Farms Resort, Inc. v. Investors Insurance Co. of*

110. Kelly, *supra* note 105, at 354.

111. "The present judicial rule requiring bad faith . . . seems thoroughly entrenched. Therefore, insurance companies should consider offering to the public, at least, as an alternative to present policy provisions, a clause agreeing to strict liability; or the legislature should consider making the offer of such a clause mandatory." Note, *supra* note 76, at 485.

112. "When the court says that [strict liability] would not place a greater burden upon insurers, it speaks from either vast ignorance or worse. Under this kind of rule, the insurer could be at the mercy of every attorney who made a demand within the policy limits, no matter how exorbitant or ridiculous." P. MAGARICK, *supra* note 26, at 203.

113. Note, *supra* note 11, at 378.

114. Brittle, *supra* note 22, at 308-09.

115. See, e.g., Hills, *Development and Direction of the California Bad Faith Insurance Doctrine or "O Ye of Little Faith,"* 8 U.S.F.L. REV. 29, 52 (1974).

116. See *supra* note 102 and accompanying text.

117. "[A]ll recent bad faith cases have used an 'after-the-fact' approach in imposing liability on the insurer. This judicial approach is at least an analogue to strict liability which, of course, is not necessarily absolute liability." Hills, *supra* note 115, at 52.

America,¹¹⁸ which held that an insurer has a positive fiduciary duty to initiate settlement negotiations. The court stated that an insurer may not simply accept reasonable settlement offers when proffered.¹¹⁹ The insurer's only permissible defense to liability imposed by *Rova Farms* is to demonstrate that settlement was virtually impossible. Furthermore, if settlement above policy limits were possible, the insurer must establish that the insured refused to contribute the excess amount to the settlement.¹²⁰ The court claimed, however, that its decision did not eliminate insured's burden of proving bad faith.¹²¹ Although this requirement may not be eliminated expressly, the imposition of an affirmative fiduciary duty on the insurer to elicit settlement offers actively lessens the insured's burden in an action against his or her insurer.¹²²

Rova Farms illustrates the difficulty in applying the good faith and equal consideration doctrines. If the insured-insurer relationship necessarily involves conflicting interests, it seems incongruous to require the insurer to balance the insured's best interest against its own. This balancing, however, is exactly what the courts require the insurer to do.¹²³ The requirement may be understood better if the insurer is viewed as a being in a fiduciary relationship with its insured. Thus, the insurer would be expected to equate the insured's interest with its own interest.

The case law development concerning the duty of an insurer to its insured has prompted the creation of specific duties which an insurer owes its insured. Among these are the insurer's duty to defend¹²⁴ and to settle.¹²⁵ The cases, however, have failed to establish a definitive legal standard by which the insurer's performance of its duties may be assessed. An insurer clearly may no longer claim a good faith belief in its insured's noncoverage as a defense against a bad faith claim for its refusal to defend or set-

118. 65 N.J. 474, 323 A.2d 495 (1974).

119. The court stated that "an insurer, having contractually restricted the independent negotiating power of its insured, has a positive fiduciary duty to take the initiative and attempt to negotiate a settlement within the policy coverage." *Id.* at 496, 323 A.2d at 507.

120. *Id.*

121. Miller, *supra* note 24, at 40.

122. See Note, *supra* note 27, at 129.

123. In most legal relationships determination of the merits of conflicting interests by one of the parties to the conflict is forbidden. . . . [Yet the insurance] carrier who receives an offer to settle an excess claim within the policy limits is instructed to weigh its own interest on the scales along with those of its assured in order to make a good faith determination whether to accept or reject the offer.

Rova Farms, 65 N.J. at 499, 323 A.2d at 509.

124. See *supra* notes 60-75 and accompanying text.

125. See *supra* notes 53-67 and accompanying text.

tle.¹²⁶ This prohibition does not solve the problem of an insurer's potential liability for bad faith solely arising from the insurer's method of handling a claim against its insured. California and other jurisdictions seem to have solved the problem by evaluating the insurer's conduct under strict liability standards.¹²⁷ The strict liability analysis now applied simply means that an insurer will be liable for failure to settle a claim against its insured where hindsight indicates settlement was reasonably possible. This determination is made without regard to the insurer's motive in deciding not to settle.¹²⁸

Proponents of this standard view it as an effective prod to induce insurers to consider their insureds' best interests.¹²⁹ The confusion arises when courts affix a "bad faith" label to the insurer's decision in the settlement process. This label redefines "bad faith" so as to include actions which the insurer honestly, though mistakenly, believed to be in the insured's best interest. Critics of the quasi-strict liability rule believe it will have a debilitating effect on the insurance industry.¹³⁰ Some of this criticism and uncertainty might be dispelled if courts would cease to cloud their decisions with murky and inappropriate "bad faith" labels.

II. DUTY OF INSURED TO INSURER

A. *Duty to Cooperate*

An insured also has certain correlative obligations and duties to its insurer. The insured, for instance, owes a general duty of cooperation to its insurer. This obligation may be written into the policy,¹³¹ or a court may infer the duty from the relationship of the parties.¹³² The extent to which the duty of cooperation is expanded by an insured's arguable duty of good faith dealing with his or her insurer is not yet clear. It has been established, how-

126. See *supra* notes 76-87 and accompanying text.

127. See *supra* notes 91-102 and accompanying text.

128. See *supra* note 101 and accompanying text.

129. See *supra* notes 104-11 and accompanying text.

130. See *supra* notes 112-15 and accompanying text.

131. In a typical liability policy, the cooperation clause would read: "The insured shall cooperate with the company and, upon the company's request, shall attend hearings and trials and shall assist in effecting settlements, securing and giving evidence, obtaining the attendance of witnesses and in the conduct of suits." Keeton, *supra* note 1, at 1154 n.45.

