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COMMENTS

INSURERS' LIABILITY FOR EXCESS JUDGMENTS IN VIRGINIA: NEGLIGENCE OR BAD FAITH?

I. INTRODUCTION

Liability insurers have become increasingly concerned over the possibility that they may be responsible for satisfying excess judgments.¹ This concern is justified.² In *Crisci v. Security Insurance Co.*,³ the California Supreme Court generated new developments in insurance law by predicated an insurer's liability for failing to settle claims against its insured upon a finding of mere negligence.⁴ Traditionally, an insurer was held liable for an excess judgment only if the insured was able to bear the burden of showing that the company acted in "bad faith" in failing to settle a claim.⁵ Virginia adopts this traditional view.⁶

The purpose of this comment is to consider whether Virginia should reevaluate its standard of liability in light of the *Crisci* decision. An his-

1. The possibility of an excess judgment arises where a claimant sues an insured for an amount exceeding the insured's policy limit. The insurer decides to defend the case in court rather than settle for an amount equal to or within the policy limits. The resulting verdict is greater than the policy limit. Unable to pay the difference between the judgment and its insurance coverage, the insured brings an excess liability suit against the insurer.

2. The concern is evidenced by numerous articles advising the insurer on how to properly conduct settlement situations to avoid possible liability. See generally Hume, *New Bad Faith Litigation and Practical Suggestions for Avoiding Excess Liability*, 21 FED'N OF INS. COUNSEL Q. 95 (1970); Luvaas, *Excess Judgments - Defense Counsel's Liability*, 18 DEF. L.J. 259 (1969); Parks & Heil, *Insurers Beware: "Bad Faith" is in Full Bloom*, 9 FORUM 63 (1973); Wymore, *Safeguarding Against Claims in Excess of Policy Limits*, 11 FED'N OF INS. COUNSEL Q. 9 (1960).

3. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

4. Some courts referred to a "negligence" standard in assessing an insurer's liability for excess judgments prior to the *Crisci* decision. See Annot., 40 A.L.R.2d 168, 186-90 (1955). The criteria established in *Crisci*, though called a basis for negligence, seems to fall more appropriately between negligence and strict liability. Because it is almost impossible for an insurer to overcome the "presumption of negligence" when it fails to settle a claim within policy limits, the *Crisci* decision has in fact been interpreted to provide strict liability. See *Crisci's Dicta of Strict Liability for Insurers' Failure to Settle: A Move Toward Rational Settlement Behavior*, 43 WASH. L. REV. 799 (1968).

5. This second standard has been inversely labeled the "good faith" standard.

6. The only case in Virginia which has decided the question of an insurer's liability for excess judgments is *Aetna Cas. & Sur. Co. v. Price*, 206 Va. 749, 146 S.E.2d 220 (1966).

toric overview of early court decisions and an examination of the development of the negligence and good faith standards as they are used by the courts today will be presented.⁷ The advantages and disadvantages of each standard will be delineated in light of selected institutional and social concerns.

II. HISTORIC OVERVIEW

The early cases held that an insurer was under no duty to settle a claim against its insured, even if the terms of a settlement were below policy limits and should have been accepted to avoid a possible excess judgment.⁸ This freedom to control the settlement of claims stemmed from the insurance policy itself.⁹ Any terms regarding settlements were permissive in nature, rather than mandatory, so that the insurer could exercise its discretion in deciding whether to settle or litigate.

These insurance policies were known as adhesion contracts¹⁰ since they placed the insurer in a very advantageous position vis-a-vis the insured.¹¹ When an insurer failed to settle a claim within policy limits, it was, in

7. This comment limits its discussion to these two standards. Several commentators have however posed strict liability as an alternative to both standards. See Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954); Note, *Insurer's Refusal to Settle - A Proposal for Imposition of Liability Above Policy Limits*, 60 YALE L.J. 1037 (1951); Crisci's *Dicta of Strict Liability for Insurers' Failure to Settle: A Move Toward Rational Settlement Behavior*, *supra* note 4.

8. *New Orleans & C.R. Co. v. Maryland Cas. Co.*, 114 La. 153, 38 So. 89 (1905); *Rumford Falls Paper Co. v. Fidelity & Cas. Co.*, 92 Me. 574, 43 A. 503(1899); *Best Bldg. Co. v. Employers' Liab. Assur. Co.*, 247 N.Y. 451, 160 N.E. 911 (1928); *Auerbach v. Maryland Cas. Co.*, 236 N.Y. 247, 140 N.E. 577 (1923); *C. Schmidt & Sons Brewing Co. v. Travelers' Ins. Co.*, 244 Pa. 286, 90 A. 653 (1914).

9. A typical clause reads: "As respects the insurance afforded by the other terms of this policy . . . the company shall: (a) defend any suit against the insured . . . even if such suit is groundless, false or fraudulent; but the company *may* make such investigation, negotiation and settlement of any claim or suit as it deems expedient . . ." Keeton, *supra* note 7, at 1137 n.1 (emphasis added).

10. An adhesion contract is usually a standardized, mass produced contract drawn in favor of a party with an immensely greater bargaining power than the consumer with whom it deals. The weaker party must "adhere" to the terms of the form contract if he wants the goods at all. No bargaining is engaged in with respect to it. J. MURRAY, *MURRAY ON CONTRACTS* § 350, at 737-38 (2d rev. ed. 1974).

Insurance policies are still considered to be adhesion contracts. R. KEETON, *BASIC TEXT ON INSURANCE LAW* § 6.3(a), at 350 (1971). Their harsh effects, however, have been somewhat alleviated by judicial and legislative regulation of the conduct of insurers.

