

NOTE

SANCTIONING INSURANCE CARRIERS FOR BAD-FAITH LITIGATION PRACTICES: A PROPOSAL TO CHANGE THE “NAMED PARTY” RULE

I. INTRODUCTION

It was three days before Christmas in 1996. Earnest and Eleanor Brown, a retired couple from Shinnston, West Virginia, were driving on the freeway. The retired couple had twenty-two children, seventeen of whom were adopted, many of them with special needs. As they were driving home, a drunken man in a Mustang swerved into their lane and collided with their car. As a result of the accident, Mr. Brown suffered a concussion and Mrs. Brown seriously fractured her ankle, leaving doctors with doubt as to whether she would ever be able to walk again. Eleanor Brown’s ankle was eventually held together with “a plate, two screws and three wires.”¹

Due to her serious injuries, Eleanor Brown had grave difficulty carrying out her ordinary daily activities. Her ability to give her seventeen special-needs children the attention they required was impaired. Mrs. Brown was forced to climb the stairs in her home in a sitting position, one step at a time. In addition to her physical impediments, she also suffered financial problems. As her medical bills began to accumulate, her medical insurer denied coverage because it felt that the “driver who caused the accident” should be responsible for the medical bills.²

Unfortunately, both the Browns and the drunk driver were insured by the same carrier, State Farm Insurance Company. The insurer offered to pay a mere \$10,000 of the medical bills the Browns incurred, the amount covered under Mrs. Brown’s policy. The drunk driver who was liable for the accident had much higher insurance coverage, but it was apparent to Mrs. Brown that State Farm refused to acknowledge this fact and did not want to tap into his insurance policy coverage.³

It was at this point that Mrs. Brown hired an attorney. As a result, the insurance carrier offered Mrs. Brown \$100,000, the amount covered

1. Scott Finn, *A Question of Bad Faith: Third-party Lawsuits Called Consumer Tool and Legal Club*, CHARLESTON GAZETTE & DAILY MAIL, Feb. 27, 2005, at 1B.

2. *Id.*

3. *Id.*

under the drunk driver's insurance policy. In exchange, State Farm wanted the drunk driver released from all liability. The Browns rejected the offer, however, because they feared their medical bills would accrue to an amount in excess of the offer made. The Browns requested an advance payment in order to be able to pay some of the medical bills, but the company refused. Consequently, Ernest and Eleanor Brown filed a lawsuit for the insurer's bad faith, which prompted the insurance carrier to settle the case for an amount in excess of \$200,000.⁴

While many critics of bad-faith claims, which result in substantial monetary judgments against insurers, call this "jackpot justice," the Browns felt that they would not have received a fair settlement if a bad-faith action had never been filed.⁵ Furthermore, notwithstanding Eleanor's ultimate settlement, one cannot contend that she hit a "jackpot." Because of the insurer's refusal to settle in good faith, in addition to her mental anguish, Eleanor Brown's "credit was destroyed and her life disrupted"⁶ by the unnecessary litigation. The judicial system was used as a "bargaining chip" to effectuate a just result.

This is not an unusual scenario. Insurance carriers have been known to exercise bad faith when third-party claims are brought against their policyholders.⁷ The Brown case is just one example of this unfortunate bad-faith conduct of insurers. However, the remedies currently available in most jurisdictions to policyholders who are injured by an insurer's bad faith are often expensive, time consuming, and impracticable.⁸

Rule 1 of the Federal Rules of Civil Procedure ("FRCP") provides that the rules "shall be construed and administered to secure the just, speedy, and inexpensive determination of every action."⁹ This rule has been mirrored in many state jurisdictions¹⁰ and is the centerpiece of civil litigation. However, this rule is often forgotten by civil litigants.

Courts often consider many matters that involve both parties and non-parties. However, the written laws and rules that guide civil actions in both federal and state courts only lead to the resolution of claims

4. *Id.*

5. *Id.*

6. *Id.*

7. *See infra* notes 115-23 and accompanying text.

8. *See infra* text accompanying notes 26-28.