132. Professor Keeton refers to the insured's duty of cooperation as arising from the parties' relationship. "In this respect it is analogous to the insurer's duty of good faith in relation to settlement, as to which, it is generally argued, the insurance contract is silent." Keeton, *supra* note 45, at 847.

ever, that a breach of a cooperation clause relieves the insurer of liability for failure to settle within the policy limits.¹³³ Furthermore, there are a few other specific situations in which the insurer has been relieved of liability for its decision not to settle. These situations include: if the insurer's decision is influenced by the insured's misrepresentation or wrongful actions;¹³⁴ if there is strong evidence of collusion between the insured and claimant designed to force the insurer to settle;¹³⁵ or if the insured refuses to disclose facts pertinent to the insurer's decision to settle or defend.¹³⁶

B. *Reciprocal Duties of Good Faith and Fair Dealing*

Aside from specific obligations outlined in the insurance contract, the extent of an insured's duty to his or her insurer remains unclear. The issue is whether the insured owes a duty to his or her insurer which is essentially the reciprocal of the duty the insurer owes its insured. If a reciprocal duty is not imposed, it is necessary to determine whether the insured has a lesser obligation to the insurer.¹³⁷

One of the few cases to consider this issue is *Transit Casualty Co. v. Spink Corp.*¹³⁸ Transit, an excess insurer,¹³⁹ sued both its policyholder, Spink, and Spink's primary insurance carrier for their refusal to settle death and injury claims resulting from a construction site accident. Although Spink's policy had a "settlement clause" which allowed the insured to reject proposed settlements, the court found sufficient evidence to uphold a jury determination that Spink had violated its "duty of reasonable settlement" and that the violation was the proximate cause of Transit's loss.¹⁴⁰

Transit is significant in suggesting that an insured may be liable for unreasonable refusal to settle.¹⁴¹ The court also suggested

133. P. MAGARICK, *supra* note 26, at 191.

134. See *Stevens v. Northwestern Nat'l Casualty Co.*, 305 F.2d 513 (6th Cir. 1962).

135. See *State Auto. Mut. Ins. Co. v. York*, 104 F.2d 730 (4th Cir. 1939).

136. See *Hall v. Preferred Accident Ins. Co.*, 204 F.2d 844 (5th Cir. 1953).

137. The implication of the creation of an insured's good faith duty to his or her insurer might mean that the insured would be required to put the insurer's financial interests on the same level as his or her own interests. *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 26 Cal. 3d 912, 919, 610 P.2d 1038, 1042, 164 Cal. Rptr. 709, 713 (1980).

138. 94 Cal. App. 3d 124, 156 Cal. Rptr. 360 (1979).

139. See *infra* notes 166-71 and accompanying text.

140. 94 Cal. App. 3d at 138, 156 Cal. Rptr. at 368.

141. See Lanzone, *Duties Owed by a Primary Insurer and an Insured with a Self-Insured Retention to an Excess Insurer—An Update*, 28 FED'N INS. COUNS. Q. 267 (1978). "This case is significant because it suggests that the insured may be held liable for the amount of

that when the insured has a large self-insured retention,¹⁴² a reciprocal duty to settle may exist when dealing with a primary or excess insurer.¹⁴³

In analyzing the duty of an insured with a self-insured retention to contribute to reasonable settlements, an analogy may be drawn between the insured with a self-insured retention and an insured with a deductible feature in his or her policy. It has been shown that a standard of good faith and fair dealing imposed on the insurer demands a correlative, though not fully reciprocal, duty on the insured.¹⁴⁴ The good faith duty of an insured with a deductible includes a duty to be reasonably cooperative with the insurer in the settlement process. Application of this implied duty to cooperate leads to the conclusion that "an insured must have an obligation to tender the full amount of its deductible towards a reasonable settlement negotiated by the carrier."¹⁴⁵ In appropriate circumstances, a court may find that an insured's failure to tender a deductible constitutes a breach of the insured's duty to the insurer.¹⁴⁶ By analogy, it may be argued that an insured who is self-insured must also tender an amount equal to the self-insured limit to the insurer negotiating a reasonable settlement.¹⁴⁷

It must be noted, however, that self-insurance differs from a deductible on a liability policy in one important respect—the insured with a deductible does not establish a claim fund to meet

a judgment when it arbitrarily, selfishly or improperly refuses to consent to what would otherwise be an appropriate settlement." *Id.* at 277.

142. Self-insurance specifically means that the insured establishes its own fund from which recurring liability judgments may be satisfied:

If one is engaged in a sufficient volume of ventures of a given type, he can spread the risks of individual ventures among all the ventures in the group, paying losses from a fund created by charging a proportionate part of the total predicted cost against each venture without reference to which ones in fact produce harm. He is thus engaging in planned risk retention.

R. KEETON, *supra* note 48, at 7.

143. Lanzone, *supra* note 141, at 277. Insureds who are self-insured must "now be aware that their obligations to the excess insurer may be similar to a primary insurer's duties to an excess insurer." *Id.*

144. See Kurland & Simon, *The Insured's Duty to Tender a Deductible in Settlement*, 1980 INS. COUNS. J. 552. "Beyond this reciprocal obligation of good faith and fair dealing, an insurer also has an implied right to insist upon the reasonable cooperation of the insured." *Id.* at 553.

145. *Id.*

146. *Id.* See also *Riley v. State Farm Mut. Auto. Ins. Co.*, 420 F.2d 1372, 1377 n.6 (6th Cir.), *cert. denied*, 399 U.S. 928 (1970).

147. See Kurland & Simon, *supra* note 144, at 554. This principle also applies to an insured with a deductible or a self-insured portion. When an insurer negotiates a reasonable settlement and the insured fails to tender its deductible, then the insured is gambling capriciously at the insurer's expense for a verdict less than the deductible amount.

the adverse eventualities. The insured with a deductible merely chooses to assume a risk level which is uninsured. The analogy, therefore, between these two types of insureds must be limited in scope.

The imposition of some limited duty on insureds to accept reasonable settlements may be predicated on the public policy goal favoring settlement of lawsuits.¹⁴⁸ Furthermore, the movement toward self-insurance might be slowed if an insured could refuse to contribute to settlements without fear of legal sanction.¹⁴⁹ This trend could destroy an insurer's incentive to issue policies to provide umbrella coverage for self-insured risk retention. Insulating an insured from liability for refusing to contribute to settlements also might force insurers to increase premiums to compensate for the insured's missing contribution.¹⁵⁰

California courts, as forerunners in developing the good faith concept as applied to insurers, are reluctant to fashion a limited version of this same duty to apply to insureds. In *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*,¹⁵¹ Commercial Union, an excess insurer, claimed that Safeway owed it a duty to accept settlement offers below the amount of excess coverage when it was likely that a liability judgment above the primary coverage would occur.¹⁵² The court rejected this argument and made the following observation:

This theory, while possessing superficial plausibility and exquisite simplicity, cannot withstand closer analysis. [The duty of good faith and fair dealing] is dependent upon the nature of the bargain struck between the insurer and the insured and the legitimate expectations of the parties which arise from the contract.¹⁵³

148. *Id.* at 556.