11. Not only did the insurer enjoy exclusive control over settlement decisions, but it also foreclosed the insured from making any settlements or compromises on his own. Appleman, *Duty of Liability Insurer to Compromise Litigation*, 26 KY. L. J. 100, 101 (1937).

effect, gambling with the insured's money.¹² The insured was powerless to change this state of affairs because early court decisions encouraged this unequal relationship by applying strict contract principles in determining the insurer's liability.¹³ Thus, the insurer enjoyed immunity from liability until the early twentieth century.¹⁴

Courts gradually began to recognize that the insurer and insured do not deal at arm's length with one another. In *Brassil v. Maryland Casualty Co.*,¹⁵ the court decided that although the insurer literally complied with the written terms of its contract with the insured by defending the preliminary suit, the insurer was still liable for breach of contract because it failed to bear its "obligation of good faith" in carrying out what was written in the contract.¹⁶ This obligation of good faith, underlying all written agreements, required the insurer to prosecute an appeal on behalf of its insured. Thus, the implied covenant of good faith and fair dealing was breathed into the insurance contract.¹⁷ This implied covenant imposed a duty on the insurer to deal fairly and in good faith with its insured, and prohibited either party from doing anything which would injure the right

12. For example, if an insurer refuses to settle a case within the limit of the policy and a verdict in excess of the limit is rendered at trial, the insurer is liable only for the amount of the policy limit. The insured is responsible for payment of any amount over the limit. This presents a classic example of a "conflict of interests" between the insurer and the insured. The insured's interests are best served by settling the claim within the policy limits, thereby avoiding any risk of liability for a large excess verdict. The insurer often prefers taking the chance of litigating the claim in an effort to "save money on the policy" by possibly keeping the verdict within the policy limits or defending the suit successfully. Keeton, *supra* note 7, at 1145.

13. The courts expressly held that the rights of the parties were determined by the agreement into which they entered. As one opinion stated:

Whether the interests of the assured are in all respects sufficiently guarded by the stipulations in the contract, it is unnecessary to consider. These corporations had the same right that individuals have to make their own contract. The court has no power to add to it or take from it.

Rumford Falls Paper Co. v. Fidelity & Cas. Co., 92 Me. 574, ___, 43 A. 503, 506 (1899).

Indeed, a New York court made the point most vigorously: "It [the insurance company] . . . was under no legal obligation, whether express or implied, to compromise or settle the claims prior to the trial." *Auerbach v. Maryland Cas. Co.*, 236 N.Y. 247, ___, 140 N.E. 577, 579 (1923) (emphasis added). See also *C. Schmidt & Sons Brewing Co. v. Travelers' Ins. Co.*, 244 Pa. 286, 90 A. 653 (1914).

14. Miller, *Living with Bad Faith*, 46 INS. COUNSEL J. 34, 34 (1979).

15. 210 N.Y. 235, 104 N.E. 622 (1914).

16. *Id.* at ___, 104 N.E. at 624.

17. See also *Brown v. Superior Court*, 34 Cal. 2d 559, 212 P.2d 878 (1949); *Hilker v. Western Auto Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on rehearing*, 204 Wis. 1, 235 N.W. 413 (1931).

of the other to receive the benefits of an agreement.¹⁸ Judicial standards were later established to measure the company's conduct in dealing with its insured.

III. THE JUDICIAL STANDARDS

A. *The Good Faith Standard*

The implied covenant of good faith and fair dealing provided a basis for the good faith standard. A breach of the duty to use good faith¹⁹ results in a breach of contract.²⁰ If an insured can prove the insurer exercised "bad faith" in not settling a claim, the insurer will be held liable for an excess judgment.²¹ Although there are some guidelines as to what actions may in fact constitute a breach of the duty of good faith,²² jurisdictions applying this standard have assessed varying weight to the impact of several factors, and consequently there is no uniform criterion for determining liability. It is therefore conceivable that two cases presenting very similar factual situations would be decided differently.²³

In *Aetna Casualty & Surety Co. v. Price*,²⁴ the Virginia Supreme Court

18. *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 328 P.2d 198 (1958).

19. Although the insurer retains the exclusive power under the insurance contract to defend or settle, the exercise of this power does not involve the assumption of any duty to use due care, nor can the law impose such a duty. Since the reservation of power and control over settlements is for the protection of the insurer, he must be allowed some discretion in the use of this power. While the insurer is not to arbitrarily disregard the insured's interests, to hold him to the standard of due care in the conduct of settlement negotiations would deprive him of this discretion. *Liability of Insurer for Judgment in Excess of Policy Limits*, 48 MICH. L. REV. 95, 98-99 (1949).

20. See *Brassil v. Maryland Cas. Co.*, 210 N.Y. 235, 104 N.E. 622 (1914); *Tort of Bad Faith: A Perspective Look at the Insurer's Expanding Liability*, 8 CUM. L. REV. 241, 263 (1977). See also Annot., 40 A.L.R.2d 168, 178-83 (1955).

21. See, e.g., *Brown v. Guarantee Ins. Co.*, 155 Cal. App. 2d 679, 319 P.2d 69 (1958); *Hilker v. Western Auto. Ins. Co.*, 204 Wis. 1, 231 N.W. 257 (1930), *aff'd on rehearing*, 204 Wis. 1, 235 N.W. 413 (1931).

22. Certain acts which may constitute bad faith on the part of the insurance company are: 1) disregard of the claims manager's authorization to settle, 2) failure to listen to defense counsel's advice, 3) failure to keep the insured advised of all correspondence and proceedings regarding negotiations, 4) failure to investigate properly, 5) failure to affirmatively explore settlement, 6) failure to consider the claimant's demands within reasonable time, 7) inducement of the insured to contribute, and 8) failure to consider the insured's interests. Miller, *supra* note 14, at 36.

23. Compare *Lawson & Nelson Sash & Door Co. v. Associated Indem. Corp.*, 204 Minn. 50, 282 N.W. 481 (1938) (attempt to coerce insured into contributing to settlement is not bad faith) with *Spang Baking Co. v. Trinity Universal Ins. Co.*, 68 N.E.2d 122 (Ohio App. 1946) (attempt to coerce insured into contributing to settlement is bad faith).

