2-1-1974

Liability Insurance -- The Movable Link Between Coverage Denial and Settlement Offers

William Richard Purdy

Follow this and additional works at: http://scholarship.law.unc.edu/nclr

Part of the Law Commons

Recommended Citation
Available at: http://scholarship.law.unc.edu/nclr/vol52/iss3/13

This Note is brought to you for free and open access by Carolina Law Scholarship Repository. It has been accepted for inclusion in North Carolina Law Review by an authorized editor of Carolina Law Scholarship Repository. For more information, please contact law_repository@unc.edu.
and wages and salaries without a minimum for subsistence are all subject to seizure.

The federal tax lien is wholly a federal creature and "matters directly affecting the nature or operation of [the lien] are federal questions, regardless of whether the federal statutory scheme specifically deals with them or not." The language of the statute specifies that there shall be a lien on "all property or rights to property" without exception. If state law were to govern the attachment, a state could place recognized property rights beyond the reach of the federal lien and, thus, produce undesirable vagaries in the federal tax collection effort. The underlying policy of federal taxation is to insure as much uniformity as possible. By permitting federal law to govern, courts would be able "to subject to the lien the wide range of property interests commanded by the sweeping language of the statute, as well as to exclude some interests as not being within the statutory purpose."

In recent years, Congress has shown a tendency to expand the category of property exempt under section 6334(a). Hopefully, it will recognize the need for uniformity with respect to protection of the homestead and expand section 6334(a) to include provisions similar to the more progressive state homestead exemptions.

STUART T. WILLIAMS

Liability Insurance—The Movable Link Between Coverage Denial and Settlement Offers

Insurance litigation has produced uncertainty about a carrier's obligations when its insured has caused damages beyond policy limits; the insurer denies coverage to its insured because it believes, in good

57. United States v. Brosnan, 363 U.S. 237, 240 (1960). The Court, however, recognized that when "Congress resorted to the use of liens, it came into an area of complex property relationships long since settled and regulated by state law." Thus the Court felt that in regards to divestiture of federal tax liens, where there existed well-established state procedures, state law should be adopted as a matter of federal policy. \textit{Id.} at 241-42. \textit{But see} Comment, 25 Sw. L.J., \textit{supra} note 38, at 460 n.43.
60. Comment, 77 \textsc{Harv. L. Rev.}, \textit{supra} note 17, at 1503.
61. \textit{See} 9 J. \textsc{Mertens, supra} note 13, at § 49.192.
faith, that the policy does not apply; and the injured party then offers settlement. At least one jurisdiction has held that the insurance company must either accept "reasonable settlement offers," despite grounds for disclaiming coverage, or face liability in excess of policy limits if a subsequent suit determines that coverage exists. Confusion has arisen because other jurisdictions, although purporting to reject this strictly liable rule, still impose excess liability on companies that have rejected settlement following a good faith denial of coverage. The purpose of this note is to show how courts are reaching this excess liability result and to suggest measures insurers can take to avoid it.

The dangers of excess liability in connection with coverage denial and settlement refusal were demonstrated in *Luke v. American Family Mutual Insurance Co.* American issued a 50,000 dollar automobile accident policy. The insured, intoxicated and driving on the wrong side of the road, collided with the plaintiffs' car, killing one person and injuring two. American did not dispute the material facts of the accident, but its thorough investigation disclosed a coverage exclusion de-
The injured parties sued the insured in a tort action in which American took no part. Before obtaining judgments, the plaintiffs offered to settle with American for 49,000 dollars, but American refused. Since the state courts had not interpreted the exclusion American was asserting, the plaintiffs offered to hold their suit in abeyance until American could file a declaratory action to determine whether coverage obtained. When American failed to seek a declaratory judgment, the plaintiffs proceeded with their suit against the insured in the South Dakota court. The plaintiffs received over 138,000 dollars in judgments and obtained from the insured an assignment of his rights against American.

