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Insurance Law - Recovery - Action for Wrongful Refusal to Settle Claim Precluded by Bankruptcy of Insured

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INSURANCE LAW — RECOVERY — ACTION FOR WRONGFUL REFUSAL TO SETTLE CLAIM PRECLUDED BY BANKRUPTCY OF INSURED — The plaintiff, as trustee in bankruptcy of the insured, sued the defendant insurer to recover damages resulting from a judgment entered against the insured in a personal injury suit. This judgment subjected the insured to a liability of 89,000 dollars in excess of the 10,000 dollar automobile liability coverage carried with the insurer. The insurer, pursuant to its policy, had undertaken the insured's defense and had failed, allegedly in bad faith, to settle the suit for an amount within the limits of its coverage. Before judgment was entered in the personal injury suit the insured was insolvent; six months following the entry of judgment he was adjudicated bankrupt. At no time had the excess judgment been paid. The trial court awarded the trustee 89,000 dollars in damages.[1] On appeal, *held*, reversed, one judge dissenting. Proof of payment of the excess judgment is a condition precedent to recovery of damages from an insurer for tortious failure to settle a claim within the limits of its coverage when it has undertaken the insured's defense. *Harris v. Standard Acc. & Ins. Co.*, 297 F.2d 627 (2d Cir. 1961), *cert. denied*, 82 Sup. Ct. 875 (1962).

The courts have increasingly recognized a duty in an insurer to exercise good faith or due care in settling a claim against its insured, where practicable, when it assumes his defense under a liability policy.[2]

[1] Harris v. Standard Acc. & Ins. Co., 191 F. Supp. 538 (S.D.N.Y. 1961).

[2] Some jurisdictions have permitted recovery against the insurer on its negligent failure to settle, while others follow the majority rule requiring demonstration of the

However, these courts have divided on whether, in order to recover damages, the insured must have paid the excess judgment entered against him resulting from the insurer's breach of this duty. The older decisions require payment of the excess judgment as a condition precedent to recovery,[3] reasoning that until actual payment is made, the injury to the insured is both contingent and speculative. On the other hand, the more recent decisions have held that the entry of judgment completes the actionable wrong and that it is sufficiently injurious to permit the insured to recover damages from the insurer.[4] Several reasons have been offered in support of this result. First, it has been said that to require prepayment in this situation would result in a windfall to the insurer fortunate enough to have insured an insolvent, and that the insurer would thus profit from its own wrong.[5] A second theory suggested, which is related to the first, is that if prepayment were required the insurer would be less responsive to its duty where the insured is insolvent than in cases where the insured is able to discharge any judgment in excess of the policy limits which might be rendered against him.[6] Thirdly, one court has advanced

insurer's bad faith. While these theories are apparently divergent, in practice they have coalesced and the same result would probably be reached under either. See generally Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954).

3 Attleboro Mfg. Co. v. Frankfort Marine Acc. & Plate Glass Ins. Co., 240 Fed. 573, 580 (1st Cir. 1917); Dumas v. Hartford Acc. & Indem. Co., 92 N.H. 140, 141, 26 A.2d 361, 362 (1942); Boling v. New Amsterdam Cas. Co., 173 Okla. 160, 162, 46 P.2d 916, 918 (1935); Universal Auto. Ins. Co. v. Culberson, 126 Tex. 282, 289, 86 S.W.2d 727, 730 (1935); State Auto. Mut. Ins. Co. v. York, 104 F.2d 730, 734 (4th Cir.) (alternative holding), *cert. denied*, 308 U.S. 591 (1939); *cf.* American Mut. Liab. Ins. Co. v. Cooper, 61 F.2d 446, 448 (5th Cir. 1932), *cert. denied*, 289 U.S. 736 (1933); RESTATEMENT, TORTS, § 871, comment *j* (1939).

4 Lee v. Nationwide Mut. Ins. Co., 286 F.2d 295, 296 (4th Cir. 1961); Wessing v. American Indem. Co., 127 F. Supp. 775, 780-81 (W.D. Mo. 1955); Alabama Farm Bureau Mut. Cas. Ins. Co. v. Dalrymple, 270 Ala. 119, 122-23, 116 So. 2d 924, 925-26 (1959); Farmers' Ins. Exch. v. Henderson, 82 Ariz. 335, 342-43, 313 P.2d 404, 409 (1957); Brown v. Guaranty Ins. Co., 155 Cal. App. 2d 679, 689-92, 319 P.2d 69, 76-77 (Dist. Ct. App. 1958); Henke v. Iowa Home Mut. Cas. Co., 250 Iowa 1123, 1142-44, 97 N.W.2d 168, 180-81 (1959); Southern Fire & Cas. Co. v. Norris, 35 Tenn. App. 657, 671-73, 250 S.W.2d 785, 791-92 (1952); Schwartz v. Norwich Union Indem. Co., 212 Wis. 593, 595-96, 250 N.W. 446, 446-47 (1933).