9. FED. R. CIV. P. 1.

10. *See, e.g.*, KAN. STAT. ANN. § 60-102 (1994) ("The provisions of this act shall be liberally construed and administered to secure the just, speedy and inexpensive determination of every action or proceeding."); MO. ANN. STAT. § 506.010 (2003) ("This code . . . shall be construed to secure the just, speedy and inexpensive determination of every action."); N.Y. C.P.L.R. § 104 (McKinney 2003) ("The civil practice law and rules shall be liberally construed to secure the just, speedy and inexpensive determination of every civil judicial proceeding.").

involving “parties.”¹¹ For example, FRCP Rule 11 provides that a court may impose sanctions on “attorneys, law firms or parties” that defend claims frivolously.¹² Without this option of judicially imposed sanctions, civil actions would be unjust, time consuming and often very expensive for those forced to defend the adversaries’ non-meritorious claims. The unavailability of judicially imposed sanctions may lead to much confusion in the insurance company context.¹³ It is often the case that the defendant’s insurance company, who is a non-party, has more control over litigating the civil cases.¹⁴ The named parties in such cases may be no more than innocent bystanders.

Insurance carriers are a prime example of this contention. While civil claims are brought against their policyholders, the insurance carriers, who are not named as parties to the action, generally have sole control over the litigation of the claims.¹⁵ Insurance carriers have two obligations: the duty to indemnify and the duty to defend civil claims against their policyholders.¹⁶ Additionally, they have an implied fiduciary duty to defend in “good faith”¹⁷ when the claim is covered under the insurance policy,¹⁸ or to settle within the contractual limits of the insurance policy when there is no viable defense.¹⁹

The duty to settle flows from the insurance carrier’s contractual duties²⁰ and the legal system’s overarching goal to keep civil actions “just, speedy, and inexpensive”²¹ for all claimants. However, insurance carriers do not always abide by these duties that are imposed on them. In fact, sometimes carriers have economic incentives for avoiding the timely settlement of claims and advancing with litigation instead.²²

11. Jeffrey A. Parness & Tait J. Lundgren, *Nonparty Insurers in Federal Civil Actions: The Need for New Written Civil Procedure Laws*, 36 CREIGHTON L. REV. 191, 191 (2003).

12. FED. R. CIV. P. 11. Some states have similar statutes providing for the imposition of sanctions on parties. *See, e.g.*, OKLA. STAT. ANN. tit. 12, § 2011(C) (West 1993) (“[T]he court shall . . . impose an appropriate sanction upon the attorneys, law firms, or parties . . . responsible for the violation.”); UTAH R. CIV. P. 11(c) (2005) (“[T]he court may . . . impose an appropriate sanction upon the attorneys, law firms, or parties . . . responsible for the violation.”).

13. *See* Parness & Tait, *supra* note 11, at 191-92.

14. *See* Cindie Keegan McMahon, Annotation, *Duty of Liability Insurer to Initiate Settlement Negotiations*, 51 A.L.R.5th 701, § 2 (1997).

15. *Id.*

16. *See id.*

17. *See id.*

18. Andrew Janquitto, *Insurer’s Duty to Defend in Maryland*, 18 U. BALT. L. REV. 1, 3-4 (1988); Susan Randall, *Redefining the Insurer’s Duty to Defend*, 3 CONN. INS. L.J. 221, 222 (1997).

19. *See* McMahon, *supra* note 14, at § 7; *see also* Mendota Elec. Co. v. N.Y. Indem. Co., 211 N.W. 317, 318-19 (Minn. 1926).

20. *See* Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113, 1117-27 (1990).

21. *See* FED. R. CIV. P. 1.

22. John N. Ellison et al., *Bad Faith and Punitive Damages: The Policyholder’s Guide to Bad Faith Insurance Coverage Litigation—Understanding the Available Recovery Tools*, SJ099 A.L.I.-

An insurer's decision to breach may lead to a plethora of harms imposed on a policyholder who was relying on the carrier's duty to indemnify, defend, or settle claims against her. For example, a policyholder may be subject to pay damages in excess of the insurance policy when a settlement could have been effectuated well within the bounds of the policy limit.²³ A policyholder may be forced to expend needless and extensive funds by bringing suit against an insurance carrier for exposing her to a judgment in excess of the policy limits.²⁴ A policyholder may have her life disrupted and credit destroyed because of an insurer's bad-faith refusal to settle the claim for a reasonable amount.²⁵

Insurance policyholders who have been wrongly subjected to unwarranted or excess liability because of an insurance carrier's unreasonable refusal to settle claims against them may have remedies available. They may successfully bring causes of action in tort or for breach of contract.²⁶ However, these claims cannot arise until a full trial has been completed and a verdict is rendered against the policyholders in excess of the original insurance policy coverage.²⁷ Thus, the judicial goal to have civil cases determined in a "just, speedy and inexpensive"²⁸ manner is frustrated.

