California - In Search of a Solution for Excess Liability Problems

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CALIFORNIA—IN SEARCH OF A SOLUTION
FOR EXCESS LIABILITY PROBLEMS

The typical liability insurance policy reserves to the insurer the sole right of settlement.\(^1\) Under certain circumstances an insurer may be held liable to its insured for its failure to settle.\(^2\) If a claimant offers to settle within policy limits \textit{and} the insurer rejects the offer \textit{and} the judgment at trial is in excess of the policy limits, the stage is set for an excess liability suit.

That the policyholder may have a cause of action for failure to settle in the above situation is accepted by most jurisdictions today.\(^3\) These courts recognize that the insurer, by reserving the right to accept or reject settlement, can adversely affect the interests of its insured; a decision by the insurer not to settle within policy limits comes into conflict with the insured's natural desire to settle and avoid the risk of a judgment in excess of the policy limits.\(^4\) The courts believe that the insurance carrier's power to control settlement and thereby affect the interests of its policyholder should be coupled with responsibility for its exercise.\(^5\)

There is some disagreement among the jurisdictions recognizing the cause of action as to whether the theory of the insurer's liability is founded upon contract or tort. The majority of these jurisdictions understand an insurer's liability to lie in tort.\(^6\) These courts view the insurer's duty as arising from the nature of the relationship between

\(^1\) \textit{E.g.}, a common form of this reservation provides that the insurer "[M]ay make such investigation, negotiation, and settlement of any claim or suit as it deems expedient." Keeton, \textit{Liability Insurance and Responsibility for Settlement}, 67 Harv. L. Rev. 1136, 1137 (1954).


\(^3\) Evans, \textit{The Practical Handling by Defense Counsel of Lawsuits in Excess of Policy Limits}, 1960 Ins. L.J. 565, 566.


\(^5\) "The insurance company, of course, being in the business, plays the law of averages. The policyholder who is in court perhaps for the only time in his life cannot afford to concern himself with 'averages.' There is no averaging so far as he is concerned—this is \textit{his} lawsuit. It may be the only time he will ever be in court and he is definitely concerned about what his risk of personal loss may be. He cannot afford to gamble, even if the company can. If his policy limits were high, then he could relax—but usually the company would then be quick to settle to avoid the risk of greater loss. This being true, the use of 'averages' would tend to indicate that the insurer is, to some extent, willing to permit the risk of loss to fall upon the insured." \textit{Id.} at 554.


\(^6\) J. Appleman, \textit{Insurance Law And Practice}, §§ 4711-12 (1962); Keeton, \textit{supra} note 5 at 1138 n.5.
insured and insurer. The minority of the jurisdictions recognizing the cause of action hold that the insurer's liability arises out of the "implied covenant of good faith and fair dealing" which is found in every contract.\(^7\)

Superimposed on these differing theories of liability is a disagreement as to the standard of care imposed on the insurer. A majority of jurisdictions hold that the insurer is required to exercise good faith toward the insured's interests.\(^8\) The minority view is that the insurer must act as the reasonable prudent businessman would act in considering the interests of the insured. The majority standard of care is often called the "bad faith test," whereas the minority standard is called the "negligence test."\(^9\)

The above diversities of approach are evidenced in the development of excess liability law in California. This comment will explore the problems which result from the confusing nature of California's excess liability law and will suggest a solution.

**EXCESS LIABILITY IN CALIFORNIA**

**The Theory of Liability**

In *Brown v. Guarantee Ins. Co.*,\(^{10}\) the court surveyed the various theories of liability upon which a cause of action for failure to settle could be predicated.

The solution may be sought in the terms of the policy itself, and the court may attempt to resort to contract law. Or the insurer may be viewed as a fiduciary, possibly as an agent, and thereupon the court will employ the principles of law which govern an agent's relationship to his principal. In such situations the law generally demands good faith. Or the courts may turn to tort law and hold that the insurer in dealing with the defense, including the matter of settlements, must exercise due care.\(^{11}\)

Relying on a Wisconsin decision,\(^{12}\) the court decided that the cause of action stems from the clause in the insurance contract granting the absolute power of settlement to the insurance com-

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\(^7\) 1967 Wis. L. Rev. 483, 491; see Uniform Commercial Code § 1-203.

\(^8\) Annot., 40 A.L.R.2d 168, 171, 178 (1955). This annotation sets forth the various states accepting either the bad faith or negligence test and provides examples of the various factual circumstances which have been held to constitute an insurer's bad faith or negligence.

\(^9\) Id.


