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BAD FAITH SUBCOMMITTEE

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Bryan M. Weiss discusses a recent decision by a federal appeals court in California which may have far-reaching implications concerning an insurer's duty to initiate settlement discussions and whether it can be held liable in bad faith for failing to settle even in the absence of a demand by the claimant.

CALIFORNIA COURTS AND THE DUTY TO INITIATE SETTLEMENT NEGOTIATIONS: RAMIFICATIONS OF THE *DU* DECISION(S)

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I. Introduction

On June 11, 2012, the 9th Circuit Court of Appeals announced its decision in Du v. Allstate Insurance Co., 681 F.3d 1118 (9th Cir. 2012), sending ripples of concern throughout the insurance industry in California. In that decision, the Court held that an insurer may be held liable for bad faith on a failure to settle theory if it fails to ***initiate*** settlement negotiations, even in the absence of a within-policy limits demand. Perhaps in response to those rumblings, the Court amended its decision on October 5, 2012 (found at 697 F.3d 753), backing off its earlier pronouncement. In its amended decision, the Court instead held that it need not address the "duty to initiate" issue because under the specific facts of this case, no such duty ever arose – at the time the plaintiff in that case suggested that the insurer should have initiated settlement discussions, it did not have enough information about the claim to do so.

With that amended decision, it could be said that the insurance industry "dodged a bullet" and that the California courts are not prepared to impose an affirmative duty to initiate settlement negotiations. Or are they? What if, under the facts of Du (or a case in the future) the insurer ***did*** have sufficient information to initiate settlement discussions prior to any settlement demand from the claimant? This Article will examine the ramifications of the Du decision and the status of the "duty to initiate" issue in California.

II. Background of Bad Faith/Duty to Settle Liability

Before turning to the specifics of Du and its ramifications, it is necessary to briefly discuss the principles underlying the bad faith/duty to settle issue. In addition to the duties imposed on contracting parties by the express terms of their agreement, the law implies in every contract a covenant of good faith and fair dealing (Comunale v. Traders & General Ins. Co., 50 Cal.2d 654, 658 (1958). The implied promise requires each contracting party to refrain from doing anything to injure the right of the other to receive the benefits of the agreement (Egan v. Mutual of Omaha Ins. Co., 24 Cal.3d 809, 818 (1979); Murphy v. Allstate Ins. Co., 17 Cal. 3d 937, 940 (1976); Crisci v. Security Ins. Co., 66 Cal.2d 425 (1967)).

This implied covenant of good faith and fair dealing is equally applicable to insurance contracts, resulting in tort liability for its breach. The California Supreme Court in Comunale v. Traders & Generals Ins. Co., supra, 50 Cal.2d 654, addressed the nature and extent of duties imposed by this implied covenant in liability insurance policies. There, the Supreme Court held that an insurer, in determining whether to settle a claim, must give at least as much consideration to the welfare of the insured as it gives to its own interest. The governing standard is whether a prudent insurer would have accepted the settlement offer if it alone were to be liable for the entire judgment (Johansen v. California State Auto. Assn. Inter-Ins. Bureau, 15 Cal.3d 9, 16 (1975). Thus, an insurer may be held liable for a judgment against the insured in excess of its policy limits where it has breached the implied covenant of good faith and fair dealing by unreasonably refusing to accept a settlement offer within the policy limits (Commercial Union Assur. Cos. v. Safeway Stores, Inc., 26 Cal.3d 912, 916-917 (1980)).

In short, the insurer must settle when there is a danger of a high recovery:

> "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." (Comunale v. Traders & General Insurance Co., 50 Cal.2d 654)).

The key phrase, of course, is "refusing to accept a settlement offer within policy limits". This trigger of potential bad faith liability is premised on a sequence of events which begins with a settlement demand by the plaintiff at or below policy limits, a rejection of that demand by the insurer, and a subsequent judgment in excess of the policy limits. Under that scenario, it is virtually universally held that the insurer will be held liable for that excess judgment as a consequence of its "bad faith" rejection of the settlement demand.

But, does that duty to settle include the duty to actually and affirmatively initiate settlement discussions, and can an insurer be held liable in bad faith for its failure to do so? In California, there are cases seemingly falling on either side of that question. The foundation for that issue is found in California Insurance Code §790.03(h)(5), which provides, as a prohibited "unfair claims settlement practice": "Not attempting in good faith to effectuate prompt, fair, and equitable settlements of claims in which liability has become reasonably clear." While a violation of that statute is no longer directly actionable (Moradi-Shalal v. Fireman's Fund Insurance Co., 46 Cal.3d 287 (1988), a violation can serve as "evidence" of a breach of the covenant (see Jordan v. Allstate, 148 Cal.App.4th 1062 (2007); Rattan v. United Services Automobile Assn., 84 Cal.App.4th 715, 724 (2000) – holding that "at most the regulations, which were in evidence, may be used by a jury to infer a lack of reasonableness on USAA's part.") Thus, the statute is "fair game" from an evidentiary standpoint in bad faith actions.