Notwithstanding the fact that such causes of action are available to insurance policyholders, judicial efficiency is nevertheless threatened because they may ultimately result in trial. Causes of action arising from an insurance carrier's wrongful refusal to settle waste the court's time and the litigant's money. This additional litigation could easily be avoided by an insurer's good-faith attempt to settle the case or by the judicial imposition of sanctions on the insurance carrier for its unreasonable refusal to do so.

Few courts have imposed sanctions on insurance carriers who frivolously refused to settle when there was no viable defense.²⁹ However, this Note proposes that this rule should be considered and

A.B.A. 235, 237 (2004).

23. See, e.g., *Knobloch v. Royal Globe Ins. Co.*, 38 N.Y.2d 471, 474, 476-77 (1976); *Campbell v. State Farm Mut. Auto. Ins. Co.*, 840 P.2d 130, 133, 134 (Utah Ct. App. 1992).

24. See *Bedoya v. Ill. Founders Ins. Co.*, 688 N.E.2d 757, 759-60 (Ill. App. Ct. 1997).

25. See *supra* text accompanying notes 4-5.

26. See RICHARD A. LORD, *INSURER'S RIGHT AND OBLIGATION TO SETTLE CLAIM AGAINST INSURED*, 16 WILLISTON ON CONTRACTS § 49:105 (4th ed. 2000).

27. See *id.*

28. See FED. R. CIV. P. 1.

29. See, e.g., *Saastomoinen v. Pagano*, 183 Misc. 2d 781 (N.Y. Sup. Ct. 2000), *rev'd*, 278 A.D.2d 218 (N.Y. App. Div. 2000) (sanctions imposed by trial court reversed on appeal); *Patitucci v. Laverty*, No. 2107, 1989 WL 817175 (Pa. Ct. Com. Pl. Sept. 15, 1989), *rev'd*, 576 A.2d 992 (Pa. Super. Ct. 1989) (sanctions imposed by trial court reversed on appeal).

adopted by a majority of jurisdictions. Allowing courts to impose sanctions on “non-parties” such as insurance carriers, the real parties in interest in civil litigation, would result in a more efficient judicial system, conserving time and money for all those involved.

Part II of this Note will look at the purpose of insurance carriers, their rights, and the duties they owe to policyholders. This Part will explore the difference between the contractual, statutory, and fiduciary duties, and what each duty entails. Furthermore, it will assess insurance carriers’ role in the litigation process, probing whether they can and should be considered the real parties in interest for all purposes of litigation, including the imposition of sanctions.

Part III will examine the possible causes of action that may arise out of the insurer’s breach of its several duties and will examine the definition of “bad faith.” Part III will discuss whether insurers have a reasonable duty to settle claims, although the carrier’s money and assets are at stake. Additionally, it will analyze cases based on an insurer’s bad faith, the implications of such misconduct and the possibility of the insurance carrier’s reluctance to settle as a result of the policyholder’s bad faith in insurance claims.

In Part IV, this Note will evaluate the possible economic incentives insurance carriers have for choosing not to settle and instead prolonging litigation. In addition, it will discuss the externalities imposed on the judicial system by the insurer’s refusal to settle claims in a timely and reasonable manner while exploring how certain jurisdictions have handled this very issue resulting in conflicting decisions. This Part will balance the costs and benefits to the insurance carriers and to the community as a whole.

Part V will conclude with the possible solution of judicial power to sanction insurance carriers. This Part will assert that the public policy of having an efficient, just, and trustworthy judicial process far outweighs any economic benefits conferred by the prolonging of litigation by insurers’ refusals to settle claims. It will assert that public policy demands that a stronger check be placed on insurance carriers who try to escape their duties under the insurance contracts possibly avoiding liability.

II. INSURANCE CARRIERS MUST INDEMNIFY POLICYHOLDERS FOR CLAIMS COVERED UNDER THEIR INSURANCE POLICIES: THE PURPOSE OF INSURANCE

Insurance is a contract between parties where a policyholder pays a

premium in consideration of the insurer's guarantee to indemnify³⁰ the policyholder against unforeseeable or contingent harms.³¹ The guarantee of indemnification is the most important reason, possibly the sole reason, most people obtain insurance policies. In general, parties obtain insurance policies under the premise that being insured is more beneficial than being uninsured.³² However, an insurance policy is unlike the traditional contract.³³

Ordinarily, an "opportunistic breach" of contract would be permissible, and in some instances even commendable.³⁴ Nevertheless, insurance contracts do not carry the same implications. There is no such thing as an opportunistic breach of an insurance contract.³⁵ Though breaching the contract may benefit the insurer, the policyholder is almost always harmed when an insurer breaches its contract.³⁶ Because insurers have an incentive to breach their contracts at the expense of the policyholders, the underlying purpose of the insurance contract³⁷ is undermined.³⁸