24. 206 Va. 749, 146 S.E.2d 220 (1966). See 53 VA. L. REV. 181, 222 (1967).

considered what actions by an insurer would constitute bad faith in Virginia. In that case, the insured, a doctor, was sued for malpractice in rendering the claimant permanently disabled as a result of alleged negligent treatment subsequent to the claimant's birth. Throughout the litigation the insured had denied any liability to the claimant. The insurer's defense counsel undertook an investigation of the case which included his own independent medical study as well as interviews with several prominent doctors in all areas of medicine. The insurer reached the conclusion that the case was one of "no liability." Settlement was subsequently offered for \$5,000 below the policy limit. The insurer failed to accept the settlement offer and an excess judgment over twice the policy limit was rendered. The Virginia Supreme Court held that the insurer was not guilty of bad faith and therefore was *not liable* for an excess judgment on account of its failure to settle for the following reasons: 1) it had made a comprehensive investigation extending over a period of six years; 2) it had advised its insured of the opportunity to settle within policy limits and had supported its insured's continuous denial of liability by its own investigations; and 3) its refusal to accept a settlement recommendation by its attorney was insufficient, by itself, to sustain a charge of bad faith.²⁵ Since the insured had paid a specific premium for a fixed amount of insurance, he was entitled to only that amount of recovery and had to bear the excess where there was no showing of bad faith. According to the court, it was not bad faith to forego settlement where an insured had made an honest and intelligent decision based on diligent investigation of the facts and a fair weighing of the probabilities of an excess judgment.²⁶ The Virginia Supreme Court, in making its decision, relied on an earlier New Jersey case, *Radio Taxi Service, Inc. v. Lincoln Mutual Insurance Co.*²⁷ which held: "Where reasonable and probable cause appears for rejecting a settlement offer and for defending the damage action, the good faith of the insurer will be vindicated"²⁸

B. *The Negligence Standard*

*Comunale v. Traders & General Insurance Co.*²⁹ laid the foundation upon which subsequent California cases were to adopt the negligence standard. The California Supreme Court held that the implied covenant of good faith and fair dealing requires the insurer to settle in an appropri-

25. 206 Va. at 762-64, 146 S.E.2d at 228-30.

26. *Id.* at 762, 146 S.E.2d at 228.

27. 31 N.J. 299, 157 A.2d 319 (1960).

28. *Id.* at —, 157 A.2d at 323.

29. 50 Cal. 2d 654, 328 P.2d 198 (1958).

ate case, even though the express terms of the policy do not impose such a duty.³⁰ In the court's opinion, an appropriate case for settlement exists when there is a great risk of recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement made within the policy coverage.³¹

The landmark decision of *Crisci v. Security Insurance Co.*³² incorporated not only the *Comunale* decision, but broadened its scope to include liability for mental distress. The insured, Mrs. Crisci, was sued by a third party for injuries sustained as a result of a fall on her property. The third party claimant offered to settle its case for \$9,000, which was \$1,000 below Mrs. Crisci's policy limit. Mrs. Crisci's insurer had been advised that if the case went to trial and the claimant won an award for psychosis allegedly resulting from her fall, the award would be at least \$100,000. The insurer was also aware that the psychiatrists were divided as to whether the fall precipitated psychosis. Therefore, the insurer refused to accept the settlement offer, believing that the jury would not accept the claimant's psychiatric testimony. Nevertheless, an excess judgment was rendered for \$100,000. In an attempt to satisfy the judgment, the seventy year old Mrs. Crisci became indigent, suicidal, and hysterical. She brought an action against Security to collect the excess judgment and damages for negligent infliction of mental distress.

In rendering its decision, the California Supreme Court reiterated that under the covenant of good faith and fair dealing, the insurer was bound to use due care to protect the insured's interests. Through the insurance contract, the insurer had assumed the responsibility of acting as the exclusive agent of the insured and therefore, in determining whether to settle, it had a duty to give the interests of the insured at least as much consideration as it gave to its own interests.³³ The test to determine whether Security considered Mrs. Crisci's interests in settlement was "whether a prudent insurer without policy limits would have accepted the settlement offer."³⁴ In this case, a prudent insurer would have settled be-

30. *Id.* at ___, 328 P.2d at 201. This decision is a departure from the good faith standard. A court applying the good faith standard does not interpret the implied covenant of good faith to require an insurer to settle in any case. As long as objective facts exist which support the insurer's decision not to settle, the judgment will be upheld.

31. *Id.* The court stated that the "decisive factor" in establishing the insurer's liability "is not the refusal to defend; it is the refusal to accept an offer of settlement within the policy limits." *Id.*

32. 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967).

33. *Id.* at ___, 426 P.2d at 176, 58 Cal. Rptr. at 16.

34. *Id.* at ___, 426 P.2d at 176, 58 Cal. Rptr. at 16. This means that the insurer must act as though it alone would be liable for the entire amount of any judgment. Note, *Insurer's*

cause there was a considerable risk of substantial recovery beyond the policy limits.³⁵ Both the insurer's attorney and claims manager knew that all the evidence favored the third party claimant; it was unreasonable for them to believe otherwise. Should an insurer decide to litigate the claim in light of these considerations, it would do so at its own risk. If it would reap the benefits of its determination not to settle, it should likewise suffer the detriments of its decision.³⁶ In *Crisci*, the insurer did not give as much consideration to the financial interests of its insured as it gave to its own interests. The court considered this action tortious³⁷ and as a result, regular tort damages were recoverable. The insurer was thus liable for any injuries incurred by its insured as a proximate result of the negligent performance of its duty.³⁸

The California court recognized that the insured reasonably expects the amount of its policy will be used to avoid liability. In view of this expectation and the conflict of interests between the parties, it was imperative that a strict standard be imposed on the insurer to prohibit it from furthering its own interests at the expense of the insured. The court has made subsequent decisions which have extended the *Crisci* decision.³⁹ It has been said that these post-*Crisci* cases have led to an unannounced policy of strict liability in California.⁴⁰

IV. COMPARISON OF THE STANDARDS

There are several advantages and disadvantages inherent in the application of both the negligence and good faith standards. Since the courts have stopped short of introducing strict liability in holding an insurer liable, practitioners are confined to litigate on the basis of these two standards only. In determining which standard Virginia should apply, a com-

Liability for Refusal to Settle: Beyond Strict Liability, 50 S. CAL. L. REV. 751, 760 (1977).