149. The self-insurance discussion is important in light of the California Supreme Court's holding in *Commercial Union* which repudiates *Spink*. See *infra* notes 151-57 and accompanying text.

150. Kurland & Simon, *supra* note 144, at 557. The authors predict that it is likely that premiums will be adjusted to reflect this trend, and carriers might not write policies with high deductibles. "This could limit the trend to greater self-insurance and the consequential diminution of losses engendered by the direct responsibility of an insured for its losses." *Id.*

151. 26 Cal. 3d 912, 610 P.2d 1038, 164 Cal. Rptr. 709 (1980). Commercial Union, an excess liability carrier, brought an action against its insured (Safeway) and Safeway's primary insurance carrier (Travelers). Commercial Union claimed that both Safeway and Travelers violated the implied covenant of good faith and fair dealing by not settling the case below excess liability coverage. *Id.* at 915-16, 610 P.2d at 1040, 164 Cal. Rptr. at 711.

152. *Id.* at 918, 610 P.2d at 1041, 164 Cal. Rptr. at 712.

153. *Id.*

Thus, the same court which held in *Comunale v. Traders & General Insurance Co.*¹⁵⁴ that an insurance company must equate the insured's interest with its own, refused to impose a similar standard on the insured in *Commercial Union*.¹⁵⁵ The court believed that the purpose of excess insurance was to allow the insured to gamble, and the protection of the insurer's pecuniary interest was not part of the bargain.¹⁵⁶ In reaching this conclusion, the court dismissed any contrary implications that might have been expressed in *Transit Casualty Co. v. Spink Corp.*¹⁵⁷

The holding in *Commercial Union* is consistent with California precedent in that it favors the insured. To protect the insured, however, the court reverted to the strict contract language which early twentieth century courts utilized to shield the insurance industry from liability.¹⁵⁸ The duty of good faith originally developed to prevent the insurer from gambling with the insured's money during settlement.¹⁵⁹ *Commercial Union*, however, indicates, at least in the excess insurance context, that gambling with the insurer's money is permissible.¹⁶⁰ This criticism does not suggest that the insured should owe its insurer a fiduciary duty. Nevertheless, to allow an insured unreasonably to ignore settlement prospects is contrary to the theory and spirit of the good faith doctrine.¹⁶¹

While the insured may not owe its insurer a reciprocal good

154. 50 Cal. 2d 654, 328 P.2d 198 (1958). For a discussion of *Comunale*, see *supra* notes 61-75 and accompanying text.

155. The court found no duty which required the insured to put the insurer's financial interests on at least an equal plane with its own. "Such a duty cannot reasonably be found . . . in the absence of express language in the contract so providing." 26 Cal. 3d at 921, 610 P.2d at 1043, 164 Cal. Rptr. at 714. The court acknowledged that equity mandated fair dealing between the parties to an insurance contract. The court, however, rejected the conclusion that the insured's "covenant of good faith and fair dealing should be extended to include a 'Comunale duty'—that is, a duty which would require an insured contemplating settlement to put the excess carrier's financial interests on at least an equal footing with its own." *Id.*, 610 P.2d at 1043, 164 Cal. Rptr. at 714. While this Note does not suggest that the insured owes a *fiduciary duty* to his or her insurer, issue is taken with the court's reasoning. See *infra* notes 158-60 and accompanying text.

156. "The insured owes no duty to defend or indemnify the excess carrier; hence the carrier can possess no reasonable expectation that the insured will accept a settlement offer as a means of 'protecting' the carrier from exposure." 26 Cal. 3d at 919, 610 P.2d at 1041-42, 164 Cal. Rptr. at 712-13.

157. *Id.* at 921, 610 P.2d at 1043, 164 Cal. Rptr. at 714. See *supra* notes 138-41 and accompanying text.

158. See *supra* notes 20-24 and accompanying text.

159. See *supra* notes 40-43 and accompanying text.

160. See *supra* note 156 and accompanying text.

161. See *supra* notes 131-33 and accompanying text.

faith duty, the insured clearly owes his or her insurer at least a duty of cooperation.¹⁶² To date, courts have limited an insured's liability under a duty of cooperation clause to unconscionable acts.¹⁶³ In light of the extensive development of the insurer's duty of good faith and fair dealing, the major controversy over the extent of the insured's duty to his or her insurer is whether the duty of good faith should be fully reciprocal. Those who argue affirmatively claim that requiring the insured to exercise good faith enhances the public policy favoring out-of-court dispute settlement.¹⁶⁴ California, however, has rejected imposition of full reciprocity of the good faith duty of the insured to his or her insurer—at least in the excess insurance context. The California Supreme Court maintains that such a duty, unless explicitly agreed to, is not within the legitimate expectations of the parties to an insurance agreement.¹⁶⁵ The implication of this view, especially in the case involving an insured with a self-insured risk retention,¹⁶⁶ is that an insured may have great latitude in refusing to settle without violating his or her obligation to the insurer.

III. THE PRIMARY-EXCESS INSURER RELATIONSHIP: HOW IS IT INFLUENCED BY THE INSURED-INSURER RELATIONSHIP?

To obtain adequate protection against high damage awards by juries, an insured may purchase more than one insurance policy.¹⁶⁷ The mechanism through which this extended protection is accomplished is excess insurance. While each insurer owes a duty to the individual insured through the contractual privity which an insurance policy creates,¹⁶⁸ complications arise in attempting to delineate the rights and obligations between primary and excess insurers.