In light of this language, several California decisions (some of which are referenced in the Du decisions) have resulted in holdings which seem to suggest that an insurer has a good faith duty to initiate settlement negotiations. For example, in Pray v. Foremost Insurance Co., 767 F.2d 1329 (9th Cir. 1985), a defendant in a medical malpractice action was insured under a policy with $100,000 limits. The plaintiff in the underlying action made a policy limits demand, which the insurer rejected. The action went to trial and the jury awarded plaintiff an amount ***less*** than the policy limits. The insurer was nevertheless sued for bad faith, the argument being that the insurer breached its duty to "attempt to settle" the claim, instead forcing it to go to trial. The 9th Circuit Court of Appeal reversed a summary judgment in favor of the insurer, holding that "[i]t is reasonably clear that California courts will interpret the California statute as imposing upon an insurance company the duty actively to investigate and attempt to settle a claim by making, and by accepting, reasonable settlement offers once liability has become reasonably clear. (Id. at 1330). The Court further noted that Foremost "made no counteroffer to settle for what it considered a reasonable amount. If the disputed issues of fact were resolved against Foremost, a reasonable jury could conclude that Foremost breached its duty to investigate and attempt to settle." (Id.)

In McLaughlin v. Nat'l Union Fire Ins. Co., 23 Cal. App. 4th 1132 (1994), the court stated in dicta that "[s]ection 790.03(h)(5) sweeps in a broader range of behavior than Plaintiffs' first assigned cause of action for rejection of a settlement demand within policy limits", thereby implying a duty to actively attempt to settle.

In Gibbs v. State Farm Mutual Insurance Co., 544 F.2d 423 (9th Cir. 1976), an insured accidentally shot another person, resulting in the amputation of that person's leg. The homeowner's policy at issue had limits of $25,000. The claims personnel engaged in internal debates as to whether the shooting was accidental or not and how much should be offered in settlement. However, it was not until a lawsuit had actually been filed against its insured that the insurer offered its policy limits, which were rejected. The action proceeded to trial, resulting in a judgment in excess of the limits. Plaintiff, as an assignee of the insured, sued State Farm for bad faith/failure to settle the claim within policy limits. Plaintiff prevailed.

The 9th Circuit Court of Appeal affirmed. After reviewing the evidence, it determined that State Farm had ample evidence at its disposal to conclude that there was a "reasonable opportunity to settle the claim within the policy limits". (Id. at 427). However, "State Farm failed to conduct any negotiations with Gibbs, neglecting its ***good faith duty to take affirmative action in settling the claim***." (Id.) (emphasis added)

Finally, there is Boicourt v. Amex Assurance Co., 78 Cal. App. 4th 1390 (2000). There, a claimant sustained catastrophic injuries as a result of an automobile accident involving the insured. Prior to filing suit, his attorney asked the insured's carrier to disclose the amount of the policy limits. The insurer refused to disclose the limits (which were $100,000), and refused to contact its own insured about the request, citing a corporate policy not to disclose limits. Ultimately, the claimant was forced to file a formal lawsuit. After the filing, the insurer offered its $100,000 policy limits, which the plaintiff rejected. His attorney later testified that he would have accepted those limits had they been disclosed and offered prior to the suit being filed. The case went to trial, resulting in a stipulated judgment of $ 2,985,000. Plaintiff, as an assignee, filed suit for bad faith.

In the bad faith action, the insurer prevailed on a summary judgment motion. The judgment was reversed on appeal. Essentially, as relevant to this Article, the court held that a formal settlement demand, and a rejection thereof, was not necessarily a prerequisite to a finding of bad faith. The court declined to "explore the degree to which the implied covenant of good faith and fair dealing imposes on a liability insurer a duty to be 'proactive' in settling cases . . . . We do not even explore the extent of the lengths an insurer should go to in the course of contacting the policyholder." (Id. at 1400).