5 See Southern Fire & Cas. Co. v. Norris, *supra* note 4, at 672, 250 S.W.2d at 791. The court in the principal case at 633 correctly observes that the windfall rationalization avoids the ultimate issue in these cases. Rather than responding to the question of whether the insured incurs an injury upon the entry of judgment, the windfall theory merely interposes an equitable consideration which is, at best, an argument collateral to the question of law involved.

6 See Southern Fire & Cas. Co. v. Norris, 35 Tenn. App. 657, 672, 250 S.W.2d at 791. The court in the principal case at 633 again correctly observes that this argument obscures the essential question of whether the insured has actually been harmed by the bad faith or negligent refusal to settle. The court also suggests that the importance of this argument is negligible because in only a small percentage of the cases is the insured insolvent at the time of the settlement negotiations. What the court fails

the theory that the insured's cause of action against the insurer might be barred by the statute of limitations if he were forced to await the time when he could marshal sufficient assets to pay the judgment debt.[7] The fourth and perhaps most prevalent justification analogizes the insured's situation to that of the plaintiff in a personal injury suit who needs only to incur medical expenses to recover damages from the tortfeasor.[8] Finally, as an outgrowth of the medical expense analogy, it has been held that the entry of judgment results in an immediate injury to the insured's financial security and credit,[9] and that bankruptcy might be his sole recourse if prepayment were required.[10]

The significance of the principal case lies in its resuscitation of the outmoded prepayment doctrine. The court found that the insured had suffered no loss because he was insolvent prior to the entry of judgment, had not paid the judgment, and had been discharged of liability for it in bankruptcy. It therefore held that the insured's trustee in bankruptcy, as assignee of his rights in this matter, could not recover damages. The reason assigned for this decision was that the law "requires proof of actual loss to support recovery for a tort of this type."[11] The court justified this reasoning by resorting to the principle that the "purpose of tort damage is to compensate an injured person for a loss suffered and only that."[12] The court refused to recognize that the fact than an insured has

to recognize is that the magnitude of contemporary verdicts involving liability arising out of automobile collisions may easily reduce the insured to insolvency following the entry of judgment, notwithstanding his solvency prior to judgment. The evil involved in both cases would seem to be the same.

7 See Wessing v. American Indem. Co., 127 F. Supp. 775, 781 (W.D. Mo. 1955). The court in the principal case suggests at 633 that this argument is specious because the insured's cause of action accrues only upon the payment of the judgment, and therefore, only at that time does the statute of limitations commence to run. This court's criticism is fallacious, however, for in those jurisdictions in which the non-prepayment rule applies, the insured's cause of action arises upon the entry of judgment. But, by the same token, this reasoning of the non-prepayment rule courts is also fallacious because it assumes that in the prepayment rule jurisdictions the statute of limitations commences to run from the date of judgment.

8 See Wessing v. American Indem. Co., *supra* note 7. The court in the principal case at 633-35 argues that this analogy is inappropriate because, in the physical injury situation, the basis for recovery is the actual injury to the plaintiff's person, while the medical expenses incurred are merely incidental. The court attempts to distinguish this from the situation in the principal case by asserting that the payment of the judgment is the primary injury, not merely an incidental expense. However, this distinction assumes the prepayment rule to be in effect, because in the non-prepayment jurisdictions it is not the *payment* but the *entry* of the judgment which constitutes the injury. Consequently, in the non-prepayment jurisdictions the analogy is viable, for the payment of the judgment is incidental to the injury suffered.

9 See Lee v. Nationwide Mut. Ins. Co., 286 F.2d 295, 296 (4th Cir. 1961).

10 See Southern Fire & Cas. Co. v. Norris, 35 Tenn. App. 657, 672, 250 S.W.2d 785, 791 (1952).

11 Principal case at 631.

12 *Ibid.*

not paid the judgment does not necessarily mean that he suffers no loss. The *injury* inflicted upon the insured by the insurer's tortious misconduct is the subjection of his assets to an unallocated liability, usually of substantial size. The *loss* incurred may have a double aspect. First, the insured's assets are in effect diluted by the accrual of this unpaid and unfunded liability. Second, this dilution of assets may result in collateral injuries causing additional losses. In certain instances the judgment may be more debilitating to the insured who is unable to discharge the liability, than would be the actual payment of the judgment debt to another whose circumstances enable him to discharge it. Certainly this is apparent where the unliquidated judgment debt subjects the insured to the consequences of insolvency, or where it forces an insured already insolvent into bankruptcy although recovery from insolvency might otherwise have been possible.[13] So viewed, the essence of the insurer's tort is the wrongful dilution of the insured's assets accompanied by the possible collateral impairment of his financial reputation, credit resources and economic stability, resulting in additional losses.

This approach is not free from substantial difficulties. The object of tort damages is to restore the injured party as nearly as possible to the position which he occupied prior to the tort's commission.[14] In the simple case where the insured has suffered nothing more than the temporary dilution of his assets, this objective may be accomplished by awarding him damages equal to the amount by which his assets were diluted—in this case the amount of the judgment entered against him. When the temporary dilution of the insured's assets is accompanied by collateral injuries caused by the dilution, the measure of recovery becomes more complicated. Theoretically, assuming causation could be established, there should be added to the increment due the insured an amount equal to the additional losses sustained by the collateral injury.

