Acting "Reasonably" About Settlements: Assessing Insurer Duties at a Crossroads for the Law

by Mark M. Bell, Drew A. Warth, and Joseph Harrington

Abstract

Liability insurers have a longstanding duty to act reasonably when settling a claim. To the extent that an insurer controls the defense of a claim and the insured may be exposed to a loss in excess of the policy limits if settlement is not reached, this duty is increasingly pronounced. Proposed action by a leading legal reference service may have the effect of altering—or clarifying—this duty.

What is a liability insurer to do when it believes it can successfully contest a claim, but would trigger damages in excess of the policy limit if it fails?

Some legal observers believe that scenario gives liability carriers an incentive to gamble with the insured defendant's fate, as long as the insurer's exposure is restricted by the policy limit. For that reason, this well-established principle exists in common law: an insurer that provides defense coverage under a liability policy must make reasonable decisions regarding settlement offers, taking into consideration the potential for the entire judgment, not just the part that falls within policy limits.

The extent of this duty is under renewed scrutiny as the legal community debates a restatement of common law principles by a leading legal reference. Specifically, the American Law Institute (ALI) is scheduled to vote in May on a Restatement of Principles of Insurance Liability Law. Critics contend that the restatement

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will erroneously and unreasonably expand an insurer's duty to settle claims, while the restatement's authors say it reflects existing law.

Before considering that controversy, insurance professionals should be aware of the evolution of the standard of duty on insurers regarding settlement decisions. That there is such a duty is well-established, and a policy's coverage limit is not always the limit of exposure for an insurer.

Evolution of the Law

The insurer's duty to act reasonably regarding settlement of claims dates back to English common law rulings. These rulings have precedential standing in the United States under the legal doctrine of *stare decisis*, which holds that existing rulings retain the status of settled law unless new facts or conditions make them inapplicable.

As liability insurance has grown in the U.S. over the past century, so has insurer control over the defense of claims. The duty to act reasonably in settlement matters arises, in part, from standard insurance policy language that effectively grants control of claims defense to the liability insurer.

The baseline provision appears in the commercial general liability (CGL) policy developed by Insurance Services Office, Inc. (ISO) and used throughout the U.S. The relevant provision reads:

> "We may, at our discretion, investigate any 'occurrence' and settle any claim or 'suit' that may result."

In addition, the ISO CGL explicitly requires the insured to "cooperate with us in the investigation, settlement or defense of the 'suit.'"

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Expansion of Duty

Generally speaking, to the extent that insurers have divested their insureds of effective control over claims defense, courts have found that insurers can be held liable for damages beyond policy limits for failing to make or accept reasonable offers to settle claims.

This principle is commonly called the Stowers Doctrine, establishing a "Stowers duty," so named for a landmark 1929 ruling by the Texas Court of Common Appeals in a case brought by G.A. Stowers Furniture Co. against its insurer. Collectively, related rulings establish standards applied in jurisdictions across the country through their incorporation into law treatises, or summaries of prevailing common law in most areas of the law, such as the ALI restatement, and compendia, including Appleman's, Couch, and American Jurisprudence.

In addition, some states have added statutory requirements for making reasonable settlement decisions. And in certain jurisdictions, courts may require insurers to make settlement offers even when there is no active claim against the insured.

In Nevada, for instance, an insurer is liable for any damages beyond the policy limit if an insurer-controlled defense is judged to have acted unreasonably in avoiding or resisting settlement of a claim. Also, Oregon requires insurers to offer settlements in cases when liability becomes what is considered reasonably clear. In other states, however, the duty to offer settlement is triggered only after liability is clear and damages would likely exceed the policy limit. In still others, there is no duty at all to volunteer settlements.

Triggers

Traditionally, four elements to a claim have had to be in place to trigger a liability insurer's duty regarding settlements:

- First, coverage under the policy has to apply to at least one allegation within a claim. Under policies that typically cover a claim in its entirety, particularly auto and CGL policies, the insurer will usually defend the entire claim if any part of the claim is covered. Specialty liability policies (professional, managerial, etc.) often have provisions allocating coverage and defense costs to covered allegations of a claim; these commonly lead to negotiations between an insured and its insurer when a claim arises. Beyond what is said in a policy, court jurisdictions can employ different doctrines regarding the extent of an insurer's duty to defend against allegations covered or not covered under a policy, and on the extent of an insurer's duty to defend once covered claims have been adjudicated and/or limits exhausted.
- A claim must include a clearly stated demand for redress. This is typically expressed as monetary damages, but may sometimes include an apology, public acknowledgement of wrongdoing, or some other action.