On the other hand, other decisions (also referenced in Du) have reached the opposite conclusion. In Merritt v. Reserve Ins. Co., 34 Cal.App.3d 858 (1973), Reserve's insured was sued as a result of a trucking accident and Reserve provided it with a defense under an auto policy with limits of $100,000/$300,000/$25,000. The investigation revealed a strong case of non-liability on the part of the insured. No settlement offer was ever made and the only demand was for $400,000. At the trial of the underlying action, the jury returned a verdict in excess of $400,000. The insured assigned its rights to the plaintiff, which then sued Reserve for bad faith. One of the bad faith allegations was that Reserve "failed to properly undertake, initiate, entertain or pursue discussions with plaintiff [Merritt] for the disposition and settlement of said case at any stage of the proceeding prior to judgment

. . . ." (Id. at 863). The jury returned a verdict of $499,000 in that bad faith action.

The court of appeal reversed, noting first that since no offer to settle within policy limits was ever made, "no conflict of interest ever developed between assured and carrier, and therefore the issue of the carrier's bad faith in relation to its assured never arose." (Id. at 877)

With respect to the alleged "failure to initiate settlement overtures", plaintiff argued that if Reserve had made such overtures the case could have been settled. The court rejected that argument, holding that "[t]his theory is supported by no evidence whatsoever." (Id. at 878). The court examined the factors at play in the underlying suit that made a settlement virtually impossible, the fact that there was never a demand within policy limits and that neither the plaintiff nor the insured ever requested that Reserve initiate settlement negotiations, concluding that "[n]o suggestion that settlement was feasible was ever made prior to judgment by anyone connected with the suit." (Id. at 878)

In Coe v. State Farm Mut. Auto. Ins. Co., 66 Cal. App. 3d 981 (1977), the underlying action also involved an automobile accident and a liability policy with $25,000 limits. The insured appeared to be liable for the accident and the injuries far exceed the limits. The plaintiff demanded the policy limits. State Farm wrote back, indicating that the demand was "premature" because there was additional investigation that still needed to be done. Plaintiff's counsel did not respond to that letter. His client then died (as a result of injuries sustained in the accident) and his heirs obtained a wrongful death judgment for $250,000. Plaintiff then took an assignment from the insured and obtained a judgment against State Farm in excess of $300,000 in the subsequent bad faith action.

On appeal, State Farm argued that the demand letter was not a "reasonable offer of settlement" for the rejection of which appellant could be held liable". (Id. at 989). The court of appeal reversed the judgment. Although it did not directly address the "duty to initiate" issue, it's holding was firmly based on the notion that bad faith liability rests on an unwarranted failure to accept a reasonable settlement offer (Id. at 996), citing Merritt for support.

Thus, California courts have landed on both sides of this issue, with there being no clear imposition of an absolute duty to initiate settlement discussion under any and all circumstances. It is against this backdrop that Du was decided.

III. The Du Decisions

In Du, Deerbrook's insured, Kim, was involved in an auto accident, resulting in injuries to four individuals including Du. Deerbrook (a subsidiary of Allstate) insured Kim under a policy with a $100,000 limit of liability per individual, and a per accident aggregate limit of $300,000. After the accident and the filing of a claim by all injured occupants against Kim, Deerbrook attempted to evaluate the claim. They were unable to obtain documentation of the claimants' damages but did eventually conclude in February 2006 that Du had sustained serious injuries and that its insured's liability was clear. It did not, however, make any settlement offers at that point in time. Deerbrook eventually made a $100,000 settlement offer, which was rejected as "too little too late." Du subsequently filed a lawsuit against Kim, and obtained a jury verdict in excess of $4 million.

Du, as Kim's assignee, filed a bad faith suit against Allstate and Deerbrook. Du argued that the insurers breached the covenant of good faith and fair dealing by failing to affirmatively settle Du's claim for its policy limits after Kim's liability was reasonably clear, and it was apparent that there was a chance of an excess judgment against its insured. At trial, Du proposed a jury instruction which would have effectively permitted the jury to impose bad faith liability on the insurers for its failure to initiate settlement negotiations.

The trial court rejected this jury instruction. First, the court held that an insurer does not have a duty to initiate settlement discussions in the absence of a settlement demand from the third-party claimant. Second, the court ruled that there was no factual foundation for the instruction because the issue of settlement arose at an early time in the underlying litigation when the insurer did not have sufficient information to discuss settlement. Plaintiff appealed.

In its original decision, the 9th Circuit Court of Appeal directly addressed the issue of whether bad faith liability on a failure to settle theory can be imposed absent a settlement demand from the third party claimant. The Court concluded that such a duty exists, holding that, under California law, an insurer has a duty to "effectuate" a settlement where liability is reasonably clear, even in the absence of a settlement demand. The Court primarily based it ruling on the notion that when there is a risk of an excess judgment, a conflict exists between the insurer and its insured and that "this conflict remains regardless [of] whether a settlement demand is made by the injured party." However, the Court affirmed the trial court's ruling on the basis that from a factual standpoint, the insurer did not have sufficient information at its disposal to "effectuate" a settlement in February 2006, and as such, there was no evidentiary basis for the jury instruction proposed by Du.