During the 2005 hurricane season, Hurricane Katrina and Hurricane Rita brought massive devastation to various regions of the United States. In light of these recent tragedies, insurers' attempts to avoid making payments to their policyholders were widely reported.³⁹ Insurance carriers have sought to rely on the language of the policies, but have not

30. "Indemnify" means "[t]o reimburse (another) for a loss suffered because of a third party's or one's own act or default," or "[t]o give (another) security against such a loss." BLACK'S LAW DICTIONARY 783-84 (8th ed. 2004).

31. See *Auto. Funding Group v. Garamendi*, 114 Cal. App. 4th 846, 851 (Cal. Dist. Ct. App. 2003).

32. See *Economics of Insurance: Why Companies Sell Insurance*, <http://userweb.port.ac.uk/~fyshd/eoi/wcsi.htm> (last visited Sept. 5, 2006) [hereinafter *Economics of Insurance*].

33. See Ellison, *supra* note 22, at 239.

34. See *id.* at 239. In an action where an "opportunistic breach" (a "breach designed to take advantage of the vulnerable promisee") has been effectuated, recovery is limited to consequential damages "to foster efficient breaches." *Id.* at 240. A breach of contract can be efficient when both parties to the contract are better off as a result of the breach, even after the breaching party has fully compensated the non-breaching party. *Id.* at 239. Thus, in some situations, there are incentives for parties to breach a contract. See David W. Barnes, *The Meaning of Value in Contract Damages and Contract Theory*, 46 AM. U. L. REV. 1, 2-4 (1996).

35. See Ellison, *supra* note 22, at 239.

36. See *id.* at 240.

37. It is common knowledge that the insurance carrier has the responsibility to indemnify policyholders by making a payment on their behalf for a claim covered in the policy in exchange for the premiums paid.

38. See *id.* at 241-42; see also Eugene R. Anderson & James J. Fournier, *Why Courts Enforce Insurance Policyholders' Objectively Reasonable Expectations of Insurance Coverage*, 5 CONN. INS. L.J. 335, 377-78 (1998).

39. See Jeff French, *An Inflection Point for Cat Bonds; After Katrina, Investors May Face Losses on Principal for the First Time*, INVESTMENT DEALERS' DIG., Sept. 12, 2005.

been very successful.⁴⁰ Although there were disputes as to whether damage was caused by “flooding, wind or wind-blown rain,” possible negative publicity has been a driving force, encouraging insurers to pay the claims.⁴¹ As a result, private insurers are likely to make payouts to Hurricane Katrina victims because the federal government only provides for minimal flood coverage.⁴²

This is an example of the reluctance exhibited by the insurance carriers to pay out or settle claims. This unwillingness to abide by their insurance contracts can also be seen in civil litigation. Due to the insurance carriers’ refusal to settle claims where there is no viable defense, insurers are often subject to needless litigation, and possibly additional liability, after the initial suit is over. However, insurers do not seem to be bothered by additional litigation.⁴³ Insurers spend substantial time in court, and often bring suits against their own policyholders, to litigate whether the claims are in fact covered, in an attempt to avoid payment pursuant to their insurance policies.⁴⁴

A. Insurance Carriers’ Duties Are Twofold: The Duty to Defend and the Duty to Settle in “Good Faith”

Insurance carriers have two important duties that underlie their very purpose to indemnify their policyholders. First, insurance carriers have the duty to reasonably defend claims against the insured.⁴⁵ Second, insurance carriers have the duty to settle within policy limits when no viable defense exists.⁴⁶ The duty to defend and the duty to settle in good faith often overlap. Insurers must make a good faith determination as to the merits of their defense and proceed accordingly. Insurance carriers have a “good faith” duty because of their relationship to the policyholder and their role in the litigation process.⁴⁷ Once a claim is brought against a policyholder, the insurance carrier has exclusive control over all parts

40. *Id.*

41. *Id.*

42. *Id.*

43. *See* Ellison, *supra* note 22, at 247.

44. *Id.*

45. *See, e.g.*, N.M. UNIF. JURY INSTRUCTION CIV. § 13-1703 (West 2005) (“An insurance company acts in bad faith in refusing to defend a claim if the terms of the insurance policy do not provide a reasonable basis for the refusal.”); OHIO REV. CODE ANN. § 3937.21 (West 2005) (“No insurance company issuing a policy of automobile or motor vehicle liability insurance shall be relieved of its contractual obligation to defend its insured against any claim on the basis of coverage for such claim being provided by any other policy, unless the insurer of such other policy has assumed and is performing the obligation to provide such defense.”).

