

THE WAR BETWEEN THE LAYERS

Are Excess Insurers' Claim Representatives From Venus
And Primary Insurers' Claim Representatives From Mars?

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It has been observed by a court deciding an excess versus primary case that the competing interests between an excess carrier (in this case an insured who was exposed to an excess judgment) and the primary insurer “cause them to rub against each other like unmoored rowboats on a placid pond.”¹ Why is it, in such a troubled industry, that otherwise reasonable and rational company representatives seem to lose their perspectives when they have to make judgments involving the interplay between excess and primary insurers? Given, that experienced claims executives can have different views of a liability situation or of a damage assessment. But when the pushing comes to the shoving, it appears that positions harden, good sense and caution are thrown to the winds, and these differences of opinion wind up being extensively litigated (not that the attorneys of the insurance bar are complaining) and ultimately adjudicated by a judge or judges whose collective insurance experience doesn't hold a candle to the ladies and gentlemen who started the dispute in the first place. A look at some of the recent cases decided around the country might give us some insight into how these problems arise and what can be done to avoid this test of wills that can be so costly to both sides in an excess versus primary dispute.

The litigation arising from this “eternal bickering” has taken on a number of labels, depending on which court is deciding the case. By and large, we have come to

¹ Pinto v. Allstate Insurance Company, 221 F.3d 394 (CCA 2d, 2000)

call these types of cases “bad faith” litigation, meaning, that where an excess layer is penetrated in a case where the primary carrier could have or should have settled within its available limits and didn’t, the excess insurer sues the primary insurer alleging bad faith (among other things) on the part of the primary insurer in the manner in which the underlying claim was handled and disposed of (or not disposed of, as the case may be).

Put another way, it has been held that:

Because an insurance company has exclusive control over a claim against its insured once it assumes defense of the suit, it has a duty under New York law to act in “good faith” in deciding whether to settle such a claim, and it may be held liable for the breach of that duty.²

While, in almost all situations, there is no privity of contract between an excess and primary carrier giving the excess insurer a breach of contract cause of action, the courts have fashioned a remedy, mostly commonly called “equitable subrogation.” A California court explained the concept, holding that

The excess carrier may maintain an action against the primary carrier for wrongful refusal to settle within the latter’s policy limits. This rule, however, is based on the theory of equitable subrogation. Since the insured would have been able to recover from the primary carrier for a judgment in excess of policy limits caused by the carrier’s wrongful refusal to settle, the excess carrier who discharged the insured’s liability as a result of this tort, stands in the shoes of the insured and should be permitted to assert all claims against the primary carrier which the insured himself could have asserted. Hence, the rule does not rest upon the finding of any separate duty owed to an excess carrier.³

Courts in other states have expressed similar sentiments in devising a remedy for an insured or an excess insurer where the primary carrier has allegedly put its own

² New England Insurance Company v. Healthcare Underwriters Mutual Insurance Company, 295 F.3d 232 (CCA 2d, 2002)

³ Commercial Union Assurance Companies v. Safeway Stores, Inc., 26 Cal.3d 912 (1980)

interests ahead of those of its insured (or excess insurer). In the Pinto case cited above, the dispute arose from a motor vehicle accident in which the insured vehicle owned by Bell, struck the Pinto vehicle head-on while Bell was driving the wrong way on a one-way street. Allstate, Bell's insurer, exercised Delphic wisdom and conceded liability. However, when it came to assessing damages, Allstate apparently lost sight of the fact that its policy limit was only \$100,000 and opted to try damages. Pinto claimed an assortment of injuries and although Allstate had conducted an IME, the plaintiff was never deposed. Prior to trial, Allstate offered \$30,000 to settle. During the trial, Pinto said she would accept the policy limit to settle and, although defense counsel told the claims examiner that he expected a verdict in excess of policy limits, Allstate did not change its position. During jury deliberations, the jury asked if it "could adjust the amount demanded by plaintiff" (\$1 million ad damnum). Defense counsel, not wanting to be the guy left holding the bag, advised Allstate that the inquiry by the jury should be viewed as "extremely negative" and that Allstate should be prepared for a "very large verdict." One would think that, given the liability situation, someone, somewhere in the Allstate infrastructure would have recognized the fact that defense counsel, who was holding his finger in the dike, was about to be overcome and the dam was going to give way. No such luck (or else we wouldn't be writing about the case). Jury verdict, \$350,000, reduced on appeal to \$331,200. Allstate pays Pinto \$100,000 and leaves Bell to fend for himself with respect to the overage. Plaintiff's counsel, being ever resourceful (as most plaintiffs' counsel can be when it comes to leeching dollars out of an insurance company), takes an assignment of Bell's "bad faith" claim against Allstate and brings an action to recover the difference between the policy limit and the judgment. The court, in

defining the duty owed by the primary insurer to the insured (or the excess carrier),
stated:

Although an insurance company has a contractual obligation to defend its insured, it also has a contractually defined limit of exposure to plaintiff's suit. An insurer has an economic incentive not to settle, hoping a jury will bring in a verdict for less than the policy limits. But when such hope goes awry, as it did here, the insured is the loser, being personally responsible for the excess. *** To resolve the conflict, New York implies a duty of good faith in insurance policies requiring the company — when it decides whether to settle a claim — to give the same consideration to its insured's interests as it does to its own. Good faith as defined in New York law is an intangible quality, but certainly includes the absence of a design to seek an unconscionable advantage. Generally speaking, good faith imposes a duty on the company to act in accordance with the standards of honesty, and in manner faithful to its obligations.⁴

Although the court, in holding for the plaintiff, decided the case under New York law, courts in other states have come to similar conclusions in deciding these cases.⁵ On the other hand, at least one state court has determined that, although an insured who is damaged by the insurer's bad faith has a right of action against his carrier, no such duty extends to the excess carrier in the absence of a contractual obligation.⁶

Now that we know that, in most instances, there is a duty running from the primary insurer to its insured and to the insured's excess carrier, what is the standard to be applied to the primary insurer's conduct in determining whether it has acted in "good

⁴ Pinto, *supra*, at page 396.

⁵ See, for instance, *Kransco, et al v. American Empire Surplus Lines Insurance Co.*, 23 Cal. 4th 390 (2000); *Ranger Insurance Company v. Travelers Indemnity Co.*, Court of Appeals of Florida, 389 So.2d 272, (1980); *Haddick, etc., v. Valor Insurance Company*, 198 Ill. 2d 409 (2001); *Certain Underwriters of Lloyd's, et al v. General Accident Insurance Co. of America*, 909 F.2d 228 (CCA 7th, 1990, decided under Indiana law); *Commercial Union Insurance Company v. Medical Protective Company*, 426 Mich. 109 (1986); *Continental Casualty Company v. Reserve Insurance Co.*, 307 Minn. 5 (1976)

⁶ *Federal Insurance Company, et al v. Travelers Casualty and Surety Company, et al.*, (Supreme Court of Alabama) 843 So.2d 140 (2002)

faith” in the handling of the underlying claim. A recent decision of the United States Court of Appeals for the Second Circuit, deciding a case under New York law, may give us some guidance. In that case⁷, the underlying claim was a medical malpractice action against an obstetrician and a hospital arising from brain damage allegedly sustained by an infant at birth.

Prior to the trial of the underlying case, the plaintiffs settled with the ob/gyn and offered to settle with the hospital for \$1 million, that being the limit of the primary medical malpractice policy covering the hospital. New England provided \$3 million excess coverage to the hospital. Prior to and during trial, New England sent the primary insurer five “hammer” letters noting that “plaintiff has established approximately 10 million dollars in past and future damages to the infant for rehabilitative care” and demanding that HealthCare put up its policy limit. At the conclusion of the trial of the malpractice case, the jury returned a verdict in the sum of \$9.6 million, apportioning 75% of the liability against the hospital (\$7.2 million). Thereafter, the case was settled for \$2.1 million with HealthCare paying its \$1 million and New England paying \$2.1 million.

New England, not wanting to be regarded as an excess insurer who permits its “hammer” letters to be ignored, brought a “bad faith” action against HealthCare seeking recovery of the \$2.1 million it paid in settlement. Upon the trial of the bad faith action, the jury returned a verdict in favor of New England and against HealthCare. However, the trial judge set aside the verdict, holding that, in bad faith cases, there must be “clear

⁷ New England Insurance Company v. HealthCare Underwriters Mutual Insurance Company, *supra*.

liability” on the part of the insured for the excess carrier to succeed in the bad faith litigation.⁸

The Circuit Court held a different view. In reversing the District Court and reinstating the bad faith verdict, the Court of Appeals stated that the standard for determining whether a primary carrier acted in “bad faith” is a multi-factor test:

Bad faith may only be found where the insurer acts in gross disregard of the excess carrier’s interests, not where the insurer is merely negligent (citing cases). “Gross disregard” means “a pattern of behavior evincing a conscious or knowing indifference to the probability that an insured would be held personally accountable for a large judgment if a settlement offer within the policy limits were not accepted (citing cases). Bad faith does not require a “sinister motive.”

It may be of some comfort to the primary claims executive facing a bad faith suit to know that whether or not he or she had a “sinister motive” in failing or refusing to settle within policy limits is of no moment. The court went on:

In assessing gross disregard, the jury must first consider and balance a number of . . . factors among others, “the plaintiff’s likelihood of success on the liability issue in the underlying action, the potential magnitude of damages and the financial burden each party may be exposed to as a result of a refusal to settle. (citing cases). Other factors indicative of bad faith include the insurer’s failure to properly investigate the claim and any potential defenses thereto, the information available to the insurer at the time the demand for settlement is made, and any other evidence which tends to establish or negate the insurer’s bad faith in refusing to settle. (citing cases).