- Most importantly for this discussion, the degree of control an insurer exercises over the defense of a claim determines its level of duty regarding settlement decisions. The greater the degree of insurer control, the stricter the duty to act reasonably regarding settlement.
- Finally, the standard of duty for the insurer regarding settlement decisions is affected by the standard of care imposed on the defendant, which can be either objective (based on what a "reasonable person" would have done) or subjective (based on particular circumstances of the claim and expectations on the parties to it).

Insured vs. Insurer

An insurer's duty to act reasonably regarding settlement will be tested in those situations where the insured wants to settle and the insurer does not, and vice versa—especially when a claim includes some allegations that are covered and others that are not. Insureds may be more eager than their insurers to settle in situations where they fear exposure in excess of policy limits, and/or want to avoid or be done with the stress of fighting a claim.

In those cases, insured defendants may be able to enter into stipulated judgments with plaintiffs. Under stipulated judgments, the defendant agrees not to dispute liability; in return, the plaintiff only seeks to collect against the insurer. Insureds that enter these agreements run the risk of conceding far-reaching liability, however. And courts often do not enforce these agreements.

Policy provisions related to settlement tend to vary more under nonstandardized professional and managerial liability forms. Under claims covered by these types of policies, insureds can often be more reluctant than their insurers to settle, out of professional pride or fear of damage to their reputation. For that reason, professional and managerial liability policies utilize hammer clauses that can make insureds liable for damages that exceed amounts in a rejected settlement, even if those increased damages fall within the policy limit.

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The ALI Restatement

Depending on one's point of view, the law governing an insurer's duty to act reasonably regarding settlements will be either clarified or upended by the impending restatement of insurance liability law.

For background, the ALI is a group of attorneys, judges, and legal scholars founded in 1923 to codify rulings from jurisdictions across the U.S. into treatises. The ALI's current restatement started as a "principles of the law" project in 2010 and was converted into a restatement in 2014. It was scheduled to be voted on for adoption at the ALI's annual meeting in May 2017, but final action was postponed for a year on certain sections, including the one addressing insurer's settlement duties.

The evolution of the restatement is significant and controversial because formulations of principles are commonly considered to be aspirational statements of what the law should be, while restatements are commonly supposed to "reflect the law as it presently stands or might appropriately be stated by a court."[1]

Critics of the proposed restatement claim that it expresses the authors' aspirations for the law more than the reality of the law. Supporters say the opposite: they believe the proposed restatement will reflect the law in the majority of states. *(See the accompanying sidebar on page 28 for the restatement's proposed language on settlement decisions.)*

In essence, the restatement as proposed states that a liability insurer's duties regarding settlements can extend beyond the parameters established by statutory requirements, findings of bad faith, and other traditional protections for policyholders.

Thus, an insured would not necessarily have to identify an act of wrongdoing on the part of the insurer to claim that it failed to meet the standard of care required.

Also, the restatement indicates that an insurer has a duty to act as a "reasonable insurer" when making decisions regarding settlement, but

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that those decisions must disregard the policy limits and consider the entire exposure of the insured. However, the duty as expressed in the proposed restatement is to "make reasonable settlement decisions"[2] and is not a duty to settle as such.

Nonetheless, insurance and defense bar critics of the restatement claim that the restatement, to the extent it influences judicial rulings, will force insurers to settle an increasing number of claims for more than is warranted, a trend they claim would drive up losses and premiums and destabilize liability insurance markets.

CPCUs should be mindful of the potential changes when acting on behalf of policyholders or insurers, as standard protocols used in the past may no longer be appropriate. ■

Endnotes

1. The American Law Institute (ALI), Frequently Asked Questions, www.ali.org/publications/frequently-asked-questions/#differ (accessed January 30, 2018).
2. ALI Restatement: §24—Insurer's Duty to Make Reasonable Settlement Decisions.

Mixed Reviews

Section 24 of the American Law Institute's proposed restatement of liability insurance law has had both critics and supporters. The restatement's proposed language on settlement decisions follows.

§24—Insurer's Duty to Make Reasonable Settlement Decisions:

1. When an insurer has the authority to settle a legal action brought against the insured, or the authority to settle the action rests with the insured but the insurer's prior consent is required for any settlement to be payable by the insurer, the insurer has a duty to the insured to make reasonable settlement decisions to protect the insured from a judgment in excess of the applicable policy limit.
2. A reasonable settlement decision is one that would be made by a reasonable insurer who bears the sole financial responsibility for the full amount of the potential judgment.
3. An insurer's duty to make reasonable settlement decisions includes the duty to make its policy limits available to the insured for the settlement of a covered legal action that exceeds those policy limits if a reasonable insurer would do so in the circumstances.

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