46. *See* Campbell v. State Farm Mut. Auto. Ins. Co., 840 P.2d 130, 138 (Utah Ct. App. 1992).

47. *Id.*; *see also infra* notes 144-147 and accompanying text.

of the litigation, including settlement.⁴⁸

1. Insurance Carrier's "Right" to Defend is Often Waived

The duty to defend is an insurance carrier's right.⁴⁹ Insurers often desire to defend the claims against policyholders who are covered under the policy because the carriers' financial interests are also at stake.⁵⁰ However, insurers in many instances have breached their duties to defend and indemnify, bringing suit against their policyholders (mostly declaratory judgment actions) in an attempt to avoid liability and fight coverage under the policies.⁵¹

Some jurisdictions have recognized insurers' "vexatious" refusals to settle and have provided some remedies for injured parties.⁵² In *Bedoya v. Illinois Founders Insurance Co.*,⁵³ the plaintiff brought an action against the insurer for the "vexatious and unreasonable" breach of its duty to defend under its policy.⁵⁴ In the underlying suit, the plaintiff, a café owner, was sued by a woman who had allegedly been assaulted and raped by an unknown patron of the establishment.⁵⁵ One of the claims of the complaint was made pursuant to the "Dram Shop Act."⁵⁶ The insurance carrier was supposed to cover the insured from liability incurred by the Dram Shop Act. However, the insurer breached its duty to defend the plaintiff and only settled one count of the underlying multi-count lawsuit.⁵⁷ The insurer contended that it only had the obligation to

48. *Id.*

49. *See* Randall, *supra* note 18, at 261.

50. *See id.*

51. *See* Ellison, *supra* note 22, at 247.

52. *See, e.g.*, 215 ILL. COMP. STAT. ANN. § 5/155(1) (West 2004) ("In any action by or against a company wherein there is in issue the liability of a company on a policy or policies of insurance or the amount of the loss payable thereunder, or for an unreasonable delay in settling a claim, and it appears to the court that such action or delay is vexatious and unreasonable, the court may allow as part of the taxable costs in the action reasonable attorney fees [and] other costs.") (emphasis added).

In Missouri, the state statute provides that:

In any action against any insurance company to recover the amount of any loss under a policy . . . except automobile liability insurance, if it appears from the evidence that such company has refused to pay such loss without reasonable cause or excuse, the court or jury may, in addition to the amount thereof and interest, allow the plaintiff damages . . . and a reasonable attorney's fee; and the court shall enter judgment for the aggregate sum found in the verdict.

MO. ANN. STAT. § 375.420 (West 2005).

53. 688 N.E.2d 757 (Ill. App. Ct. 1997).

54. *Id.* at 760.

55. *Id.* at 759.

56. A "dram-shop act" is "[a] statute allowing a plaintiff to recover damages from a commercial seller of alcoholic beverages for the plaintiff's injuries caused by a customer's intoxication." BLACK'S LAW DICTIONARY 531 (8th ed. 2004).

57. *Bedoya*, 688 N.E.2d at 760.

defend claims that were clearly covered under the policy.⁵⁸

Disagreeing with the insurer's contention, the court held that, since it was well-established in the State of Illinois that "the duty to defend extends to cases where the complaint alleges several causes of action or theories of recovery against an insured, one of which is within the coverage of [the] policy,"⁵⁹ the insurer had a duty to defend *every* count of the underlying suit.⁶⁰ The insurance company was sanctioned, ordered to pay the insured for the injury suffered, and estopped from raising a non-coverage defense to liability as a result of its failure to defend in the underlying suit.⁶¹ Though the trial court's imposition of attorney's fees pursuant to the vexatious refusal to settle was upheld, the judicial sanctions imposed pursuant to Illinois Supreme Court Rule 137 were not.⁶² The court held that no proper explanation was provided by the trial court in imposing the sanctions.⁶³ Nonetheless, the court did note that the record contained sufficient evidence of the defendant insurance carrier filing papers with "blatantly incorrect legal analysis."⁶⁴

2. Failure to Settle in "Good Faith" Results in Excessive Litigation

Although insurers often do feel compelled to defend suits against their policyholders because it is the carrier's assets that are at stake, this compulsion does not carry over to their good-faith duty to settle. Generally, a cause of action for an insurance carrier's failure to settle a claim in good faith may be encountered when the following four elements are satisfied.⁶⁵ First, a settlement offer must have been made by the claimant.⁶⁶ Second, the offer made must have been within the policy limit.⁶⁷ Third, no viable defense must be available for the policyholder

58. *Id.* at 761.