The primary-excess insurance relationship is formed most frequently by the insured purchasing two separate rate policies—one providing primary and the other providing excess coverage.¹⁶⁹

162. An insured must not necessarily accept a settlement merely to avoid exposing the excess insurer to liability. See Wall, *Bad Faith, Excess Liability Actions By or Against Excess Insurers*, INS. COUNS. J. 311, 324 (1981).

163. See *supra* notes 134-36 and accompanying text.

164. See *supra* notes 147-50 and accompanying text.

165. See *supra* notes 151-61 and accompanying text.

166. See *supra* note 142 and accompanying text.

167. Keeton, *supra* note 45, at 841.

168. Note, *supra* note 70, at 291.

169. *Id.*

This purchase does not form a contractual relationship between the primary and excess carriers; rather, it serves to link them to the common insured.¹⁷⁰ The primary insurer generally is responsible for defending the insured, negotiating settlements, and indemnifying the insured up to his or her primary policy limits.¹⁷¹ The excess insurer's role is to protect the insured by providing coverage when the limits of the primary insurance policy are exceeded: "In effect, the excess carrier provides 'umbrella' coverage against the larger losses that the assured may suffer."¹⁷²

Given the extensive development of the insured-insurer relationship, the question arises whether primary or excess insurers may benefit against the other by claiming the application of a doctrine analogous to the good faith duty an insurer owes its insured. Courts have held, on varied theoretical grounds, that this doctrine inures to the excess insurer's benefit. Professor Keeton has observed, "This result may be supported either on the theory of subrogation of the excess insurer to the rights of insured against the primary insurer, or upon the theory that the primary insurer owes to the excess insurer the same duty that it owes to the insured."¹⁷³

Before examining the merits of either theory, it is necessary to examine the working relationship of the primary and excess insurers regarding their common insured, the rights and obligations of the respective insurers, and the role of the aforementioned alternative legal theories in shaping this relationship.

A. *Rights and Duties as Between Two Insurers*

As a general rule,¹⁷⁴ it is the primary insurer's obligation to handle the defense.¹⁷⁵ This obligation exists because it is the primary insurer that has the best facilities to investigate and handle

170. *Id.* at 292.

171. See Knepper, *Relationship Between Primary and Excess Carriers in Cases Where Judgment or Settlement Value Will Exhaust the Primary Coverage*, 20 INS. COUNS. J. 207, 208 (1953).

172. Note, *supra* note 70, at 292.

173. Keeton, *supra* note 1, at 1152.

174. Although no case may be found which holds that the excess carrier has the sole duty of defense, there is so much disagreement among the courts as to the proper allocation of the burden of defense between primary and excess carriers . . . that support may be found for almost any other position a carrier would want to take on this issue.

German & Gallagher, *Allocation of the Duties of Defense Between Carriers Providing Coverage to the Same Insured*, 47 INS. COUNS. J. 224, 228 (1980).

175. See *Continental Casualty Co. v. Reserve Ins. Co.*, 307 Minn. 5, 238 N.W.2d 862, 865 (1976).

claims.¹⁷⁶ Furthermore, the primary insurer's rate structure is designed to include defense costs.¹⁷⁷ The matter is complicated, however, because some excess insurers operate under policies which contractually obligate them to defend the insured. Other excess insurers have no specific obligation to defend until the primary insurer's policy limits are exceeded.¹⁷⁸ For an excess insurer in the former category, its rights and duties are fairly clear. The excess insurer has a duty to defend when its policy limits are involved.¹⁷⁹ Should the primary insurer wrongfully refuse to defend, the excess carrier assumes the defense and may recover from primary insurer the amount of any judgment which is within the limits of the primary coverage.¹⁸⁰ If the primary and excess insurers have a contractual duty to cooperate in the defense, defense costs generally are prorated among the insurers.¹⁸¹

Courts have held that excess insurers with no contractual obligation to defend are not obligated to reimburse the primary insurer for any part of the defense costs where the judgment is within the primary insurer's policy limits.¹⁸² Other decisions, however, have held that "all other factors being equal, there is at least an equal or coexisting duty to defend on the part of the excess carrier, and . . . the excess carrier must at least share in the defense costs."¹⁸³ The better view is that an excess insurer, unless contractually obligated, has no duty to aid in the insured's defense

176. "Excess insurance is routinely written in the insurance industry with the expectation that the primary insurer will conduct all of the investigation, negotiation and defense of claims until its limits are exhausted"

7C J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4682, at 28 (1979).

177. *American Sur. Co. v. State Farm Mut. Auto. Ins. Co.*, 274 Minn. 81, 142 N.W.2d 304 (1966).

178. When the value of the case greatly exceeds primary coverage and involves excess coverage by a large proportion, the excess carrier may be forced to take the lead, especially if there is any indication that the primary carrier has lost interest in the defense and is simply going through the motions.

Knepper, *supra* note 171, at 208.

179. *See Aetna Casualty & Sur. v. Coronet Ins. Co.*, 44 Ill. App. 3d 744, 358 N.E.2d 914 (1976).

180. Bloom, *Recovery From Primary Insurer by Excess Carrier for Bad Faith Failure to Settle*, 36 INS. COUNS. J. 235, 236 (1969).

181. *See Otter v. General Ins. Co. of Am.*, 34 Cal. App. 3d 940, 109 Cal. Rptr. 831 (1971).

182. *See, e.g., Bettenburg v. Employers Liab. Ins. Corp.*, 350 F. Supp. 873 (D. Minn. 1972). Magarick condemns this approach stating that it is "only fair for the excess carrier to share in the defense costs, because . . . it is unjust for the excess carrier to get a free ride as a result of the diligence and competence of the primary insurer." P. MAGARICK, *supra* note 26, at 22.

183. *Continental Casualty Co. v. Zurich Ins. Co.*, 57 Cal. 2d 27, 366 P.2d 455, 17 Cal. Rptr. 12 (1961).

until the primary policy limits are exceeded.¹⁸⁴ If, however, the primary insurer has wrongfully refused to defend the insured, the excess insurer may defend. The excess carrier then is subrogated to the insured's cause of action against the primary insurer for failure to defend.

Practically, the excess carrier should not control the insured's defense, at least not until the primary carrier has ceded its limits to the excess insurer.¹⁸⁵ Since it is initially the primary carrier's obligation to defend, the excess insurer, while maintaining an active interest in the case, should allow it to do so.¹⁸⁶ Insurance practitioners recommend that the primary insurer willingly assume the defense responsibility.