35. 66 Cal. 2d at ___, 426 P.2d at 178, 58 Cal. Rptr. at 18.

36. *Id.* at ___, 426 P.2d at 177, 58 Cal. Rptr. at 17.

37. *Id.* at ___, 426 P.2d at 179, 58 Cal. Rptr. at 19.

38. The unique feature of this decision is that the court found no reason to distinguish between mental distress accompanying personal injury and that accompanying an invasion of property rights. The main reason for limiting such damages in the past has been the fear of fictitious claims and litigation of trivialities. W. PROSSER, LAW OF TORTS § 12, at 51 (4th ed. 1971). The implications of viewing the failure to settle as tortious are obvious. Not only is the insurer held to a strict standard of care consistent with public expectations, but it can also be held liable for any damages proximately caused by its acts.

39. See *Royal Globe Ins. Co. v. Superior Court*, 23 Cal. 3d 880, 592 P.2d 329, 153 Cal. Rptr. 843 (1979); *Johansen v. California State Auto. Ass'n Inter-Ins. Bureau*, 15 Cal. 3d 9, 538 P.2d 744, 123 Cal. Rptr. 288 (1975).

40. *Johansen v. California State Auto Ass'n: Has California Adopted Strict Liability for an Insurer's Failure to Settle?*, 27 HASTINGS L.J. 895, 911 (1976).

parison between the standards should be made in light of legal, economic and social concerns.

A. *Legal Concerns*

Traditionally, legal obligations and causes of action have been divided into two categories—those arising out of tort and those arising out of contract. For years, insurance companies have been protected from extra-contractual duties and liabilities as a result of this distinction. This immunity, however, is slowly withering away.

One of the major developments that has helped to pierce the insurer's immunity is judicial recognition that liability in tort may co-exist with liability in contract.⁴¹ Under many types of agreements, not only are contractual duties brought into being by the will of the parties, but there are also duties prescribed by law as incidents of the relationship⁴² which the parties have created by their agreement.⁴³ One court has thus expressed that "[t]he existence of a contractual relationship does not immunize a tortfeasor from tort liability for his wrongful acts in breach of the contract."⁴⁴ Similarly, insurance companies can no longer rely on the contractual character of an insurance policy to insulate themselves from liability beyond that stated in the contract. Courts are shifting in the direction of imposing tort liability for several reasons.

One of the main reasons for the shift is that more courts are recognizing that the insurer is a fiduciary to its insured. This relationship is based on several factors. First, the insurer maintains exclusive control of settlement proceedings, foreclosing the insured from taking any action on his own behalf. The insurer therefore has an affirmative duty to initiate settlement negotiations with the insured's interests foremost in mind.⁴⁵ Second, the insured relies on the insurer for protection from liability. He is paying premiums for the specific purpose of freedom from economic ruin. He reasonably expects that his policy limit will be available to avoid lia-

41. *Crisci v. Security Ins. Co.*, 66 Cal. 2d at ___, 426 P.2d at 178, 58 Cal. Rptr. at 18; *Comunale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d at ___, 328 P.2d at 203. Both decisions allowed the insured to elect under which theory to bring an action. The benefit of the contract theory provided a longer statute of limitations. Under tort, however, greater damages could have been awarded.

42. A fiduciary relationship may be recognized between an insurer and its insured. *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 65 N.J. 474, 323 A.2d 495 (1974); Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, *supra* note 34, at 761-62 n.57 (1977).

43. Langdon & Sytsma, *The Duty of Good Faith and Fair Dealing and the Pre-Adjudicatory Role of the Insurance Company Advocate*, 45 INS. COUNSEL J. 309, 310 (1978).

44. *Eads v. Marks*, 39 Cal. 2d 807, ___, 249 P.2d 257, 260 (1952).

45. *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 65 N.J. 474, 323 A.2d 495 (1974).

bility. Thus, the insurer must perform the function which it holds itself out as rendering in accordance with the insured's expectations. Third, the insured relies on the expertise of the insurer in settling his claims. The insurer must maintain the standard of conduct that a reasonably prudent insurer with the same qualifications would exhibit. Finally, the insured does not enter the relationship entirely on his own free will. Since insurance today is almost an economic necessity, the public has no choice to "take it" or "leave it." Thus, the burden of possible tort liability must be placed on insurers to ensure that they exercise their fiduciary duties in a responsible manner.⁴⁶

The negligence standard is consistent with the insurer's fiduciary duties. It injects a standard of reasonableness into a determination of liability and places a higher duty of care on the insurer for the benefit of the insured. If there is a great risk of recovery beyond the policy limits, in light of the circumstances, then the most reasonable manner of disposing of the claim is to settle. If the insurer fails to settle, it then bears the burden of an excess judgment. This seems equitable since the insurer in all likelihood has the assets to carry the burden of an excess judgment with little hardship, while an insured may be financially ruined by such a judgment.

