Obligations of the Insurer to the Insured in Litigation and Settlements: Avoiding Bad Faith Claims

Eric L. Zalud*
J. Philip Nester**

Litigation

To avoid a claim of bad faith, an insurance company generally has to act reasonably and in a timely manner to reported claims, and to its insured. An insurer must have a reasonable justification for the positions that it takes regarding its contractual duties owed to its insured under the insurance policy, especially where there are potential coverage-related issues in connection with the facts or circumstances of a claim. In this regard, insurers are required to:

- Timely acknowledge the receipt of the claim.
- Promptly investigate whether there is coverage.
- Timely communicate any coverage decisions to the policyholder.
- Properly and timely reserve rights under the policy, where appropriate, based upon the facts and applicable law, and provide written notice to the policyholder of the same.
- Retain competent defense counsel (or coverage counsel if necessary).
- Objectively evaluate, on an ongoing basis, the liability exposure to the policyholder and act to protect the policyholder's interests.

Settlement

Policy Limits.

Losses may give rise to potential damages that are so large that they exceed the applicable insurance policy limits. In cases such as these, the insured (if it does not have excess or umbrella coverage) becomes, in essence, the excess insurer, as it will be "on the hook" for any verdict or judgment award that exceeds its policy limits.

In these situations, what duty does an insurer owe to its insured to settle a claim within the policy limits when there is a possibility that, if taken to trial, a verdict could exceed the policy limits and thereby require the insured to make up the difference?

Settlement Obligations.

An insurer is not necessarily liable for refusing to settle a claim brought against the insured for an amount within the policy limits. The mere fact that insurer refuses to settle within policy limits is not itself conclusive of bad faith and does not automatically give rise to tort liability,[1] and in absence of bad faith a liability insurer is generally free to settle or litigate at its own discretion, without incurring liability to its insured for a judgment in excess of the policy limits.[2]

Duty of Good Faith.

An insurer can be found liable to its insured for refusing to settle a claim brought against the insured for an amount within the policy limits if it fails to act in good faith regarding settlement of the claim and, as a result, exposes the insured to additional liability that is over and above the policy limits. A decision by the insurer to expose the insured to direct out-of-pocket money damages must be grounded upon an honest and well-founded belief by the insurer that the facts and circumstances of the case indicate that there is a reasonable possibility of a verdict for the insured, or a verdict within the policy limits.

Standards in Various Jurisdictions.

The reasonable justification standard is used to determine whether an insurer has breached its duty to act in good faith towards its insured. Under this standard, the insurer must base its conduct upon circumstances that provide a reasonable justification for its actions. However, the insurer's intent is not necessarily an element of the reasonable justification standard.[3] Other courts find that to establish an insurer's bad faith in failing to settle a claim, the insured must prove that the insurer's conduct constituted a "gross disregard" of the insured's interest – that is, a deliberate or reckless failure to place on equal footing the interest of its insured with its own interests when considering a settlement offer.[4] Still other courts find that an insurer, as a professional defender of lawsuits, is held to a higher standard than an unskilled practitioner such that what may be neglect on the part of the latter, may constitute bad faith on the part of the insurer.[5]

* Co-Chair, Transportation & Logistics Practice Group, Benesch (Cleveland, OH)
** Associate, Benesch (Cleveland, OH)

Duty of Good Faith/Interests in Conflict.

The insurer has a duty to act in good faith even when its interests conflict with its insured's interests. In these situations, the insurer must devote an equal degree of attention and concern for the interests of the insured as it would for its own interests in the matter. This duty does not require the insurer to place the interests of the insured above its own interests, but on an equal basis with it.[6] The insurer should evaluate such claims without considering the policy limits and as though it alone would be solely responsible for the potential exposure in the event that an unfavorable judgment is rendered against its insured. Generally, the insurer must conduct itself with the same degree of care that would be used by an ordinary prudent person in the management of his or her own business. Other courts have diverged somewhat from this plateau of equal interest and held insurers to more rigorous and higher standards and obligations. As the Court in *Maryland Cas. Co. v. Dixie Ins. Co.* summarized, "[t]he interests of the insured are paramount to those of the insurer, and the insurer may not gamble with the funds and resources of its policyholders."[7]

Checklists – Good Faith.