On October 5, 2012, the 9th Circuit issued an amended decision in <u>Du</u>, found at 697 F.3d 753. In that opinion, the Court discussed the language of Insurance Code § 790.03(h)(5) and summarized the cases discussed <u>infra</u> concerning the seemingly divergent views on the duty to initiate settlement discussions. Ultimately, the Court stated that it did not need to resolve this legal issue because it found that the district court did not abuse its discretion in ruling that there was no factual foundation for Du's proposed jury instruction. It was reasonable for Deerbrook to wait until it had corroboration of Du's injuries before it began settlement discussions. Thus, the district court's ruling was affirmed. Ultimately, the Court "punted" on the duty to initiate issue, leaving that to be decided by another court on another day.

IV. <u>What Now?</u>

The "duty to initiate" is one that has been addressed directly by courts in other jurisdictions. For example, in Florida, the court in <u>Powell v. Prudential Property & Casualty Insurance Co.</u> 584 So. 2d 12, 14 (1991) held that an insurer has duty to initiate settlement negotiations, even without a demand, where the insured's liability is clear and there is a likelihood of a judgment exceeding the policy limit. The <u>Powell</u> decision was followed in <u>Snowden v. Lumbermens Mutual Casualty Co.</u>, 358 F. Supp. 2d 1125 (N.D. Fla. 2003), <u>Shin Crest PTE, Ltd. v. AIU Insurance Co.</u>, 605 F. Supp. 2d 1234 (M.D. Fla. 2009), and <u>Noonan v. Vermont Mut. Ins. Co.</u>, 761 F. Supp. 2d 1330 (M.D. Fla. 2010). Florida law thus does not appear to require a demand for the policy limits as a re-requisite to a finding of bad faith.

In New Jersey, the court in Rova Farms Resort, Inc. v Investors Ins. Co., 65 NJ 474 (1974), held that an insurer has an affirmative duty to initiate settlement negotiations, unless there is no realistic possibility of settlement within the policy limits and the insured will not contribute to a settlement figure above the policy limits.

Illinois law generally does not require an insurance provider to initiate settlement negotiations (Adduci v. Vigilant Insurance Co., 98 Ill.App.3d 472, 475 (1981); Kavanaugh v. Interstate Fire & Casualty Co., 35 Ill.App.3d 350, 356 (1975). The Illinois Supreme Court, in Haddick v. Valor Ins., 198 Ill. 2d 409 (2001), however, held that "[t]here is an exception to this general rule where the probability of an adverse finding on liability is great and the amount of probable damages would greatly exceed policy limits". (Id. at 717, n.1)

In Morrell Constr., Inc. v. Home Ins. Co., 920 F2d 576 (9th Cir. 1990), the court held that in the absence of a contractual provision to the contrary, the Idaho Supreme Court would not extend its bad-faith cause of action to encompass failures to investigate or failures to initiate settlement negotiations before suit is filed. Courts in Kansas (Roberts v. Printup, 422 F.3d 1211 (10th Cir. 2005), Texas (American Physicians Ins. Exch. v Garcia, 876 S.W.2d 842 (1994) and Ohio (Miller v Kronk, 35 Ohio App 3d 103 (1987) have similarly refused to impose a strict "duty to initiate" standard.

As noted above, California law has been less than clear on this issue. While the original decision in Du paved the way for the imposition of an affirmative duty to initiate settlement discussions, the amended decision took a great leap backwards, thus leaving California law in the same state of limbo that existed prior to Du. Even though the Court avoided tackling that unresolved issue, it left the door open for the imposition of such a duty in the future, under the "right" set of facts. In other words, the inference from the Du decision is that ***if*** the insurer in fact ***did*** have all of the facts it needed to evaluate the claim, and ***if*** that information revealed both adverse liability and the danger of an excess verdict, the insurer may have had a duty to initiate settlement discussions, rather than simply wait for a demand that might never come, followed by an excess verdict. By relying on the specific facts of the case to avoid resolving the "duty to initiate" issue, it may be said that the Court's silence speaks volumes. The Court could have said, albeit in dicta, that even if Deerbrook had all of the facts it needed to make a settlement offer, there was no duty on its part to do so. By stopping short of that pronouncement, the uncertainty under California law remains. What can be said with some degree of certainty is that the more likely it is that there is a danger of an excess verdict, the more likely it is that some sort of affirmative duty will be found to exist.

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