The district court permitted recovery against the company but only to the limits of the policy. Cross appeals went to the Eighth Circuit Court of Appeals where a three judge panel approved the "strict liability" rule of Comunale v. Traders & General Insurance Co. and imposed liability on American for the entire judgment returned against its insured. On rehearing en banc, a sharply divided court affirmed. The three judges who heard the initial appeal adopted

6. 476 F.2d at 1017-18. The insured never applied for coverage of the accident vehicle. He relied upon a thirty day automatic coverage clause for newly acquired automobiles, which applied only if at the time of the accident American had insured "all private passenger and utility automobiles owned by the named insured on the day of its acquisition." Id. at 1017 (emphasis by the court). The insurance company argued that on the day the insured acquired the accident vehicle he legally owned a 1959 Oldsmobile, which he had driven for three months without insurance before it became disabled with engine trouble. Coverage turned upon the district court's finding "that the 1959 Oldsmobile was not an automobile owned by the named insured within the meaning of the 'automatic insurance' provisions of the policy . . . ." 325 F. Supp. at 1333, aff'd, 476 F.2d at 1017.

7. 325 F. Supp. at 1331; 476 F.2d at 1017.
8. 476 F.2d at 1020.
9. Id.
10. Id. at 1017.
11. 325 F. Supp. at 1334. In limiting liability to policy limits, the court reasoned from Kunkel v. United Security Ins. Co., 84 S.D. 116, 168 N.W.2d 723 (1969), that liability for damages in excess of policy limits would be conditioned by the South Dakota Supreme Court "upon a finding that the insurer had exercised bad faith in rejecting the settlement offer" and "upon a finding that the insurer exercised bad faith in reaching its decision not to defend." 325 F. Supp. at 1333-34. Kunkel involved an insurer who had undertaken the defense, thus it is factually distinguishable from Luke; nevertheless, Kunkel is the authority relied upon in both the district court and court of appeals opinions. The better interpretation of Kunkel seems to be that, given the court's emphasis on the jury's determining bad faith from the totality of circumstances, it does not foreclose the possibility of finding bad faith for refusing to settle when preceded by a good faith denial of coverage. This is the dissent's conclusion in Luke. 476 F.2d at 1026-27.
12. 50 Cal. 2d 654, 328 P.2d 198 (1958); see note 4 supra.
13. 476 F.2d at 1022.
14. Id. at 1023.
their previous opinion, but the three judges concurring in the result agreed with the three dissenters that the company's excess liability for refusing to settle should be based upon bad faith in not giving equal consideration to the insured's interests. Although the dissent urged that the issue of bad faith was for the jury, the concurring judges found American "guilty of bad faith in refusing to settle as a matter of law." 

Luke raises two major questions. The first is the method the concurring judges used to find American guilty of bad faith as a matter of law when, by all accounts, the company had investigated the facts, researched the available law, and interpreted its exclusion claim in a "not unreasonable" way in deciding to deny coverage. The second is the means, short of settlement, American could have employed to protect itself from excess liability. The answers involve the manipulation of the link between a good faith denial of coverage and the duty to settle.

The typical automobile liability policy provides that the insurer "shall defend . . . any suit against the insured . . . even if such suit is groundless, false or fraudulent . . . ." This standard defense clause clearly imposes a duty to defend, which the company must discharge with due care or be subject to liability for damages in excess of the policy's coverage. With some exceptions, the words "groundless, false, or fraudulent" refer to suits instituted against the insured stating allegations which, if true, would come within the scope of policy coverage. Accordingly, a claim outside policy coverage or the insured's noncompliance with the express conditions in the policy normally per-

15. Id.
16. In finding American had not acted in bad faith as a matter of law by denying coverage and refusing settlement, the district court cited American's diligence in investigating the facts and interpreting the law. 325 F. Supp. at 1334. In rejecting plaintiffs' claim for attorneys' fees, the panel on first appeal incorporated the lower court's review of American's good faith in denying coverage and found that American's refusal to pay the plaintiffs as assignees of the insured was neither "vexatious" nor "without reasonable cause." 476 F.2d at 1022-23. None of the judges on rehearing en banc challenged American's good faith in refusing to defend and denying coverage.
17. 4 W. FREEDMAN, RICHARDS ON THE LAW OF INSURANCE 2043 (5th ed. 1952); R. KEeton, Basic Text on Insurance Law 658 (1971).
mits the company to deny coverage and may remove the duty to defend. Because courts interpret coverage exclusions "equitably" instead of "functionally," however, insurance carriers are seldom confident their exclusion defenses will succeed. Even so, as long as the carrier denies coverage in good faith, losing the exclusion argument ordinarily results in liability limited to the amount of the policy plus the insured's attorneys' fees and court costs.