Basic elements involved in an insurer's good faith negotiation, settlement, and defense of a claim include the following handy checklist:

- Appropriate conferences and touchpoints between the insured's trial counsel and the insured.
- Appropriate and adequate investigation of the facts and circumstances of the accident or occurrence giving rise to the claim, including acts of the persons involved and other physical facts present (e.g., for a motor vehicle accident, the highway conditions, weather, traffic conditions, and traffic control devices).
- Insurance counsel should formulate an advisory opinion as to the applicable legal bases for the parties' claims and defenses, based upon the information gathered during the investigation and convey the same fully and accurately to the insured.
- The insurer and its counsel should formulate a general determination of the degree of liability, if any, of the insured, and share this information with the insured, including an analysis of the applicable liability laws in the jurisdiction where the claim arose or the lawsuit is venued (especially where there are multiple tortfeasors or the plaintiff contributed to the loss).
- The insurer has a duty to look to settle within the policy limits where there is a reason to believe that the claim against the insured is meritorious and the reasonable expectation of successfully defending the action is negligible.
- The insurer should inform the insured of all offers to settle the claim, and particularly those that are at or near the policy limits. This communication affords the insured the opportunity to engage in settlement discussions and to make appropriate offers of contribution toward settlement (if any).

Checklists – Bad Faith.

Courts have identified combinations of underlying situations and litigation developments that are indicative of an insurer's bad faith:

- Evidence of liability and damages that are overwhelmingly against the insured, which are not disclosed or shared with the insured.
- The insurer recognizes that a settlement is advisable, but does not make an attempt to get the insured to contribute, or the insurer fails to discuss the idea of contribution with the insured. An inference of bad faith may arise even though claimant's settlement demand equals or exceeds policy limits if the insured is not informed of its right to contribute to excess in order to achieve settlement.[8]
- The insurer cannot appropriately assess the potential exposure or probabilities of the case because it failed to investigate the claim properly or fully.
- The insurer rejected the advice of its attorneys or agents urging a settlement.
- The insurer failed to act on compromise offers within or near the policy limit.
- The insurer offered an unreasonably low settlement at the time of trial after receiving a reasonable compromise offer to settle.
- The insurer failed to inform the insured of settlement negotiations and other information throughout the litigation or failed to consider the interests of the insured when rejecting a settlement demand. Such conduct on the part of the insurer can constitute breach of covenant of good faith and fair dealing.[9]

Summary/Communications.

Generally, the most important factor in these analyses is whether or not there was an open line of communication concerning the tripartite relationship: namely, between the insurer and its counsel (if any) and the insured and its counsel (if any). This line of communication must be open with regard to litigation tactics and decisions, both formal and informal discovery and the fruits of that discovery, and – of utmost importance – any potential settlement developments or offers conveyed by the counterparty. When the tripartite relationship is functioning smoothly, with full and open lines of communication, the risks to the insurer of bad faith allegations, and commensurate headaches for the insured, are minimal. After all, neither of those two involved parties benefits from a bad faith situation.

Endnotes

1 *Hoskins v. Aetna Life Ins. Co.*, 6 Ohio St.3d 272, 276, 452 N.E.2d 1315, 1320 (1983).
2 *Gourley v. Prudential Pro. & Cas. Ins. Co.*, 734 So.2d 940 (La. App. 1999).
3 *Zoppo v. Homestead Ins. Co.*, 71 Ohio St.3d 552, 555, 644 N.E.2d 397, 400 (1994).
4 *See, Pavia v. State Farm Mut. Auto Ins. Co.*, 82 N.Y.2d 445, 453, 605 N.Y.S.2d 208, 626 N.E.2d 24 (1993).
5 *See, Keith v. Comco Ins. Co.*, 574 So.2d 1270, 1277 (La. App. 1991).
6 *Netzley v. Nationwide Mut. Ins. Co.*, 34 Ohio App.2d 65 73, 296 N.E.2d 550, 558 (1971); *Farmers' Ins. Exchange v. Schropp*, 222 Kan. 612, 567 P.2d 1359 (1977); *Levier v. Koppenheffer*, 19 Kan. App. 2d 971, 879 P.2d 40, 46 (1994).
7 622 So.2d 698, 701 (La. App. 1993).
8 *Redcross v. Aetna Cas. & Sur. Co.*, 688 N.Y.S.2d, 817, 820 (1999).
9 Farmers Ins. Exch. v. Jacobs, 75 Cal.App.4th 373, 89 Cal.Rptr.2d 222, 226 (1999). See also, *Prosser v. Leuck*, 225 Wis.2d 126, 137, 592 N.W.2d 178, 182 (1999); and *Redcross, supra.*