[P]rimary carriers cannot afford to prejudice their relationship with excess carriers by trying to force them into any particular action [e.g., to shoulder defense costs]. They need each other in the over-all insurance picture, and acting in harmony works out for the benefit of both of them.¹⁸⁷

Confusion over the rights and duties of the respective insurers also arises in the claims settlement process. A primary insurer typically refuses to settle, thus causing the excess insurer to enter and settle on the insured's behalf. Many cases hold that the excess insurer is subrogated to the insured's rights and may seek redress against the primary insurer.¹⁸⁸ There is confusion, however, as to whether the primary insurer owes a separate duty in tort to the excess insurer or whether the excess insurer may seek redress only by subrogation.¹⁸⁹

The view that the excess carrier should be subrogated to the insured's cause of action has been criticized. It is argued that the excess insurer cannot be subrogated to the insured's claim since the insured has suffered no monetary damage (the excess insurer

184. Commentators support this view as the better one based on the belief that: 1) the primary carrier usually chooses counsel to defend the insured; 2) the primary insurer faces immediate exposure in litigation; and 3) the rule has a certainty which protects the insured better and allows premiums to be set with this cost in mind. *See, e.g.*, German & Gallagher, *supra* note 174, at 233.

185. "[S]ince verdicts in personal injury cases have risen to astronomical figures, the situation is not uncommon that the primary carrier's limit is known to be exhausted at the outset, and the excess carrier is the insurer who has the real hazard." Knepper, *supra* note 171, at 208.

186. Knepper, *supra* note 178 at 208.

187. *Id.* at 209.

188. *See, e.g.*, Peter v. Travelers Ins. Co., 375 F. Supp. 1347 (C.D. Col. 1974).

189. *See* Western World Ins. Co. v. Allstate Ins. Co., 140 N.J. Super. 338, 356 A.2d 83 (Law Div. 1976).

satisfied the judgment in its insured's behalf).¹⁹⁰ Thus, the debate arises over what theoretical justification there is for allowing the excess insurer a cause of action against the primary insurer. The two major theories are discussed below.

B. *Subrogated Rights or Independent Duty?*

Subrogation is an equitable remedy which generally allows a new creditor to acquire all the rights originally held by a prior creditor after liquidating the claim held by the prior creditor.¹⁹¹ This theory has been held to apply in the insurance context whenever the primary insurer breaches a duty owed to its insured, and the excess insurer defends or settles on the insured's behalf.¹⁹² Although confrontations between primary and excess carriers are increasing,¹⁹³ many excess insurers will not actively pursue their remedies against the primary insurer.¹⁹⁴ A possible explanation is that the excess insurer's cause of action, if based on subrogation, is totally dependent on whether the insured has a bad faith cause of action to which the excess carrier may be subrogated.¹⁹⁵

Many courts have ruled that a primary insurer owes a good

190. See Note, *supra* note 71, at 300.

191. 11 J. APPLEMAN, *supra* note 176, §§ 6501, 6505. "A party claiming through subrogation is required to claim through a derivative right, which presupposes an original right. . . . The party for whose benefit the doctrine of subrogation was exercised was deemed to acquire no greater rights than those of the party for whom he was substituted." *Id.* § 6506, at 445-46.

192. The primary insurer's breach of the duty to defend gives the insured a cause of action, and in many jurisdictions, through subrogation, allows the excess insurer a right to seek judgment for amounts expended in defense of the insured due to the primary insurer's wrongful refusal to defend. There is an exception to this general proposition: "Where, however, both insurers have a contractual duty to the insured to defend, the breach by the primary insurer does not necessarily run to the benefit of the excess carrier where it has taken over the defense." Bloom, *supra* note 180, at 236. See also *Continental Casualty Co. v. Reserve Ins. Co.*, 307 Minn. 5, 238 N.W.2d 862 (1976) (excess insurer subrogated to insured's rights against primary insurer for breach of primary insurer's good faith duty to settle).

193. Lanzone, *supra* note 141, at 267. The author states two major reasons underlying the increase in disputes between primary and excess insurers. First, higher jury awards often will exceed primary insurance limits. Second, the tendency by some primary insurers to gamble on the outcome of a trial when the proposed settlement approaches their policy limits.

194. In one author's opinion, "the excess carrier can and should be willing to enforce its rights whenever a primary carrier has been negligent or has acted in bad faith in settling a claim. So far, this has not been the case. . . . The excess carriers have not in the past attempted to enforce their rights against primary carriers." Bloom, *supra* note 180, at 238.

195. The equitable entity subrogating is "strictly limited to the rights possessed by the assured and can only pursue a bad faith cause of action if the assured has one." Note, *supra* note 70, at 301.

faith duty to the excess insurer. This duty requires that the primary insurer conduct the insured's defense so as not to injure the excess insurer's rights and expose the excess carrier to unwarranted liability.¹⁹⁶ The court in *St. Paul-Mercury Indemnity Co. v. Martin*¹⁹⁷ stated in dicta that the primary insurer owed the same duty of good faith and fair dealing to the excess carrier as it owed to its insured.¹⁹⁸ A more recent case held that the excess insurer need not always show bad faith for a cause of action to lie against the primary insurer.¹⁹⁹ If the excess insurer seeks solely to recover the primary limit, it needs only to establish that the settlement it arranged was "reasonable and in an amount in excess of the primary's policy limit."²⁰⁰

The move to create a duty of good faith and fair dealing between the primary and excess insurers similar to the duty already established in the primary insurer-insured relationship has been criticized.²⁰¹ Due to the prevalent theoretical confusion, courts have emphasized policy. In *Continental Casualty Co. v. Reserve Insurance Co.*,²⁰² the court held that the excess insurer was subrogated to the insured's rights against the primary insurer for breach by the primary insurer of its good faith duty to settle. The court supported its ruling on the judicial policy favoring fair settlements and on its belief that allowing the primary insurer to avoid settlement duty would produce an unfair distribution of losses among insurers:

The insured has paid for two distinct types of coverage, undoubtedly at different rates because they involve different amounts and kinds of risks. . . . When a primary insurer re-

196. *Vencill v. Continental Gas*, 433 F. Supp. 1371 (S.D.W. Va. 1977); *Aetna Casualty & Sur. Co. v. Coronet Ins. Co.*, 44 Ill. App. 3d 744, 358 N.E.2d 914 (1976); *Estate of Penn. v. Amalgamated Gen. Agencies*, 148 N.J. Super. 419, 372 A.2d 1124 (App. Div. 1977). *Contra* *Northwestern Mut. Ins. Co. v. Farmers' Ins. Group*, 76 Cal. App. 3d 1031, 143 Cal. Rptr. 415 (1978) (endorsed subrogation as the only basis on which excess insurer may recover against the primary insurer).