Further difficulties are encountered when, through bankruptcy, the liability for the judgment debt has been transferred from the insured to his trustee. By sections 70 (a) (5) and (6) of the Bankruptcy Act[15] the

13 *Cf.* Schambs v. Fidelity & Cas. Co., 259 Fed. 55, 58 (6th Cir. 1919); Maryland Cas. Co. v. Peppard, 53 Okla. 515, 522, 157 Pac. 106, 108 (1916); Malley v. American Indem. Co., 297 Pa. 216, 223, 146 Atl. 571, 573 (1929).

14 See RESTATEMENT, TORTS § 901 and comments (1939).

15 "The trustee of the estate of a bankrupt . . . shall . . . be vested by operation of law with the title of the bankrupt to . . . (5) property, including rights of action, which prior to the filing of the petition he could by any means have transferred or which might have been levied upon and sold under judicial process against him, or otherwise seized, impounded, or sequestered: *Provided*, that rights of action ex delicto for libel, slander, injuries to the person of the bankrupt or of a relative, whether or not resulting in death, seduction, and criminal conversation shall not vest in the trustee unless by the law of the state such rights of action are subject to attachment, execution, garnishment, sequestration, or other judicial process . . . ; (6) rights of

insured's trustee in bankruptcy succeeds to such of his tort claims as are not wholly personal in nature. To establish the injury necessary to recovery, these torts should ostensibly involve a diminution of the estate in bankruptcy. However, there would seem to be no significant difference in effect between the reduction of the size of the estate, with the amount of the creditors' claims remaining constant, and the increase of claims against an estate constant in size. Therefore, since there is in the principal case an effective, albeit intangible, diminution of the estate, the trustee should have standing to recover the amount by which the estate in bankruptcy, formerly the insured's assets, was diluted by the accrual of the judgment debt.[16] However, if the insured's bankruptcy was caused by the entry of judgment, he has suffered a collateral injury to his financial reputation.[17] In such a case an apparent conflict arises between the principle that the purpose of tort damages is the rehabilitation of the injured party and the reasoning which permits the trustee to recover the amount by which the bankrupt's assets were impaired. The damages so awarded to the trustee would be applied not to the insured's rehabilitation but to the satisfaction of his creditors' claims against the estate in bankruptcy, while the stigma of bankruptcy would adhere unabated to the insured's financial reputation. This apparent conflict may be circumvented if it is accepted that additional damages can be recovered for collateral injuries. Since the destruction of the insured's financial reputation involves an injury to his future earning capacity rather than to his property, his cause of action would appear to come within the provision in section 70 (a) (5) of the Bankruptcy Act that personal rights of action shall not vest in the trustee.[18] It would therefore seem reasonable to permit the bankrupt insured to obtain at least illusory rehabilitation through separate compensation for the collateral injury to his financial reputation, allowing the trustee to recover for only part of the total injury sustained.

No decision has been discovered which suggests that an insured, either

action arising upon contracts, or usury, or the unlawful taking or detention of or injury to his property . . . ." 52 Stat. 879 (1938), 11 U.S.C. §§ 110 (a) (5), (6) (1952).

16 *Ibid.;* see Brown v. Guarantee Ins. Co., 155 Cal. App. 2d 679, 692-96, 319 P.2d 69, 77-81 (Dist. Ct. App. 1958).

17 However, if the insured's bankruptcy was inevitable before the entry of judgment, it would be mistaken to presume that the judgment was the cause of the insured's economic embarrassment and his resulting loss of reputation. The plaintiff in the principal case argued that the excess judgment forced the insured into bankruptcy. But the court disposed of this argument by stating that "no testimony of any specific injury to the insured credit or reputation" had been introduced. Principal case at 636. *But see* the dissenting opinion, principal case at 638.

18 The collateral injury to the insured very closely approximates, in its effect, the defamation of his financial integrity. *Cf. In re* Farrell Publishing Corp., 165 F. Supp. 40, 45 (S.D.N.Y. 1958); Constant v. Kulukundis, 125 F. Supp. 305, 306-07 (S.D.N.Y. 1954); Gering v. Superior Court, 37 Cal. 2d 29, 30, 230 P.2d 356, 356-57 (1951).

solvent or bankrupt, may recover an amount in excess of the judgment debt for collateral injuries. In all probability this is attributable to a judicial reluctance to award damages where the extent of the collateral injury may be speculative or proof of its causation unavailable. It is suggested, however, that this judicial reluctance should yield to a recognition that these collateral injuries should be compensated. While the court's decision in the principal case possesses the virtue of simplicity, it is submitted that it may sacrifice justified reparation for expediency. The alternative solution suggested by the non-prepayment doctrine not only reaches a more satisfactory result in vindicating the damaged interests of both insured and trustee, but it accomplishes this in a manner more nearly in accord with the principles of tort recovery upon which the court in the principal case relies.

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