59. *See id.* at 761 (quoting *Md. Cas. Co. v. Peppers*, 355 N.E.2d 24 (Ill. 1984)).

60. *Id.* at 762.

61. *See id.* at 760-63.

62. *Id.* at 765. Under this rule, the reasons for the sanctions imposed must be stated with specificity. *See* ILL. SUP. CT. R. 137. Though this statute allows courts to impose sanctions on insurance carriers, these sanctions are applicable to insurers who have been named in the suit; it does not appear that sanctions under this statute are applicable to insurance carriers who have exclusive control over the defense of lawsuits against their policyholders who are often not named in the cause of action.

63. *Bedoya*, 688 N.E.2d at 765.

64. *Id.*

65. *See generally* *Freeman v. Leader Nat'l Ins. Co.*, 58 S.W.3d 590 (Mo. Ct. App. 2001) (finding that an insurer owes a duty to settle after four criteria are met).

66. *See, e.g., id.* at 598-99. Some courts do not require this element. *See infra* Part II.A.4.

67. *See* *Kransco v. Am. Empire Surplus Lines Ins. Co.*, 2 P.3d 1, 9 (Cal. 2000) ("An insurer that breaches its implied duty of good faith and fair dealing by unreasonably refusing to accept a settlement offer within policy limits may be held liable for the full amount of the judgment against

that would allow a reasonable jury to return a verdict for the defendant.⁶⁸ Finally, there must be a plaintiff's verdict at the conclusion of trial in excess of the insurance policy subsequent to the insurance carrier's refusal to settle.⁶⁹ However, these four factors are not the only instances in which a cause of action for bad-faith failure to settle may occur.⁷⁰ Various jurisdictions apply different standards in establishing comparable causes of action.⁷¹ A finding of bad faith may be tantamount to a finding that the insurance carrier breached its fiduciary duty to the policyholder.⁷²

In *Knobloch v. Royal Globe Insurance Co.*,⁷³ the insurer was subject to subsequent litigation and additional liability for its bad-faith refusal to settle the claims against its policyholders when it had an opportunity to do so. Knobloch, a policyholder of Royal Globe Insurance Company, was the plaintiff in this action. The claim in the underlying suit, where Knobloch was one of two defendants, was covered under Knobloch's insurance policy. The insurance carrier refused, in bad faith, to settle a claim brought against Knobloch in the underlying suit. As a result, Knobloch brought this action against the insurance carrier.⁷⁴

The underlying suit, which led to this subsequent litigation, was

the insured in excess of its policy limits.") (citing *Commercial Union Assurance Cos. v. Safeway Stores, Inc.*, 610 P.2d 1038 (Cal. 1980)); see also *Campbell v. State Farm Mut. Auto. Ins. Co.*, 840 P.2d 130, 138 (Utah Ct. App. 1992) ("[A]n insurer owes its insured a duty to accept an offer of settlement within the policy limits when there is a substantial likelihood of a judgment being rendered against the insured in excess of those limits.") (citing *Larraburu Bros. v. Royal Indem. Co.*, 604 F.2d 1208, 1211-12 (9th Cir. 1979)).

68. This is an integral part of the test. See *Northfield Ins. Co. v. St. Paul Surplus Lines Ins. Co.*, 545 N.W.2d 57, 60 (Minn. 1996) (stating that Minnesota requires that the policyholder be "clearly liable before the insurer may suffer liability for breach of its duty of good faith").

69. See *Mendota Elec. Co. v. N.Y. Indem. Co.*, 211 N.W. 317, 318-19 (Minn. 1926) (stating that in order for the insurance carrier to avoid liability, the insurer must believe in good faith that the proposed settlement figure was greater than what a jury would award in damages, even if it is certain that the insured policyholder is liable).

70. See *Freeman v. Leader Nat'l Ins. Co.*, 58 S.W.3d 590, 598 (Mo. Ct. App. 2001) (holding that a breach of duty to settle must allege four elements: "(1) the insurer's assumption of control over negotiation and settlement and legal proceedings brought against the insured; (2) a demand by the insured that the insurer settle the claim; (3) the insurer's refusal to settle the claim within the liability limits of the policy, and (4) proof that the insurer acted in bad faith, rather than negligently") (citing *Ganaway v. Shelter Mut. Ins. Co.*, 795 S.W.2d 554, 564 (Mo. Ct. App. 1990)); *Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 796-97 (Utah 1985) (involving a policyholder who brought a claim against its own insurance carrier for failing to settle his claim in good faith).