197. 190 F.2d 455 (10th Cir. 1951).

198. The court stated that the primary insurer "was required under its relationship to its insured and the excess insurer, to exercise good faith in determining whether an offer of compromise of settlement should be accepted or rejected. It owed them the duty to exercise an honest discretion at the risk of liability beyond its policy limits." *Id.* at 457.

199. *Northwestern Mut. Ins. Co. v. Farmers Ins. Group*, 76 Cal. App. 3d 1031, 143 Cal. Rptr. 415 (1978).

200. *Kurland & Simon*, *supra* note 144, at 555. If the excess carrier seeks to recover an amount greater than the primary insurer's policy limits, then it must show that the primary insurer declined to contribute its policy limits in bad faith.

201. *See, e.g.*, Note, *supra* note 70, at 302.

202. 307 Minn. 5, 238 N.W.2d 862 (1976).

fuses in bad faith to settle, it forces the excess insurer [into] making a reasonable settlement to cover both primary and excess liability. Thus, the purposes of the different kinds of coverage and their rating structures are thwarted as the excess insurer bears the full loss and fulfills the primary insurer's duty to the insured as well as its own.²⁰³

Primary carriers argue that this judicial perspective forces them to concede to unwise settlements under pressure exerted by overanxious excess insurers.²⁰⁴ Courts have discounted this fear, stating that the insured or its excess insurer, to collect damages, must show that the settlement which the primary insurer rejected was negotiated in good faith and for a reasonable amount.²⁰⁵

The theoretical battle over the proper scope of the excess and primary insurer's relationship continues among commentators and courts. The advocates of subrogation view the excess insurer as a third party beneficiary to the contract between the primary insurer and the insured.²⁰⁶ This view was adopted in *American Fidelity & Casualty Co. v. All American Bus Lines, Inc.*²⁰⁷ The court recognized that although the primary insurer owed no contractual duty to the excess insurer, the excess carrier still must be subrogated to the insured's rights when it pays out policy proceeds normally covered by the primary insurance contract.²⁰⁸ The court believed that the primary insurer's refusal to settle in good faith distorts the equities between the two insurers and, therefore, it is "just and equitable for [the primary insurer] to bear the loss occasioned by its own misconduct."²⁰⁹

Opponents of subrogation reject the doctrine as "failing to achieve evenhanded justice."²¹⁰ The court in *Transit Casualty Co. v. Spink Corp.*²¹¹ embraced a policy of "triangular reciprocity" whereby insurers are no longer forced to use the insured as a step-

203. *Id.* at 9-10, 238 N.W.2d at 865.

204. "If a primary carrier feels that the claim should be refused entirely or is not worth the underlying limits, an excess carrier offering its limits puts the primary carrier in an extremely awkward position." Brittle, *supra* note 22, at 319.

205. *See, e.g., Fireman's Fund Ins. Co. v. Security Ins. Co.*, 72 N.J. 63, 367 A.2d 864 (1976). *See also supra* note 200.

206. The primary insurer "ignored the duty owed to the insured and the excess insurer as a third party beneficiary and that the breach of duty many [sic] have been a tort as well." 7C J. APPLEMAN, *supra* note 176, § 4682, at 33.

207. 190 F.2d 234 (10th Cir. 1951).

208. *Id.* at 238. *See supra* note 202 and accompanying text.

209. 190 F.2d at 238.

210. *Transit Casualty Co. v. Spink Corp.*, 94 Cal. App. 3d 124, 156 Cal. Rptr. 360 (1979).

211. *Id.*

ping stone to each other. Triangular reciprocity recognizes the duties and obligations of all the parties and allows them to work together to achieve settlement.²¹²

Providing an excess insurer with subrogation rights has been said to allow the excess insurer to recover on tenuous theoretical grounds. One argument is that if there is excess insurance involved, the insured's interests are never endangered since the excess insurer owes a duty to protect the insured.²¹³ Since the insured suffers no real loss, there is no bad faith action to which the excess insurer may be subrogated.²¹⁴ The application of subrogation in this context also has been said to give the excess insurer a "windfall," since it is being compensated for liability payments for which it accepted premium payments. Furthermore, "the ultimate subsidizer of litigation between primary and excess carriers would be the assured through the medium of higher premiums"²¹⁵ The court in *Universal Underwriters Insurance Co. v. Dairyland Mutual Insurance Co.*,²¹⁶ followed this "windfall" view. The court stated, "[t]here is no privity of contract between these two insurance companies nor is there any principle of law of which we are aware that would give [the excess insurer] such a windfall because of [the primary insurer's] mistreatment of its assured."²¹⁷

Commentators have criticized subrogating the excess carrier to the insured's cause of action for a primary insurer's breach of its good faith duty. It is argued that the good faith duty is imposed on the primary insurer to protect the insured from excess liability.²¹⁸ Since the excess insurer is presumably more sophisticated than an ordinary insured, it is ludicrous to extend protection to the excess insurer that was intended originally for the average policyholder.²¹⁹ One commentator has made the following observation

212. "[T]he two carriers face interacting problems of claim adjustment, settlement and defense. Each has a choice of mutual support or naked self-interest. The law, then, would be unrealistic in demanding that either carrier use the policyholder as its stepping stone to each other. Triangular reciprocity is far more rational." 94 Cal. App. 3d at 133, 156 Cal. Rptr. at 365.

213. See *supra* notes 189-90 and accompanying text.

214. See *supra* note 190 and accompanying text.

215. Note, *supra* note 70, at 305.

216. 102 Ariz. 518, 433 P.2d 966 (1967).