The standard defense clause also states the responsibilities of the insurer regarding settlement: "... the company shall have the right to make such investigation, negotiation and settlement of any claim or suit as may be deemed expedient by the company..." Although this language indicates insurer discretion, courts have consistently held carriers to a duty to settle within policy limits because of the insurer's exclusive control of the litigation and its fiduciary relationship with the insured.

Even though an insurer has denied coverage, claimants regularly offer to settle. Since few insureds can satisfy a substantial adverse judgment, the plaintiff approaches the company in hopes of receiving some payment. Although settling within policy limits might spare the carrier extra expenses if its coverage exclusion defense fails and liability is imposed up to policy limits, the company's interests normally dictate refusing settlement. Most offers are barely within policy limits; moreover, the insurer's exclusion defense may be upheld, absolving the company of any liability. The insured, on the other hand, always advocates compromise to avoid litigation and possible personal liability for damages awarded beyond policy limits. The claimant usually has nothing to lose by forcing the interests of the insurer and the insured plainly into conflict. If the company settles, the plaintiff frequently gets more than he could realize from the insured. If the com-

---

19. 7A J. Appleman, Insurance Law and Practice § 4683 (1962) states the majority rule: "An insurer's duty to defend an action against the insured is measured, in the first instance, by allegations in the plaintiff's pleadings, and if such pleadings state facts bringing the injury within the coverage of the policy, the insurer must defend..." For modifications of this rule, in which the duty to defend remains despite claims being outside the scope of the insurance contract, see R. Keeton, supra note 17, at § 7.6(a).


22. See authorities cited note 17 supra.

pany refuses, he has laid the foundation for an excess damages verdict against it.

Two factors coalesce in determining whether the insurer breaches its duty to settle: (1) the basis for imposing liability and (2) the relative consideration the carrier must give the insured's interests. The basis for liability may be bad faith (the test adopted by the majority of jurisdictions), negligence, or some variant. Alternatives under the relative consideration factor include the company's giving either "paramount consideration to the insured's interests," or "at least equal consideration to the insured's interests," or "paramount consideration to its own interests." Nearly all courts adopt the "at least equal consideration" test so that the prevailing standard used to judge the insurer's compliance with its duty to settle is that the carrier must exercise good faith in giving equal consideration to the insured's interests.

The "relative consideration" alternatives of the duty to settle are

31. In cases where the company has acknowledged coverage, the "good faith-equal consideration" test has been translated into more workable terms: "[w]ith respect to the decision whether to settle or try the case, the insurance company must in good faith view the situation as it would if there were no policy limit applicable to the claim." Keeton, supra note 24, at 841. Although this characterization gives "equal consideration" more concreteness, the problem of explaining "good faith" remains, prompting one judge to complain that "enunciation of the rule is not difficult but its application is troublesome." Farmers Ins. Exch. v. Henderson, 82 Ariz. 335, 339, 313 P.2d 404, 406 (1957). Whatever value this working formula has in determining the duty to settle when the insurer defends, it dissipates when the insurer denies coverage and refuses to defend, since policy limits would not affect a decision based on absence of liability altogether. It is this circumstance—a refusal to settle following a good faith denial of coverage—which makes application of the "good faith-equal consideration" standard most difficult and which provides the setting for Luke.
particularly important since selecting either extreme carries significant consequences. Adherence to the "paramount consideration of the insurer's interests" standard allows the insurer to resist settlement with impunity since its interests are against settling. The opposite extreme—"paramount consideration of the insured's interests"—means always having to settle and "compel[s] the conclusion . . . that the company is strictly liable for the excess if it refuses a settlement offer within policy limits."\(^{32}\) Because of these "strictly innocent" or "strictly liable" results, the middle formula of equal consideration is by far the prevailing view.