71. See generally *infra* notes 88-106 and accompanying text.

72. See *Ellison, supra* note 22, at 278 ("In any bad faith insurance coverage litigation, emphasize that the fiduciary duties of insurance companies and the public interest nature explains why companies must place policyholders' interests before their own.").

73. 38 N.Y.2d 471 (1976).

74. *Id.* at 474.

based on a one-car accident where Knobloch was the driver. The car was owned by Knobloch's mother, the second defendant in the underlying action. Wickman, the passenger and plaintiff in the underlying suit, was seriously injured when Knobloch's car overturned. Several attempts were made by Wickman's attorney to settle the case within the policy limit of \$10,000. Nevertheless, Royal Globe Insurance Company failed to make a reasonable settlement offer, despite the fact that Wickman's injuries were substantial and the claim was covered under the policy.⁷⁵

Knobloch was dissatisfied with the attorney provided to him by the insurer and retained independent counsel to protect his personal interests. Knobloch's independent counsel made settlement offers in excess of the insurance policy in addition to the insurer's offer in the entire amount of the insurance policy. However, it was too late; these offers were declined by Wickman's attorney who decided to litigate the matter. At trial, the jury rendered a verdict in favor of Wickman in the amount of \$75,383.50, an amount more than seven times the insurance policy. The insurance carrier only paid \$10,000. Thus, the two defendants were obligated to split the judgment in excess of the policy.⁷⁶

Knobloch subsequently brought an action against Royal Globe Insurance Company for its bad-faith failure to settle the underlying claim within the policy limits. Due to the insurer's refusal to settle, the insured was exposed to excess liability, and a jury verdict was rendered in favor of the plaintiff for \$30,236.50 in excess of the insurance policy. Litigation did not end there, however. The insurance carrier, displeased with the jury's verdict, appealed on the ground that the judge wrongly instructed the jury and was successful in getting the verdict reversed. However, on final appeal, the New York State Court of Appeals ultimately reinstated the jury verdict and held that there was sufficient evidence for the jury to conclude that the insurance carrier had acted in bad faith.⁷⁷

3. Insurer Owes a Fiduciary Duty Only to Its Policyholders

In *Beck v. Kelly*,⁷⁸ the plaintiff sought to appeal a directed verdict entered in favor of the defendant insurer, in an action brought for the insurance carrier's alleged failure to settle within policy limits.⁷⁹ The court held that an insurance carrier cannot be liable for failing to settle a claim in good faith against its policyholder if no clear offer for

75. *Id.* at 471, 474-75.

76. *Id.* at 475-77.

77. *Id.* at 476-77.

78. 323 So. 2d 667 (Fla. Dist. Ct. App. 1976).

79. *Id.* at 668.

settlement was made by the claimant.⁸⁰

Plaintiff William Beck was struck and seriously injured by the policyholder's automobile while standing at a bus stop. State Farm, the defendant, began negotiations with Beck's attorneys in an effort to settle the case within the policy limits of \$10,000. However, State Farm never received a response either accepting or rejecting its settlement offer. At trial, the jury rendered a verdict of \$45,000 in excess of the insurance policy. After trial, defendant State Farm only paid \$10,000—the amount of the policy limit.⁸¹

Seeking the satisfaction of the entire judgment, the plaintiff brought this action against State Farm to recover the amount in excess of the insurance policy. The jury rendered a verdict for the plaintiff in the amount of \$45,000. In spite of this, the trial judge entered judgment for State Farm, granting a motion for directed verdict which had been reserved before the jury verdict was rendered.⁸²

On appeal, the trial court's decision was affirmed. The appellate court recognized that an insurer may be held liable for wrongfully refusing to settle claims in bad faith for the amount of the judgment in excess of the insurance policy. However, the court held that an insurance carrier cannot be liable for a bad-faith refusal to settle if no offer to settle within policy limits was made by the claimant.⁸³

Beck v. Kelly can be clearly distinguished from *Knobloch v. Royal Globe Insurance Co.* In *Knobloch*, the subsequent action was brought by the policyholder. Several attempts to settle the suit had been made by the plaintiff, but the insurer refused, in bad faith, to settle the claim within policy limits.⁸⁴ However, in *Beck*, the plaintiff, who brought the bad-faith refusal to settle action, was the very person who refused to settle. Although the insurance carrier had made attempts to negotiate settlement, the plaintiff neither accepted nor rejected the settlement offers.⁸⁵ It was because of the *claimant's* conduct that a jury rendered a verdict in excess of the policy limit. Furthermore, the insurer generally owes a duty to the policyholder to defend claims and settle suits in good faith.⁸⁶ Contractually, the insurer owes no duty to a third-party claimant who is bringing a claim against the insured based on a previous judgment.⁸⁷

80. *Id.* at 669.