217. *Id.* at 520, 433 P.2d at 968.

218. See *Northwestern Mut. Ins. Co. v. Farmers' Ins. Group*, 76 Cal. App. 3d at 1043, 143 Cal. Rptr. at 422.

219. See Knepper, *supra* note 178, at 210.

in concluding that there is no justification to support the imposition of this independent duty on the primary insurer:

There is simply no pervasive policy reason why an excess carrier should receive a "windfall" from a newly formulated application of the standard of good faith, and absent such a policy rationale, [courts] should not extend the bad faith cause of action to the primary excess carrier suit.²²⁰

The above discussion demonstrates flaws in applying either the subrogation or the good faith doctrine in the context of the excess-primary insurer relationship. The subrogation doctrine has been termed an "ancient artificiality" which leads to undesirable "all-or-nothing" results.²²¹ Since there is no contractual privity between the two insurers, the excess insurer's cause of action depends solely on the insured's rights.

Courts which equate the excess-primary and the primary-insured relationships often find that the equities between the primary and excess insurers are unequal, and subrogating *all* the insured's rights is the proper remedy.²²² Courts which find that the equities between the two insurers are equal generally deny the excess insurer *any* cause of action against the primary insurer.²²³ Other courts have attempted to expand the primary insurer's duty of good faith and fair dealing to include the excess insurer. The policy behind this duty is the protection of the insured. The fundamental tenet underlying the imposition of the duty is that the average policyholder is presumed to have little knowledge about the workings of insurance and, therefore, is held to a slight degree of care in protecting his or her interest.²²⁴ It is a tenuous extension to use the same rationale to justify the application of the good faith doctrine for the benefit of the excess insurer.

While none of the theoretical bases discussed above appears wholly satisfactory, some standard must be formulated whereby both the insured's and excess insurer's legitimate interests will be protected. The proper solution may be to develop an independent duty between the primary and excess insurer, the breach of which will give rise to a tort action. This duty must be reciprocal so that

220. Note, *supra* note 70, at 305.

221. *Transit Casualty Co. v. Spink Corp.*, 94 Cal. App. 3d at 132-33, 156 Cal. Rptr. at 365-66.

222. *See, e.g., American Fidelity & Casualty Co. v. All Am. Bus Lines, Inc.*, 190 F.2d 234 (10th Cir. 1951).

223. *See, e.g., Hartford Accident & Indem. Co. v. South Carolina Ins. Co.*, 252 S.C. 428, 166 S.E.2d 762 (1969).

224. *Knepper, supra* note 171, at 210.

neither insurer will act contrary to the other's interests in handling claims against their common insured. The creation of a new tort duty will serve important public policy functions including encouraging out-of-court settlements and providing adequate protection of the insured. This duty will eliminate the confusion and inconsistency caused by judicial attempts to apply either the good faith or subrogation doctrines to the primary-excess insurer relationship.

Whether based on a duty of good faith and fair dealing, subrogation, or the creation of an independent tort duty, it is apparent that a clear judicial elaboration of the rights and duties of and between primary and excess insurers is needed.²²⁵ Given that jury awards continue to be astronomical,²²⁶ instances where primary and excess insurers handle the same claim also are increasing. It is in both insurers' interests to define the extent of their relationship and the proximity in which they should work to resolve claims against common insureds.

In an attempt to resolve some of the problems extant in the primary-excess insurer relationship, the insurance industry has promulgated a code of conduct to establish a uniform working relationship among primary and excess insurers.²²⁷ These guide-

225. See Note, *supra* note 70, at 305.

226. Bloom, *supra* note 180, at 235.

227. 1—The primary insurer must discharge its duty of investigating promptly and diligently even those cases in which it is apparent that its policy limit may be consumed.
- 2—Liability must be assessed on the basis of all relevant facts which a diligent investigation can develop and in the light of applicable legal principles. The assessment of liability must be reviewed periodically throughout the life of the claim.
- 3—Evaluation must be realistic and without regard to the policy limit.
- 4—When from evaluation of all aspects of a claim, settlement is indicated, the primary insurer must proceed promptly to attempt a settlement, up to its policy limit if necessary, negotiating seriously and with an open mind.
- 5—If at any time, it should reasonably appear that the insured may be exposed beyond the primary limit, the primary insurer shall give prompt written notice to the excess insurer, when known, stating the results of investigation and negotiation, and giving any other information deemed relevant to a determination of the exposure, and inviting the excess insurer to participate in a common effort to dispose of the claim.
- 6—Where the assessment of damages, considered alone, would reasonably support payment of a demand within the primary policy limit but the primary insurer is unwilling to pay the demand because of its opinion that liability either does not exist or is questionable and the primary insurer recognizes the possibility of a verdict in excess of its policy limit, it shall give notice of its position to the excess insurer when known. It shall make available its file to the excess insurer for examination, if requested.
- 7—The primary insurer shall never seek a contribution to a settlement within its policy limit from the excess insurer. It may, however, accept contribu-

lines outline the specific duties of both the primary and excess insurer and provide each insurer with suggested standards of conduct in handling common claims.²²⁸ The guidelines give the primary insurer the option of either appealing an excess judgment or paying its policy limits to the excess insurer. The excess insurer has the option of appealing at its own expense or paying the judgment balance.²²⁹ While this proposal may place the burden of appeal costs on the excess insurer, it is arguably equitable since it is the primary insurer's obligation to defend the insured in the original action.²³⁰ The primary insurer may argue that it has discharged its obligation to the insured through its diligent investigation and subsequent handling of the insured's case at trial. If the excess insurer seeks to appeal an adverse judgment, the

tion to a settlement within its policy limit from the excess insurer when such contribution is voluntarily offered.