These judicial pronouncements would seem to be the basic material found in any well-written claims handling manual. Should the primary settle if the underlying plaintiff has “a likelihood of success on the liability issue” and the insured may be exposed to substantial damages in excess of the policy limit if the case is not settled? Seems like a

⁸ 146 F. Supp.2d 280 (U.S.D.C., E.D.N.Y., 2001)

no-brainer. Was the case properly prepared and defended? If the facts of the underlying case cried out for an accident reconstruction expert or any other type of expert and the claims file has a void where the expert's report should have been, you had better call the plaintiff's attorney before the case gets to trial. Did defense counsel cover all the bases: depositions, IMEs, etc? If not, and you let the case go to verdict because you had a "gut" feeling that it would turn out alright, you had better get your resume up to date.

Courts in other states appear to echo the view that a number of factors will be considered in determining whether an insurer has exercised good faith in the manner in which it dealt with its insured or the insured's alter ego, the excess carrier. Some courts, however, have erected a higher barrier for the insured or excess carrier to overcome in order to establish a bad faith case. In a Massachusetts case, the court, after opining that an insurer will be held to a standard of reasonable conduct in its defense of its insured, went on to define what it had in mind when laid down this "negligence" standard:

The negligence standard by which the actions of an insurer concerning settlement will be tested hereafter will be in practice not significantly different from the good faith test that has been evolving in this Commonwealth. The test is not whether a reasonable insurer might have settled the case within policy limits, but rather whether no reasonable insurer would have failed to settle the case within the policy limits. This test requires the insured (or its excess insurer) to prove that the plaintiff in the underlying action would have settled the claim within policy limits and that, assuming the insurer's unlimited exposure (that is, viewing the question from the point of view of the insured) no reasonable insurer would have refused the settlement offer or would have refused the offer.

Thus, the trial of the “bad faith” case may boil down to a battle of experts, that is, one expert or set of experts stating that “no reasonable insurer” would have failed to settle within policy limits and the other testifying that many, if not all, “reasonable insurers” would not have settled the underlying claim. That view of the situation sought of puts us back where we started: are excess insurers’ claim representatives from Venus and primary claims personnel from Mars? It would seem that most experienced claims professionals have worked in both capacities in their careers so that there should not be this seemingly unbridgeable chasm between their respective positions in any given case.

Another interesting permutation of this “war between the layers” arose in a California case when the insured, a manufacturer of toy water slides, sued its primary carrier for failing to settle within policy limits.⁹ The defendant-insurer argued that the insured’s own bad faith (it failed to truthfully disclose in the underlying action that its product had a history of accidental injuries) was a contributing cause of the excess verdict and should work to reduce the primary carrier’s exposure in the bad faith action. Sounds reasonable enough, and seemingly an application of the “clean hands” doctrine which is a basic tenet of the law of equity (remember, we’re dealing with equitable subrogation). Not so, said the California court (surprise! surprise!), quite to the contrary. After setting forth the California law respecting bad faith, the court went on:

Most importantly however, and as recognized by the Court of Appeal below, to have any meaning, the express promise of a liability insurer to defend and indemnify the insured against injury claims, and the implied duty to reasonably and in good faith settle third party claims within policy limits in an appropriate case, must extend to insureds that are less than perfect litigants. An insured’s

⁹ *Kransco, et al. v. American Empire Surplus Lines Insurance Co.*, 23 Cal, 4th 390 (Supreme Court of California (2000))

known weakness as a litigant should inform the insurer's assessment of the likelihood of an excess judgment, not diminish the insurer's obligation to reasonably accept settlement offers within policy limits (citing cases).

Although holding that the insurer may not be without a remedy for an insured's litigation misconduct (breach of contract defense to the bad faith action; breach of the cooperation clause thereby voiding coverage or a separate breach of contract claim), the court concluded:

An insurer may not, however, assert an insured's comparative bad faith as an affirmative defense to partially absolve itself of its own tort liability for breach of the covenant of good faith and fair dealing.

From our perspective, it would seem that the most effective use of demonstrating an insured's litigation misconduct would be in the bad faith suit and that it would certainly lose its impact if it had to be litigated in another forum or a separate case.

CONCLUSION

The volume of reported cases dealing with excess / primary litigation is of such magnitude that time and space constraints make an exhaustive survey prohibitive, short of writing a treatise. But as one reads through the cases (and we have read many), there is a thread, that in one degree or another, binds the judicial interpretations together. Whether the courts speak of the "negligence" of the primary insurer or the duty of good faith, the bottom line appears to be the use of good common sense. If the file handler for the primary insurer receives a "hammer" letter from the excess carrier or its attorney, perhaps, instead of "digging in" and vowing to litigate the claim to the bitter end, he or she should pick up the telephone or send an e-mail to the writer explaining the primary carrier's position and pointing out the reasons the case might be defensible.

By the same token, the excess insurer's claims representative should be sure of all the facts and figures in the file and a reasonable assessment of the liability and damage exposure has been made before dashing off a demand to settle. Thus, by putting to use the collective experience of the respective file handlers and their supervisors and by keeping the lines of communication open between them, perhaps the time and expense of much of the bad faith litigation that abounds (and a lot of trees) could be saved and the wars between the primary and excess layers of coverage could be abated.