The good faith standard, on the other hand, does not impose a fiduciary duty on the insurer. Such a duty is neither necessary nor consistent with a standard of liability which imposes no duty of care on an insurer.⁴⁷ Although the Virginia Supreme Court has recognized that the relationship between the insured and insurer is one of confidence and trust which imposes upon the insurer the duty to deal fairly with the insured, it has not specifically recognized the standard of care required of a fiduciary.⁴⁸

Another reason for the shift to tort theory is that simple contract damages cannot adequately compensate the insured. Under the negligence standard, compensation is awarded for all damages proximately caused by the insurer's actions. The insurer should know or foresee, at the time of

46. In a sense, the insurer is held to a fiduciary duty not only because of the nature of its relationship to the insured, but also because of its relation to the public as a quasi-public business, rather than an ordinary self-interested business. *Good Faith and Fair Dealing in Insurance Contracts: Gruenberg v. Aetna Insurance Co.*, 25 HASTINGS L.J. 699, 711 (1974).

47. The Virginia General Assembly however, has imposed a duty of good faith in the Unfair Trade Practices Act. VA. CODE ANN. § 38.1-52(8a) (Cum. Supp. 1979). Whenever the law creates a duty, the breach of such duty, coupled with consequent damage, will be a tort. Langdon & Sytsma, *supra* note 43, at 314. Thus it seems that Virginia may have left the avenue of a tort action open in some cases. The statute has not yet been interpreted by the state courts.

48. *Aetna Cas. & Sur. Co. v. Price*, 206 Va. 749, 146 S.E.2d 220 (1966).

contracting, that the insured may suffer the very injury from which he seeks protection. We see from *Crisci* that precedent has been established for recovery of damages for mental distress. Such damages are not recoverable under the narrow scope of contract theory except in situations where a contract directly concerns the emotional well-being of a contracting party.⁴⁹

Another criticism of the good faith standard is that it is too subjective and allows the insurer to be the "judge" in his own case.⁵⁰ This standard seems to instruct the insurer to weigh his own interests on the same scale with those of its insured.⁵¹ However, such a conflict of interest is too great to guarantee that the insured will be dealt with fairly. Jurisdictions using the good faith standard have interpreted bad faith several different ways because of the latitude insurers have in considering their own interests. In this regard, tort law may be more equitable than contract law in its insistence that cases similar in facts be treated in the same fashion.⁵²

The negligence standard, on the other hand, works as a deterrent to wayward insurers who are inclined to consider their own interests as paramount to those of their insured. Under the good faith standard, the insurer undoubtedly cannot avoid being influenced by the knowledge that as long as it makes a good faith judgment regarding settlement based on supportable evidence obtained from a diligent investigation, it will not bear the responsibility for an excess judgment. This may actually cause the insurer to litigate more often. However, under the negligence standard, the insurer will not be as willing to take risks where it knows there is a greater possibility of being held to pay an excess judgment.

Several commentators have found both the negligence standard and the good faith standard unworkable.⁵³ One commentator has strongly criti-

49. An example of such a situation would be the negligent embalming of a member of claimant's family or the negligent bailment of heirlooms.

50. *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 65 N.J. 474, 323 A.2d 495 (1975).

51. *Id.* at ___, 323 A.2d at 509; *The Emerging Fiduciary Obligations and Strict Liability in Insurance Law*, 14 CALIF. W.L. REV. 358, 371 (1978).

52. Ross, *Settled Out of Court: The Social Process of Insurance Claims Adjustment*, in PERSPECTIVES ON TORT LAW 86, 89 (1976).

53. A major problem with both standards is that they create what is referred to as the "Culpability-Liability Inverse Relationship" anomaly. Where a settlement opportunity exists, it seems the more faultless the client appears, the more likely he is of being subjected to all the dangers of a trial of the case by his insurer. The more culpable an insured is, the less likely he will be exposed to an excess judgment, because the insurer will not risk going to trial where no doubt exists that a judgment will be rendered against the insured. This is an undesirable result. The purpose of the legal system is to ensure that liability is imposed only on those persons who are culpable, and not on those who are free from blame. See

cized the use of the jury in excess judgment suits⁵⁴ as being grossly incompetent to determine what is reasonableness or negligence in an area where it is not knowledgeable. This is not a new criticism of the lay jury; however, it seems to manifest itself in excess judgment cases where the helpless insured is fighting the big insurance company. No juror relishes the thought that he may be faced with the same problem someday. Thus, liability is imposed on the basis of pure emotion rather than a fair weighing of the facts.⁵⁵ One solution is to have the court decide the questions of negligence and bad faith.⁵⁶ Another solution, suggested by an increasing number of commentators, is to apply strict liability.⁵⁷

One further point, in view of the standards imposed, is that settlements are necessary to the function of the legal system. Without the mechanism of settlements, the court system would become overburdened and thus unresponsive to the need for timely resolution of lawsuits. No doubt judges are aware of this consideration, and may favor imposing a stricter standard on insurers to encourage the settlement of claims, thereby leaving only irreconcilable differences for the courts to decide.

The negligence standard encourages insurers to settle, if for no other reason than to avoid liability for an excess judgment. One drawback to the standard, however, is that it may ignore the economic concerns of the insured when calculating the amount to offer within the policy coverage.

B. *Economic Concerns*

The negligence standard purports to protect the insured's interests to a higher degree than the good faith standard. The test enunciated in *Crisci*⁵⁸ requires that two factors be considered before liability is imposed on an insurer for falling below the standard of reasonableness. These considerations may in effect disregard the financial interests of the insured when a decision concerning settlement is being made.

Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, *supra* note 34, at 774.

Additionally, many writers believe that there is really no difference between the two standards. They contend that the same actions are proscribed under both standards, and that many of the results would be the same, regardless of differences in verbiage. *See, e.g.*, 7C J. APPLEMAN, *INSURANCE LAW AND PRACTICE* § 4712, at 425 (1979); Keeton, *supra* note 7, at 1140.

54. Appleman, *supra* note 11, at 109-11.

55. *See* Thornton & Blaut, *Bad Faith and Insurers: Compensatory and Punitive Damages*, 12 *FORUM* 699, 719-20 (1977).

56. *Manchester Ins. & Indem. Co. v. Grundy*, 531 S.W.2d 493 (Ky. 1976).

57. *See* note 7 *supra*.

58. *See* text accompanying notes 33-34 *supra*.