\(^{11}\) Id. at 683, 319 P.2d at 71. The court quoted Georgia Life Ins. Co. v. Mississippi Cent. R. Co., 116 Miss. 114, 76 So. 646 (1917).

\(^{12}\) Hilker v. Western Auto. Ins. Co., 204 Wis. 1, 235 N.W. 413 (1931).
pany. The insurer's power to accept or reject settlement offers was held to create an implied contract between the insurer and the insured whereby the insurance company agreed to act in good faith toward the insured's interests.

Although Brown spoke of an implied contract between the insured and insurer, the court, in the course of discussing the assignability of the cause of action, stated that the insured's cause of action was assignable even if it did arise out of tort. The Brown decision, therefore, seems to imply that the cause of action for failure to settle sounds in contract and in tort.

A year later, the California Supreme Court affirmed Brown in Comunale v. Traders & General Ins. Co. and stated that the cause of action could be assigned regardless of whether the action sounded in tort or contract. Comunale recognized that a wrongful refusal to settle has generally been treated as a tort, but stated that when a case sounds both in contract and tort the insured will have an election between the two actions.

Comunale apparently did not eliminate all confusion as to whether the theory of the cause of action is based on contract, tort, or both. The district court of appeal in Critz v. Farmers Ins. Group (decided six years after Comunale) stated:

Prior to the Comunale decision, it was not clear whether the policyholder's claim against the insurer sounded in tort or contract. In California at least, the Comunale decision established breach of an implied covenant as the theoretical basis of the claim.

The most recent case on excess liability is Crisci v. Security Ins. Co. In Crisci the Supreme Court of California unanimously disapproved of the above language in Critz, approved of Comunale as to the insured's right of election between tort and contract, and

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16 50 Cal. 2d 654, 328 P.2d 198 (1958).
17 Id. at 661, 328 P.2d at 202. The Comunale case is unique in that the insurer was found liable not only for its failure to defend but also for its failure to settle.
18 Id. at 663, 328 P.2d at 203. The court cited Eads v. Marks, 39 Cal. 2d 807, 811, 249 P.2d 257, 260 (1952), as authority for plaintiff's election of an action in tort or contract.
20 Id. at 799, 41 Cal. Rptr. at 407.
stated that the breach of the implied covenant also constitutes a tort.\textsuperscript{22}

That the cause of action for failure to settle sounds both in tort and contract has far reaching consequences. For example, the theory of liability pursued may be highly significant in determining which statute of limitations applies to the cause of action. If, in \textit{Comunale}, the court had not permitted an election, the assignee of the insured's cause of action would have been barred by the tort statute of limitations.\textsuperscript{23}

Similarly, the theory of liability elected in the \textit{Crisci} case was of paramount importance. The district court of appeals found that in actions against the insurer for failure to settle, tort damages for mental suffering could not be awarded because "[I]n California we treat such actions as sounding in contract."\textsuperscript{24} The supreme court, however, upheld the trial court's precedent-setting $25,000 award for mental suffering, citing a previous California Supreme Court decision, \textit{Eads v. Marks}.\textsuperscript{25}

In \textit{Eads} the court stated:

A tort may grow out of or be coincident with a contract, and the existence of a contractual relationship does not immunize a tortfeasor from tort liability for his wrongful acts in breach of the contract.\textsuperscript{26}

\textit{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. That the insured or his assignee is now allowed complete freedom of election necessarily expands the insurer's liability.

\textit{Measuring the Insurer's Duty}

The confusion in California surrounding the duty the insurer owes its insured in settlement negotiations has not been eliminated. The decisions from \textit{Brown} to \textit{Crisci} have developed an amorphous standard of good faith-reasonableness to measure the insurer's duty.

\textsuperscript{22} \textit{Id.} at 443, 445, 426 P.2d at 178-79, 58 Cal. Rptr. at 18-19.


\textsuperscript{25} \textit{Eads} v. \textit{Marks}, 39 Cal. 2d 807, 249 P.2d 257 (1952). \textit{Crisci} as well as \textit{Comunale} relied on the \textit{Eads} decision.

\textsuperscript{26} \textit{Id.} at 811, 249 P.2d at 260. The court explained, "[T]hat if the cause of action arises from a breach of promise set forth in the contract, the action is \textit{ex contractu}, but if it arises from a breach of duty growing out of the contract it is \textit{ex delicto}." \textit{Id.} at 811, 249 P.2d at 260.
As stated above, the *Brown* decision held that the insurer, as a result of an implied contract, owes a duty of good faith toward the interests of its insured.\(^{27}\) California, therefore (at least in theory), accepted the bad faith test recognized in the majority of jurisdictions: "[S]ubstantial culpability . . . bad faith rather than mere negligence."\(^{28}\) *Brown* set forth various factors to be considered in determining whether the insurer reached its duty of good faith.