8—In the event of a judgment in excess of the primary policy limit the primary insurer shall consult the excess insurer as to further procedure. If the primary insurer undertakes an appeal with the concurrence of the excess insurer the expense shall be shared by the primary and the excess insurer in such manner as they may agree upon. In the absence of such an agreement, they shall share the expense in the same proportions that their respective shares of the outstanding judgment bear to the total amount of the judgment. If the primary insurer should elect not to appeal, taking appropriate steps to pay or to guarantee payment of its policy limit, it shall not be liable for the expense of the appeal or interest on the judgment from the time it gives notice to the excess insurer of its election not to appeal and tenders its policy limit. The excess insurer may then prosecute an appeal at its own expense being liable also for interest accruing on the entire judgment subsequent to the primary insurer's notice of its election not to appeal. If the excess insurer does not agree to an appeal it shall not be liable to share the cost of any appeal prosecuted by the primary insurer.

9—The excess insurer shall refrain from coercive or collusive conduct designed to force a settlement. It shall never make formal demand upon a primary insurer that the latter settle a claim within its policy limit. In any subsequent proceedings between excess insurer and primary insurer the failure of the excess insurer to make formal demand that the claim be settled shall not be considered as having any bearing on the excess insurer's claim against the primary insurer.

These guidelines were promulgated by the Claims Executive Council of the American Insurance Association and the American Mutual Insurance Alliance in 1974, and are reprinted in P. MAGARICK, *supra* note 26, at 216-18.

228. *Id.*

229. *Id.* Guideline eight reads in pertinent part:

If the primary insurer should elect not to appeal, taking appropriate steps to pay or guarantee payment of its policy limit, it shall not be liable for the expense of the appeal or interest on the judgment from the time it gives notice to the excess insurer of its election not to appeal and tenders its policy limit. The excess insurer may then prosecute an appeal at its own expense

Id. at 217-18.

230. See *supra* notes 175-77 and accompanying text.

primary insurer should not be forced to share the burden of appeal costs after having tendered its policy limits.

Several excess carriers have criticized the proposed guidelines for permitting the primary insurer to disclaim one of its fundamental duties to the insured—the duty to defend.²³¹ Some courts have held that the primary insurer's duty to defend ceases once it has paid the policy limits.²³² The better view, however, is that the duty to defend is a separate insurance agreement and the primary insurer must defend regardless of the potential that its policy limits will be exhausted.²³³ As one commentator has noted, "The fact that there is an excess insurer should not alter the obligation of the primary insurer who has a responsibility to the insured as well as to the excess insurer."²³⁴ The proposed guidelines would allow the primary insurer to escape responsibility for the insured's defense by tendering the policy limits. This provision would create the undesirable result that the insured's defense or appeal would be handled by attorneys unfamiliar with the case.²³⁵

Commentators favor adoption of the guidelines so insurers may "clean their own house" without further judicial interference.²³⁶ The adoption of an industry-wide standard would not totally resolve conflicts among insurers, but it would demonstrate that the insurance industry is "ready to adopt the most stringent standards of conduct by seeking to diligently represent its insured and by avoiding the underlying causes of the excess liability suit."²³⁷

V. CONCLUSION

Most judicial intervention in insured-insurer disputes has been directed toward protecting the interests of the insured.²³⁸ This judicial intervention resulted in imposing a fiduciary responsibility

231. See Lanzone, *supra* note 141, at 278.

232. 7C J. APPLEMAN, *supra* note 176, § 4682, at 34 n.55.

233. *Id.* at 35.

234. *Id.* at 32-33.

235. *Id.* at 37. See also Knepper, *supra* note 171, at 209 (excess insurer may be forced to assume defense of case when primary insurer turns the matter over to inexperienced attorney or one with a poor trial record).

236. The proposed guidelines "provide standards of conduct which, if followed by insurers in the handling of claims, will reduce if not eliminate the incidence of controversy between primary and excess insurers [and] provide a format for the resolution of problems involving the interaction of primary and excess insurance coverages and their applicable policy limits." P. MAGARICK, *supra* note 26, at 216.

237. Brittle, *supra* note 23, at 326.

238. See *supra* notes 19-24 and accompanying text.

on insurers to act on the insured's behalf to avoid excess liability judgments against the insured. Thus, it effectively has prodded the insurance industry to recognize its responsibility to insureds.²³⁹ This recognition is evidenced by the industry's attempt to control its conduct through self-regulation.²⁴⁰ Furthermore, the insurance industry cannot function effectively without utilizing its expertise and exercising control over claims against its insureds.²⁴¹

In response to higher liability judgments, the insurance relationship has expanded to include the insured, primary insurer, and excess insurer.²⁴² Just as early twentieth century courts ignored the economic reality inherent in the relationship between a dominant insurer and a relatively powerless insured,²⁴³ modern courts must be sensitive to attempts by any of the parties in this triangular relationship to engage in self-serving activities at the other two parties' expense.

The appropriate role of courts in insured-insurer disputes is to maintain a proper balance between the legitimate interests of the insured, the insurer, and those who are affected indirectly by the impact of individual decisions. The insurance system is most effective when the insurer's need to have exclusive control over its claim fund is balanced with the insured's need to have his or her claim handled so as to avoid personal liability.

The courts faced an equally difficult challenge in balancing the legitimate interests of primary and excess insurers. This task has been difficult because the only link between the two companies is their common insured.²⁴⁴ The theories which courts have developed to protect the relatively unsophisticated insured, however, will not protect the legitimate interests of sophisticated professional insurance companies.

Courts should not adopt standards subrogating the excess insurer to the rights and claims of the average policyholder to remedy injury to the excess insurer by the primary insurer.²⁴⁵ It is inappropriate to define the scope of an excess insurer's rights by reference to whatever rights its insured has against his or her primary insurer.²⁴⁶ For these same reasons, the duty of good faith

239. *See supra* notes 26-31 and accompanying text.

240. *See supra* notes 227-28 and accompanying text.

241. *See supra* note 29 and accompanying text.

242. *See supra* notes 168-72 and accompanying text.

243. *See supra* note 24 and accompanying text.

244. *See supra* notes 169-70 and accompanying text.

245. *See supra* note 190 and accompanying text.

246. *See supra* notes 191-95 and accompanying text.

and fair dealing, developed to protect the insured, should not be made applicable in wholesale fashion to the excess insurer.²⁴⁷ Instead, courts must develop a new standard based on an independent duty sounding in tort to govern the primary-excess insurer relationship.²⁴⁸

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247. *See supra* notes 218-20 and accompanying text.

248. *See supra* note 225 and accompanying text.