The first consideration questions whether an insurer would have settled had the policy been unlimited. If the policy is unlimited, it is easy to see that an insurer will behave as a person of almost unlimited wealth and play the averages.⁵⁹ The insurer will estimate the settlement value of the claim by determining what settlement value over a series of similar cases would result in the least overall expense to the company.⁶⁰ In the majority of cases however, the policy provides limited coverage and the insured is a person of moderate means. The insured demands that an offer be made below his policy limits, yet sufficient to induce the claimant to settle. The insurer, on the other hand, would simply base the amount for settlement on averages and the lowest overall cost to the company. This conflict of interests must be resolved in favor of the insured.

The second factor inquires whether the insurer gave as much consideration to the insured's interests as to its own. An answer to this question directly concerns the financial status of the insured. If the insured is judgment-proof, or a person of considerable wealth, he may prefer to take the risks that litigation entails rather than consider settlement. As a result of their financial condition, these insureds would probably act much like the insurer under an unlimited policy. The insured of moderate means, however, would try harder to settle because of the risk of an excess judgment, which could have a devastating effect on his economic status. Thus, the insured of moderate means is always forced to consider settlement, whereas the wealthy or judgment-proof insured is seldom faced with the problems of settlement.⁶¹

The good faith standard has also been attacked on similar grounds. Under this standard, insurers may ignore the financial interests of the insured in settling and litigate a claim for "institutional" purposes.⁶² For example, in an effort to keep total settlement costs down, insurance companies occasionally adopt "no settlement" or "selective settlement" programs to "numb the public's claim-consciousness, to fight organized fraudulent claims, or to create a tight-fisted image for plaintiffs' attorneys."⁶³ If a case involves a disputed legal point, the insurer may again litigate to establish favorable precedent,⁶⁴ even though the costs of litiga-

59. Note, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule*, 18 STAN. L. REV. 475, 477 (1966).

60. *Id.*

61. Keeton, *supra* note 7, at 1147 n. 26.

62. Note, *An Insurance Company's Duty to Settle: Qualified or Absolute?*, 41 S. CAL. L. REV. 120, 128 (1968).

63. Note, *Excess Liability: Reconsideration of California's Bad Faith Negligence Rule*, *supra* note 59, at 482.

64. *Id.* at 483.

tion outweigh the cost of settlement.⁶⁵

Litigating for institutional purposes may not be as repugnant as it first appears, since it is one way insurers combat specious claims and thereby benefit all insureds. The problem which exists, however, is that it is difficult to ascertain whether the insurer is litigating for his own interests or for institutional concerns.⁶⁶ This in itself suggests the need for a stricter standard.⁶⁷

A major criticism of the negligence standard is that premiums will rise directly in proportion to the rise in liability. Insureds who fear the already exorbitant premiums dread further increases. A counter-argument was posed by one commentator⁶⁸ who states that the possibility of increased premiums is not necessarily objectionable if the basic social aim of spreading losses by means of insurance is furthered.⁶⁹ Loss-spreading will minimize economic dislocation and consequent social dislocation.⁷⁰ It will shift the burden of paying an excess judgment from the insured to the insurer, the one most able to bear the hardship.⁷¹ Furthermore, the burden of an increase in premiums is distributed among all insureds. It may even be doubtful whether 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 liable.⁷²

Another closely related criticism of the negligence standard is that business risks associated with insurance contracts are increased by holding an insurer to a stricter standard of care.⁷³ This argument, however, is of

65. Pretzel, *Economics of Trial Versus Settlement*, 1965 INS. L.J. 453, 460.

66. *Approaching Strict Liability of Insurer for Refusing to Settle Within Policy Limits*, 47 NEB. L. REV. 705, 719 (1968).

67. Professor Keeton suggests that many of the problems and criticisms of the negligence standard could be alleviated by combining the equal consideration and negligence aspects of the standard in a different form. Keeton, *supra* note 7, at 1147.

68. Calabresi, *The Costs of Accidents*, in PERSPECTIVES ON TORT LAW 142 (1976).

69. *Id.* at 145. "Loss spreading" can have several meanings. The first possible meaning is the accomplishment of the broadest possible spreading of losses, both over people and over time. The second is the placing of losses on those classes of people that are best able to pay, usually the wealthiest. A third meaning places the losses on those activities that engendered them.

70. *Id.*

71. Income from insurance companies constitutes an appreciable share of the national wealth and income. Thirty years ago insurance companies owned over a hundred billion dollars of assets. The figures today are even more staggering. Surely, it is far from inequitable to hold an insurer liable for excess judgments when it acts negligently. S. KIMBALL, INSURANCE AND PUBLIC POLICY 4 (1960).

72. Annot., 40 A.L.R.2d 168, 173 n.8 (1955).

73. Note, *Insured is Entitled to Damages for Mental Suffering Caused by an Insurer's*

little merit. Insurance companies are risk-takers. Moreover, the *Crisci* court specifically held that an insurance contract is not an agreement signed in contemplation of one party obtaining a *commercial advantage* over another party.⁷⁴ Normal business risks are not involved. Since insurance companies have moved away from the traditional business setting⁷⁵ and are now considered social institutions, they are responsible for absorbing risks of accidental losses and must also take social and public concerns into consideration.

C. *Social Concerns*

Insurance is an institution whereby economic loss is distributed among a large number of persons who are subject to the risk of such loss. The risk is transferred to the insurer in exchange for a premium paid in advance. The cost of these premiums is directly related to the predictable amount of loss from accepting the risks. Undoubtedly, the most compelling reasons for adopting the negligence standard arise from the relationship that develops between the insured and the insurer when contracting for insurance.