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\text{[T]he strength of the injured claimant's case on the issues of liability and damage; attempts by the insurer to induce the insured to contribute to a settlement; failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; the insurer's rejection of advice of its own attorney or agent; failure of the insurer to inform the insured of a compromise offer; the amount of financial risk to which each party is exposed in the event of a refusal to settle; the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and any other factors tending to establish or negate bad faith on the part of the insurer.}\(^{29}\)
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The foregoing factors used in determining bad faith are difficult to distinguish from negligence. One writer has said, "[T]his importance of basing liability on bad faith rather than negligence is winked at by our courts."\(^{30}\)

In *Comunale* the court held that an insurer is liable for breach of the implied covenant of good faith when it refuses to accept a *reasonable* settlement within the policy limits.\(^{31}\)

The insurer, in deciding whether a claim should be compromised, must take into account the interest of the insured and give it at least as much consideration as it does to its own interests. . . . When there is great risk of a recovery beyond the policy limits so that the most *reasonable* manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim. Its unwarranted refusal to do so constitutes a breach of the implied covenant of good faith and fair dealing.\(^{32}\) (emphasis added)

*Comunale* has been criticized because, while the court spoke in terms of bad faith, it was in reality, by referring to a "reasonable

\(^{28}\) *Id.* at 688, 319 P.2d at 74.
\(^{29}\) *Id.* at 689, 319 P.2d at 75. For a list of additional factors the California courts have held to evidence bad faith see 18 *Stan. L. Rev.* 475, 478 (1966).
\(^{32}\) *Id.* at 659, 328 P.2d at 201.
manner," applying a test of negligence.\textsuperscript{33} Similarly, the decision of \textit{Davy v. Public Nat'l Ins. Co.}\textsuperscript{34} has been often criticized for stating, 
\"[U]reasonable rejection of an offer of compromise constitutes bad faith. . . .\"\textsuperscript{35}

Nonetheless, the \textit{Crisci} opinion embraces the language quoted above. \textit{Crisci} states that the implied obligation of good faith and fair dealing requires the insurer to settle "when appropriate."\textsuperscript{36} The insurer must give at least equal consideration to the interests of its insured.\textsuperscript{37} The test of whether the insured's interests were given at least equal consideration is "[W]hether a prudent insurer . . . would have accepted the settlement offer."\textsuperscript{38}

The good faith-reasonableness test has the effect of increasing the insurer's duty. While placing a heavier duty on the insurer may be desirable, the use of the good faith-reasonableness test creates unnecessary confusion and hardship.

\textbf{Resulting Problems and Hardships}

It is undisputed that good faith is a subjective test of an individual's state of mind, whereas negligence is an objective test measured by the reasonable prudent man standard.\textsuperscript{39} Aside from the apparent judicial inclination to increase the insurer's duty, the courts may have interjected an objective standard of reasonableness because of the evidentiary difficulty in finding subjective bad faith. However, measuring the insurer's duty by an objective standard also presents difficulties:

\begin{quote}
Just as the trier of fact cannot see into the mind or soul of a corporation, it encounters prohibitive difficulty in isolating the care of the reasonably prudent insurance company. . . .\textsuperscript{40}
\end{quote}

A California jury trying to apply a mixed good faith-reasonableness test is faced with a doubly confusing and unsatisfactory standard.

The present standard of good faith-reasonableness also confuses the insurer trying to plan its future conduct. Aside from case-by-case factual determination as to what constitutes bad faith, the insurance company attempting to meet its duty of settlement has no concrete

\textsuperscript{33} Jarrett, \textit{supra} note 30 at 60.
\textsuperscript{34} 181 Cal. App. 2d 387, 5 Cal. Rptr. 488 (1960).
\textsuperscript{35} \textit{Id.} at 395, 5 Cal. Rptr. at 492 (emphasis added).
\textsuperscript{37} \textit{Id.} at 440, 443, 426 P.2d at 176, 178, 58 Cal. Rptr. at 16, 18.
\textsuperscript{38} \textit{Id.} at 440, 426 P.2d at 176, 48 Cal. Rptr. at 16 (emphasis added).
\textsuperscript{39} Roos, \textit{A Note on the Excess Problem}, 26 Cal. Sr. B.J. 355, 357 (1951).
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guidelines. The insurer can only speculate as to what new factual circumstances a court will consider in determining whether there has been a breach of duty. As a result of these peculiarly speculative guidelines, the insurer is faced with a dilemma. It must choose between a settlement which may be unnecessarily large and a course of litigation which may be unpredictably hazardous. If the insurer chooses to defend, and the plaintiff prevails in his action against the insured, the loss is compounded by the cost of the ensuing excess liability action.