Since the exclusion defenses leading to denying coverage apply with equal force when settlement is offered, some authority supports the proposition that a good-faith-though-mistaken denial of coverage satisfies the "good faith-equal consideration" standard of the duty to settle.\(^{33}\) Emphasizing that insurers need only consider not act upon the insured's interests, many courts have decided that refusal to settle based upon a good faith denial of coverage does not extend the company's liability beyond policy limits.\(^{34}\) However, despite an insurer's good faith denial before rejecting settlement, other courts, also asserting the "good faith-equal consideration" test, have held the carrier liable for the entire judgment rendered against the insured.\(^{35}\) Luke helps explain these inconsistent rulings by exposing how courts can manipulate the link between coverage denial and settlement refusal to shift the relative consideration standard from "strictly innocent" to "strictly liable" under the guise of equal consideration. The dissent, in particular, reveals the key to how this shifting technique operates.

Judge Bright, concurring on the finding of American's coverage but dissenting on the issue of excess liability, identifies three rules used

---

32. Keeton, supra note 23, at 1145.
33. See text accompanying note 37 infra. North Carolina adheres to the rule whereby "an insurer may not be held liable for an honest mistake in judgment, even if unreasonable," in effecting settlement. Abernethy v. Utica Mut. Ins. Co., 373 F.2d 565, 568 (4th Cir. 1967) (applying North Carolina law). The requirements for liability in North Carolina frequently appear in tandem—acting with wrongful or fraudulent purpose or with lack of good faith—suggesting that something at least akin to fraud is necessary to establish bad faith. See Wynnewood Lumber Co. v. Travelers Ins. Co., 173 N.C. 269, 91 S.E. 946 (1917). Accordingly, the insurer's good faith belief that coverage does not exist should present a strong argument against showing the company acted with bad faith in refusing settlement.
34. "Undoubtedly this is an attempt to relieve the insurer from the seemingly illogical position of having to effect a final settlement when reasonable investigation indicated no liability on its part for the claim." 57 Mich. L. Rev. 775, 776 (1959).
to relate an insurer's good faith denial of coverage to its refusal to settle: the "insulation" rule, the "strict liability" rule, and the "middle" rule.\textsuperscript{38}

The dominant feature of the "insulation" rule is the recognition of a close nexus between a good faith coverage denial and the settlement refusal. In approving this rule, courts—including the district court in \textit{Luke}—have reasoned that since the same factor, \textit{i.e.} a coverage exclusion defense, has overriding effect on both the decision to deny coverage and the decision to refuse settlement, a finding of good faith as to the former necessitates finding good faith and equal consideration as to the latter.\textsuperscript{37} Denying coverage in good faith "insulates" the company from excess liability for resisting settlement. The result is the same as the "paramount consideration of the insurer's interests" extreme, even though the court proclaims earnest adherence to the "good faith-equal consideration" test. Once the company finds a defensible reason for denying coverage, it can reject settlement attempts without risking excess liability.

The "middle" view best preserves the literal meaning of the "good faith-equal consideration" standard.\textsuperscript{38} This rule appreciates the connection between a good faith coverage denial and refusal to settle but does not preclude a finding of bad faith regarding settlement. Although good faith in denying coverage works in the insurer's favor, it is merely "one of the factors" for the trier of fact in determining bad faith on the settlement question.\textsuperscript{39} Under this view, the insurer should at

\begin{footnotesize}
\begin{enumerate}
\item[36.] 476 F.2d at 1025.
\item[37.] Of the cases cited by Judge Bright in support of the "insulation rule," only the district court opinion and State Farm Mut. Auto. Ins. Co. v. Skaggs, 251 F.2d 356 (10th Cir. 1957) seem to preclude a finding of bad faith in refusing to settle once a good faith denial of coverage has been established. Taken together, the cases under the "insulation" heading advocate a view whereby a good faith coverage denial creates a rebuttable presumption that the company exercised good faith in refusing to settle. While the practical consequences may be tantamount to "insulation," a better heading for the category would focus on the presumptive, rather than insulating effects. In the interest of clarity, however, the text adopts Judge Bright's characterization.