The insurance industry in general has been regarded as a business affected with a public interest.⁷⁶ Specifically, the purpose of liability insurance is twofold: to protect the insured from fear of liability for his actions, and to adequately compensate the injured party. As a result, insureds have developed certain expectations with regard to the disposition of claims against them.⁷⁷

Perhaps most importantly, the insured expects peace of mind from the knowledge that he is secure from financial ruin. Secondly, he expects the insurer to dispose of claims intelligently and quickly and with the expertise that insurers are considered to possess. He relies on the insurer's status as a professional,⁷⁸ because he is foreclosed from protecting his own interests. Finally, the insured expects that the amount of his policy will

Wrongful Rejection of a Reasonable Settlement Within the Limits of the Insurance Policy, 46 TEX. L. REV. 113, 118 (1967).

74. 66 Cal. 2d at ___, 426 P.2d at 179, 58 Cal. Rptr. at 19.

75. Insurance companies were early regarded as normal business concerns. This view was consistent with the early twentieth century American attitude that *laissez-faire* and freedom of contract promoted the growth of financial capitalism. S. KIMBALL, *supra* note 71, at 304. See also *Best Bldg. Co. v. Employers' Liab. Assurance Corp.*, 247 N.Y. 451, 160 N.E. 911 (1928).

76. *Barrera v. State Farm Mut. Auto. Ins. Co.*, 71 Cal. 2d 659, 456 P.2d 674, 79 Cal. Rptr. 106 (1969).

77. See R. KEETON, *supra* note 10, at 351 (1971).

78. RESTATEMENT (SECOND) OF TORTS § 299A (1965).

be available in settlement negotiations to avoid liability.⁷⁹

The negligence standard protects these expectations by imposing a strict standard of due care on the insurer. In refusing to settle where there is a fair possibility that an excess verdict may be rendered, the insurer is trying to avoid the liability which he was paid to assume;⁸⁰ he is jeopardizing the tranquility and secure economic status for which the insured paid a premium. It is justified, therefore, that the insurer be liable for its wrongful act and pay all damages incurred by the insured proximately resulting therefrom. The insurer cannot be allowed to hide behind contract principles to limit its liability.⁸¹

The good faith standard is derived from contract theory. There is no question as to whether due care was exhibited. The level of conduct, therefore, may not be sufficiently demanding to reasonably conform to the public's expectations. When the insurer fails to accept a settlement, it may not necessarily be liable for a consequent excess judgment if it has conducted all affairs with its insured in a proper manner.⁸² A further difficulty arises when the insured attempts to get reimbursed for the excess judgment. The burden of proof is high for the insured to overcome; it is the rare case where a finding will be made that the insurer acted without any good faith justification.⁸³ On the other hand, under the negligence standard adopted by the California courts, the insurer bears the burden of showing that the demand was unreasonable and that he could not accept the offer for that reason.⁸⁴

79. The *Crisci* court held that this was not an unreasonable expectation. 66 Cal. 2d at ___, 426 P.2d at 177, 58 Cal. Rptr. at 17.

80. See *Casey v. Proctor*, 59 Cal. 2d 97, 378 P.2d 579, 28 Cal. Rptr. 307 (1963). See also note 11 *supra*.

81. The duties of public service companies "do not flow from agreements which the public servant may make as he chooses, they flow from the calling in which he has engaged and his consequent relation to the public." *Gray v. Zurich Ins. Co.*, 65 Cal. 2d 263, ___, 419 P.2d 168, 172 n.6, 54 Cal. Rptr. 104, 107-08 (1966) (quoting POUND, *THE SPIRIT OF COMMON LAW* 29 (1921)).

82. See text at notes 25-26 *supra*.

83. Appleman, *Duty of Liability Insurer to Compromise Litigation*, 26 Ky. L. J. 100, 110 (1938).

84. This is a difficult burden for the insurer to overcome because in following a principal suit won by the claimant, it is unlikely that the outcome or the damages would be inaccurately determined. Furthermore, California law applies a rebuttable presumption that where a judgment over the policy limits is rendered, any previous demand under the limits is held reasonable. Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, *supra* note 53, at 760. However, in other courts applying the negligence standard, the insurer does not have this burden. California has simply taken a step further in defining the limits or magnitude of liability under the negligence standard.

A higher standard of care may be necessary to bring about an internal change within the industry. Most claims adjusters approach their work with conventional business values which make them inclined to seek low, conservative settlements.⁸⁵ Settlement figures are usually far from ideal. Organizational pressures may require the company to "close files" quickly, foreclosing the opportunity to make adequate investigation of the particular claim.⁸⁶ These institutional interests may overshadow the insured's interests. Imposing liability more liberally through the negligence standard may cause the claims adjuster to take a second look at the claim before closing the file. He may be protecting his own job in doing so.

Moving to a broader area of concern, it has been suggested that the negligence standard could encourage fictitious claims, claims-conscious plaintiffs and collusion.⁸⁷ The imposition of higher standards of conduct may cause insurers to capitulate and settle rather than risk an excess judgment. Coupled with this problem is the possibility that claimants will make demands for amounts close to the policy limits, believing that insurers will settle for any amount below the limit.⁸⁸ One might argue that an insured would not attempt any collusive agreements with the claimant because it would defeat his asserted interest in settlement. This is not always true. As long as the demand reached by the collusive agreement was below policy limits, the insured's interests in settlement would still be promoted.⁸⁹

The good faith standard works to combat any specious claim.⁹⁰ The insured would not risk any collusive agreements where the duty of an insurer to settle is not high. Furthermore, only economically foolish claimants would litigate a "no dispute" claim in a good faith jurisdiction where the insurer is virtually free to challenge any claim.

The negligence standard is the logical extension of a growing movement

85. Ross, *Settled Out of Court: The Social Process of Insurance Claims Adjustment*, in PERSPECTIVES ON TORT LAW 86, 87 (1976).

86. "The closing of files represents for adjusters something of the same kind of central goal as the attainment of good grades represents for the college student . . ." *Id.* at 88.

87. See Note, *Insurer's Liability for Refusal to Settle: Beyond Strict Liability*, *supra* note 53, at 779-81.

88. *Id.* at 780-81.