Thus, under the existing law, the insurer feels insecure whenever it refuses to settle even though it believes it has acted within the limits of the good faith-reasonableness test. Therefore, throughout the investigation of the initial claim, the insurer and its attorney are tempted to build an elaborate facade of reasonableness in anticipation of an excess liability action. "The attentions of insured, company, and their attorneys are diverted from defense against the tort claim of claimant to jockeying with each other for favorable positions with respect to the potential claim for excess liability."41

As a practical matter, the insurance company's efforts to protect itself in settlement negotiations are often of little avail if a judgment is rendered in excess of policy limits. Even though the insurer might have made an honest mistake it will be hard-pressed to explain why the trial court found that the claimant was entitled to damages in excess of the policy limits.42 Similarly, the insurer will have difficulty explaining to the jury in the excess liability action why its experienced claims adjusters miscalculated the extent of damages.

When these explanatory difficulties are coupled with the problem of overcoming a jury's inherent tendency to be prejudiced against an insurer, the task of justifying a failure to settle becomes nearly impossible. Juries have been criticized as being prone to exercise the "deep pocket" theory when dealing with insurers.43

Even if the jury in the excess liability suit is not inherently prejudiced against the insurer, it is quite probable that they will be sympathetic toward the insured. The average jury will include a number of policyholders who will sympathize with the plight of the insured.44

44 Id. at 480. The author also points out that the insurance companies' chances of
It is apparent, considering the above-mentioned inferences and prejudices, that an insurance company facing an excess liability action will find itself in a position approaching strict liability.

**Strict Liability—A Desired Solution**

It has been suggested that a solution to excess liability problems would be to hold the insurer strictly liable for the excess judgment which resulted from the insurer's rejection of a claimant's offer to settle within policy limits. However, the commentators who have lauded the benefits of strict liability as a solution, have usually concluded on a pessimistic note by saying that strict liability will probably not prevail because of judicial precedent to the contrary.

Although the court in *Crisci v. Security Ins. Co.* did not decide the case on strict liability, it did expound the benefits of the imposition of a rule of strict liability as suggested by amicus curiae. Basically, the rule would be that an insurer is strictly liable for the amount of any final judgment in excess of the policy limits whenever such insurer rejects a firm offer to settle within the policy limits.

The court pointed out that it is not uncommon for an insured to expect that, in case of a claim against him, the insurer will make available a sum of money equal to the policy limits. The court stated:

> In view of such expectation an insurer should not be permitted to further its own interests by rejecting opportunities to settle within the policy limits unless it is also willing to absorb losses which may result from its failure to settle.

There is more than a small amount of elementary justice in a obtaining reversal of an excess liability verdict are slim. "Of the eleven appellate cases in California, the insurer has lost ten, and the authority for the remaining one is doubtful."

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46 See secondary authorities cited note 45 supra.

47 *Crisci v. Security Ins. Co.*, 66 A.C. 435, 441-42, 426 P.2d 173, 177, 58 Cal. Rptr. 13, 17 (1967). After noting the beneficial aspects of strict liability the court stated, "[W]e need not, however, here determine whether there might be some countervailing considerations precluding adoption of the proposed rule because... the evidence is clearly sufficient to support the determination that Security breached its duty..." *Id.* at 442, 426 P.2d at 177, 58 Cal. Rptr. at 17.


50 *Id.*
rule that would recognize 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.\textsuperscript{51}

Similarly, it is only fair that a policyholder who has paid for a stated amount of protection should not shoulder the risk of an excess judgment when the insurance company, by accepting a settlement offer, can provide protection within the policy limits.\textsuperscript{52} Strict liability would place the risk of an excess judgment on the insurer if such insurer insisted on litigating the claim.

That the insurer shoulders the risk does not necessarily mean that it will be forced to settle sham claims or be forced to accept an unreasonably high settlement offer. The insurer will still fight these suits and, if correct in assuming the suit was a sham or the settlement offer was unreasonable, the verdict will probably be for the defendant, or damages will at least be within policy limits. As pointed out by amicus curiae in \textit{Crisci}:

There will be cases in which there will be surprise, but the very efficiency and knowledge of the insurance industry is the best guarantee that those will be minor in number.