\item[38.] By including Western Cas. & Sur. Co. v. Herman, 405 F.2d 121 (8th Cir. 1968) in the "middle" view, Judge Bright misconceives the consequences each category has on the relationship between a good faith denial of coverage and the refusal to settle. Judge Bright joined in the Herman opinion which upheld the proposition that a "good faith belief that coverage existed constitutes no excuse for its failure to settle." \textit{Id.} at 122. Furthermore, the court of appeals quotes approvingly from the court below: "The defendant gambled on the question of policy coverage and lost. They \[sic\] are required to pay the consequences." \textit{Id.} As a result \textit{Herman} properly belongs with the strict liability cases. \textit{See} text accompanying notes 41-44 \textit{infra}.

\end{enumerate}
\end{footnotesize}
least steadfastly review the situation whenever confronted with a settlement offer after having denied coverage.

*Kunkel v. United Security Insurance Co.*, the decision relied upon by the concurring opinion, clearly incorporates into its “good faith-equal consideration” standard the evidentiary relationship envisioned by the “middle” view.\(^{40}\) In applying *Kunkel*, however, the concurring judges in *Luke* only adopted the traditional two-step criteria of good faith and equal consideration and ignored *Kunkel’s* approval of the evidentiary connection between a good faith denial of coverage and the issue of bad faith in exercising the duty to settle. The concurring opinion leaves no room for interpretation:

The effect of this holding is that an insurer who breaches its contract to provide coverage is placed in *no better* and in no worse position than if it had assumed coverage when considering whether it acted in good faith in refusing to settle.\(^{41}\)

This is practically verbatim the *Comunale* or strict liability rule.\(^{42}\) Like the strict liability standard, which expressly approves of the “equal consideration” test,\(^{43}\) the concurring opinion negates the nexus between coverage denial and settlement refusal. Its instructions require the insurance company to put itself in the hypothetical circumstance of defending the insured on the merits. Since that hypothetical, by definition, rules out a good faith denial of coverage, the opinion forbids the insurer, in cases like *Luke* in which the insured is clearly at fault in causing the accident, to rely on the only reason it has for not settling. With its interest obliterated, the company has nothing with which to balance against the insured’s undiminished interest in having the settlement offer accepted. The real effect of the holding is to slide “at least equal consideration” to “paramount consideration of the insured’s interests.” As noted in the discussion of “relative interests,”\(^{44}\) the practical consequence of the latter standard is strict liability whenever an insured rejects a settlement within policy limits and coverage is later held to have obtained. Thus, acceptance of a reasonable offer is mandated.

*Luke* is a particularly valuable study in the movable link between denial of coverage and the refusal to settle since all three positions regarding the nexus issue were applied at some point in the case. The

---

40. *Id.*
41. 476 F.2d at 1023.
42. 50 Cal. 2d at 660, 328 P.2d at 202; see note 4 *supra*.
43. 50 Cal. 2d at 659, 328 P.2d at 201.
44. *See* text accompanying notes 28-32 *supra*. 
district court used the "insulation" rule, the dissent on rehearing en banc used the "middle" or "evidentiary" view, and the concurring opinion used the "strict liability" standard. Not a single judge embraced anything other than the "good faith-equal consideration" test, yet three different conclusions resulted. In fairness to judges and litigants alike, each jurisdiction should identify its position on the relationship between coverage denial and settlement refusal and make that position explicit as a third dimension of the "good faith-equal consideration" standard. Unless a clear declaration is made, the nexus issue can continue to be an escalator taking courts from "insulation" to "strict liability" under the banner of "good faith-equal consideration."