89. There is no major problem with this behavior. Such a collusive agreement could only be marginally profitable for both parties where there is a requirement that the amount be kept within policy coverage. These problems are further dispelled by the fact that most insurance policies require the insured to cooperate with the insurer in disposing of the claim.

90. *Approaching Strict Liability for Insurer for Refusing to Settle Within Policy Limits*, *supra* note 66, at 719.

in "consumer activism." Liability has been expanded in products liability and malpractice cases to persons who have the power to control the occurrence or nonoccurrence of an act.⁹¹ Where persons hold themselves out as possessing a high degree of skill and expertise in a particular field, or where they alone are able to control an event, they should be liable in tort for misfeasance.

Insurers should not be allowed to use qualifications and exceptions from liability that are inconsistent with the bargaining power between the parties, even if such exclusions are explicit and unambiguous. Insurers know that ordinary policyholders do not read their policies with the degree of care that is required for moderate understanding.⁹² Such policies are difficult to understand without detailed study. If the insurer made it clear to the policyholder at the time of contracting that it was making specific qualifications in the policy, this might be sufficient for effective notice. No doubt only a minority of insurers make it a practice to adequately inform policyholders.⁹³ If the practice of non-disclosure cannot be prevented through legislation, it should be stopped by the courts' application of greater liability to compensate for harm already suffered. The good faith standard will not provide this protection to the insured who is forced to litigate.

Virginia, like many states, has enacted an Unfair Trade Practices Act⁹⁴ which contains a section on unfair claim settlement practices.⁹⁵ The stat-

91. The courts have imposed higher standards of care on manufacturers in products liability cases, on employers under the Federal Employers' Liability Act, and on attorneys, doctors, accountants, architects and engineers in malpractice cases. Insurance carriers are the next group to be added to the list.

92. R. KEETON, *supra* note 7, at 351-52.

93. *Id.*

94. VA. CODE ANN. § 38.1-52.9 (Cum. Supp. 1980).

95. The relevant parts of the statute read as follows:

Unfair claim settlement practices. - No person shall commit or perform with such frequency as to indicate a general business practice any of the following:

(1) Misrepresenting pertinent facts or insurance policy provisions relating to coverages at issue;

(2) Failing to acknowledge and act reasonably promptly upon communications with respect to claims arising under insurance policies;

(3) Failing to adopt and implement reasonable standards for the prompt investigation of claims arising under insurance policies;

. . . .

(6) Not attempting in good faith to effectuate prompt, fair and equitable settlements of claims in which liability has become reasonably clear;

(7) Compelling insureds to institute litigation to recover amounts due under an insurance policy by offering substantially less than the amounts ultimately recovered in actions brought by such insureds;

ute is a move in the right direction towards recognition of a duty to settle claims fairly. A major defect in the Act, however, is that before any violation can be found, the conduct specified must be performed with such frequency as to indicate a general business practice. Since the courts have not yet had an opportunity to interpret the statute, no guideline as to the frequency necessary to constitute a general business practice exists. It is hopeful that the courts will give a broad interpretation to the phrase.

V. CONCLUSION

Over the past fifty years, the courts have expressed several different attitudes regarding an insurer's liability for failing to settle claims. In the landmark case of *Crisci v. Security Insurance Co.*, the California court held that mere negligence on the part of an insurer for failing to settle was sufficient to hold it liable for an excess judgment. This decision completed a move away from the traditional view that the insurer was under no duty to settle a claim, and has caused the courts across the country to once again reevaluate the doctrinal basis for imposing liability on an insurer.

Virginia has addressed this issue only once in *Aetna*, a case decided before *Crisci* and consequently based on the good faith standard, the majority rule in 1966, whereby the insurer is liable for an excess judgment only if it exercises bad faith in settling a claim. The trend, however, is clearly moving in the direction of *Crisci*.⁹⁶ Although both the good faith and negligence standards suffer from some inadequacies, the latter standard appears preferable because it fulfills public expectations and is more consistent with the growing concern for consumer protection. Economic and social considerations demand that a higher standard of conduct be

(8) Attempting to settle a claim for less than the amount to which a reasonable man would have believed he was entitled by reference to written or printed advertising material accompanying or made part of an application;

(14) Failing to provide promptly a reasonable explanation of the basis in the insurance policy in relation to the facts or applicable law for denial of a claim or for the offer of a compromise settlement.

Id.

96. Some of the most noted cases are: *United Serv. Auto. Ass'n v. Glens Falls Ins. Co.*, 350 F. Supp. 869 (D. Conn. 1972); *Campbell v. Gov't Employees Ins. Co.*, 306 So. 2d 525 (Fla. 1974); *Ledingham v. Blue Cross Plan for Hosp. Care*, 29 Ill. App. 3d 339, 330 N.E.2d 540 (1975); *Vernon Fire & Cas. Ins. Co. v. Sharp*, 161 Ind. App. 413, 316 N.E.2d 381 (1974); *Koppie v. Allied Mut. Ins. Co.*, 210 N.W.2d 844 (Iowa 1973); *Rova Farms Resort, Inc. v. Investors Ins. Co.*, 65 N.J. 474, 323 A.2d 495 (1974); *Wasserman v. Buckeye Union Cas. Co.*, 29 Ohio App. 2d 7, 277 N.E.2d 569 (1972); *Kirk v. Safeco Ins. Co.*, 28 Ohio Misc. 44, 273 N.E.2d 919 (1970).

placed on insurers as they have exclusive control of settlement negotiations, the power to protect their insureds from financial ruin, and the resources to pay the judgment. The integration of tort and contract principles no longer enables an insurer to rely exclusively on the contract to define its duties and liabilities.

Although the negligence standard need not be applied as strictly as the criteria in the *Crisci* case mandate, policy considerations require that Virginia courts reevaluate the use of the good faith standard when again confronted with an excess judgment suit.

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