If that were not true, and judgments in excess of the policy limits following a refusal to settle \textit{will} be the rule—rather than the rare exception—then what sort of light does that cast upon insurance companies? To say that is to say that bad faith is the rule, or negligence, or breach of implied covenant of fairness, or what-have-you.\textsuperscript{53}

The court in \textit{Crisci} was well aware that insurance companies sometimes play the law of averages and go to trial gambling on a verdict for the defense.

The proposed rule would also eliminate the danger 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.\textsuperscript{54}

Under a rule of strict liability, if an insurer wished to gamble it would be free to do so but would be absolutely liable for any resulting judgment for the claimant.

The California Supreme Court recognizes that there are strong inferences and prejudices against an insurer.\textsuperscript{55} As previously noted,

\textsuperscript{51} Id. at 441-42, 426 P.2d at 177, 58 Cal. Rptr. at 17.
\textsuperscript{52} 60 \textit{Yale L.J.} 1037, 1041 (1951).
\textsuperscript{55} Id. at 442, 426 P.2d at 177, 58 Cal. Rptr. at 17.
a jury trying an excess judgment case would probably find these inferences conclusive. Therefore, a rule of strict liability would not necessarily be a disastrous blow to the insurance industry, for in the great majority of cases the insurer will continue to be found liable in excess judgment actions, regardless of whether a rule of strict liability is applied or the amorphous good faith-reasonableness test is followed.

Perhaps the prime practical advantage to be gained from a rule of strict liability is that it would substitute a consistent, predictable method of determining liability. Crisci recognized this advantage of a rule of strict liability. "The proposed rule is a simple one to apply and avoids the burdens of a determination of whether a settlement offer within the policy limits was reasonable."56

If the solution of strict liability were adopted, the insurer, insured, and the claimant, who is the potential assignee of the insured's excess liability action, would not feel compelled to prolong settlement negotiations because there would be no need to jockey for favorable positions in contemplation of an excess liability action.57 It is evident that, if an insurance company clearly realizes that it bears the risk of an excess judgment, it will either settle promptly or litigate.

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.58 If it chose to litigate, and suffered an excess judgment, it would pay and save the expense of defending an excess liability action.59

Even without considering the insurer's litigation expenses it is doubtful, "[W]hether the cost of making reasonable settlements in the majority of cases would largely exceed the cost of meeting the occasional excess judgment for which the insurer is now held liable."60 Also, if the rule of strict liability did increase the insurer's

56 Id. at 441, 426 P.2d at 177, 58 Cal. Rptr. at 17.
57 See authorities cited at note 41 supra.
58 Brief for Edward L. Lascher as Amicus Curiae at 16, Crisci v. Security Ins. Co., 66 A.C. 435, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). "The case at bar is a vivid example . . . [W]ith a $10,000 policy, the company could have settled for $9,000 of which the insured would have contributed $2,500, for a net expense to the company of $6,500. Instead, it spent some $18,000 on defense of the initial action and probably not much less in defending the present action." Id. at 16.
59 Id. at 13-14. "Under a rule of strict liability there would be scant reason for trial of the second action, except for the predictably rare case in which fraud or the like were present . . . [I]nsurance companies are not managed by fools, and there is no point in defending a case which cannot be won . . . ." Id. at 14.
costs, the insurance industry would be in a unique position to distribute losses to its policyholders.61

It is submitted that the benefits of a rule of strict liability are apparent and outweigh the possible objections. In light of the Crisci decision it is not overly optimistic to predict that a court-adopted rule of strict liability is forthcoming.62

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61 Id. at 173 n.8. The annotation suggests that even if policy costs are increased, "[T]his is not necessarily objectionable if the basic social aim of spreading losses by means of insurance is furthered." Id. at 173 n.8. And see 18 Stan. L. Rev. 475, 484-85 (1966), which states that the strict liability rule would not only save the insured from having to endure mental suffering as a result of an excess judgment, but would also save the insurer money by not having to pay general damages.

62 10 American Trial Lawyers News Letter, No. 4 at 125 (1967). This news letter notes the Crisci decision, and predicts that courts will adopt a rule of strict liability.

"We believe that a careful reading of the instant splendid and far reaching opinion supports the view that in a proper case the California Supreme Court will have no inhibitions against imposing a strict liability upon carriers who, pursuing a calculus of self-interest, abandon their insureds to the improvidence of chance." Id. at 125.