Knowing how a court reaches a decision has merit, but perhaps a more pertinent inquiry for insurers is what they can do to protect themselves in a situation like Luke. The concurring opinion implies a solution in the first reason it gives for finding bad faith as a matter of law: "[t]he record shows that once the insurer refused coverage it failed to investigate further . . . ." The material facts, however, were undisputed. The only unresolved issue was how the court would interpret the coverage exclusion defense; consequently, the only further investigation the company could have done was in court by way of declaratory judgment. By implication, the lesson the concurring judges seem to be impressing upon insurers is to be absolutely certain before abandoning the insured and only through an adjudication of rights can that certainty be achieved. Perhaps the concurring opinion had in mind a rule like the one posed by Country Mutual Insurance Co. v. Murray:

if the carrier refuses to provide its insured an unrestricted defense, yet desires to ultimately urge exclusionary coverage defenses, it must;

(1) Secure a declaratory judgment of its rights and obligations, while defending its potential insured on a reservation of rights, or

45. The second reason—not considering the excess damages its insured might suffer—begs the question whether the tortfeasor was in fact the company's insured for the purposes of the litigation instituted by the injured party and raises the issue whether the insured has suffered any damages until he actually expends his own resources to discharge the adverse judgment. For a discussion of recovery by semi-solvent insureds when there has been a bad faith refusal to settle within policy limits, see Comment, Bad Faith Failure to Settle Within Policy Limits: Recovery by Semi-Solvent Insureds, 61 Geo. L.J. 1525 (1973); Recent Decision, Insurance—Insurer's Liability for an Excess Judgement Following a Wrongful Refusal to Settle Within Policy Limits, 22 J. Pub. L. 271 (1973).

46. 476 F.2d at 1023.
LIABILITY INSURANCE

(2) Defend its potential insured on a reservation of rights and adjudicate its coverage in a supplemental suit.\(^{47}\)

In either instance the insurer can eventually argue its policy defense without risking excess liability and without abandoning the insured. Although the declaratory judgment alternative presents difficulties,\(^{48}\) its possibilities appear brightest in cases like \textit{Luke}, in which the adjudication of the insurer's rights has no bearing whatever on the insured's tortious liability.

If the concurring judges wanted to adopt the procedure outlined by \textit{Murray}, they should have done more than merely hint at their desire. Maybe the judges were simply advocating the strict liability rule, but to avoid \textit{Erie} problems,\(^{49}\) they reached the same result obliquely. The debate over the economic consequences of strict liability still rages,\(^{50}\) and the expansion of the limited-risk concept of liability insurance in connection with "no fault" has commanded national attention. Accordingly, one would hope that any attempt to hold insurance carriers to greater liability than appears in the contract of insurance would be done openly rather than through deceptive terminology.\(^{51}\)

Whatever their intent, the concurring judges have helped to expose how the relationship between good faith coverage denial and the duty to settle can be manipulated to protect insurers or to impose strict liability on them. Surely this movable link should be riveted into place so that consistent results may be achieved from application of the "good faith-equal consideration" standard.

\textit{William Richard Purdy}


\(^{48}\) See, e.g., \textit{Western Cas. & Sur. Co. v. Herman, 405 F.2d 121 (8th Cir. 1968)}.

\(^{49}\) \textit{Erie R.R. v. Tompkins, 304 U.S. 64 (1938).} Adoption of the \textit{Comunale} rule clearly would conflict with standards set forth by the South Dakota Supreme Court in \textit{Kunkel}. Despite the concurring judges' rejection of \textit{Comunale}, they repudiated the "evidentiary relationship" between coverage denial and settlement refusal espoused by \textit{Kunkel}. Thus, Judge Bright concluded that "the majority has ignored the local law in this diversity case contrary to the mandate of [Erie]." \textit{476 F.2d} at 1026.


\(^{51}\) \textit{Comunale} expressly adopted the implied contract concept to require insurers to accept reasonable offers, it has furnished valuable input in the discussion of the future of liability insurance. \textit{See} notes 2-4 \textit{supra}.