81. *Id.* at 668.

82. *Id.*

83. *Id.*

84. *Knobloch v. Royal Globe Ins. Co.*, 38 N.Y.2d 471, 476-77 (1976).

85. *Beck v. Kelly*, 323 So. 2d 667, 668 (Fla. Dist. Ct. App. 1976).

86. McMahon, *supra* note 14, at § 2.

87. *See id.*

4. A Different Interpretation of the Insurance Carrier's Bad-Faith Refusal to Settle

Some courts do not require the satisfaction of all four elements in order to bring a cause of action based on the insurer's bad-faith refusal to settle. For instance, several courts have not required third-party claimants⁸⁸ to make offers to settle within the insured's policy limit as a prerequisite.⁸⁹ Additionally, courts have held that when an excess insurer exists, a policyholder is not judgment-proof:⁹⁰ "[A]bsence of an offer to settle within policy limits is not dispositive of the question of bad faith on the part of the primary insurer."⁹¹

In *General Accident Fire & Life Assurance Corp. v. American Casualty Co.*, the Florida District Court of Appeals qualified its position in *Beck v. Kelly* and limited its holding.⁹² In this case, a claim was brought by an excess insurance carrier against the primary insurer. A neighbor sued John Brown, Jr., the policyholder, when his young child drowned in Brown's pool. Brown was insured by General Accident's (the "primary insurer") liability insurance coverage, for up to \$300,000.⁹³ Additionally, Brown had also obtained an excess liability insurance policy for \$1,000,000 from American Casualty (the "excess insurer").⁹⁴ The primary insurer had sole control of litigating and defending the suit. The excess insurer did not take an active role in the litigation. However, the excess insurer notified the primary insurer and asked to be kept informed.⁹⁵

During the course of discovery, the primary insurer learned that Brown was likely to receive a potentially large judgment against him. Furthermore, counsel and the primary insurer's local adjuster were convinced that Brown would probably lose the suit with a substantial plaintiff's verdict. Consequently, counsel for the primary insurer urged

88. Claimants are those parties who have claims or bring suit to collect against an insurer for the wrongful conduct of a policyholder.

89. See, e.g., *Young v. Am. Cas. Co.*, 416 F.2d 906, 910 (2d Cir. 1969); *Gen. Accident Fire & Life Assurance Corp., Ltd. v. Am. Cas. Co.*, 390 So. 2d 761, 765 (Fla. Dist. Ct. App. 1980); *Rova Farms Resort, Inc. v. Investors Ins. Co. of Am.*, 323 A.2d 495, 504 (N.J. 1974); *State Auto. Ins. Co. v. Rowland*, 427 S.W.2d 30, 33 (Tenn. 1968); *Alt v. Am. Family Mut. Ins. Co.*, 237 N.W.2d 706, 713 (Wis. 1976).

90. "Judgment-proof" can be defined as being unable to satisfy a money judgment to pay damages because the person does not own any property or enough property within the court's jurisdiction for the judgment to be satisfied. See BLACK'S LAW DICTIONARY 861-62 (8th ed. 2004). The person who is judgment-proof may also claim a benefit that his property is statutorily exempt. *Id.*

91. *Gen. Accident Fire & Life Assurance Corp.*, 390 So. 2d at 765.

92. *Id.* at 765-66.

93. *Id.* at 762.

94. *Id.*

95. *Id.* at 763. This was usual custom in the insurance industry. *Id.*

his client, in a letter, to attempt to settle the case for the entire policy limit.⁹⁶

Counsel for the plaintiffs in the underlying action wrote to counsel for the primary insurer in an effort to settle the case. Plaintiffs made an initial demand of \$1,000,000, which was later reduced to \$900,000. Although the primary insurer's adjuster was asked to contact the excess insurer to inquire whether it would contribute toward a settlement with the plaintiffs if the primary insurer would utilize its entire policy, he failed to do so. Instead, the primary insurer refused to negotiate further with the plaintiffs because it felt that the original offer to settle was unreasonable.⁹⁷

The excess insurer demanded that the primary insurer attempt to settle the case shortly before the case went to trial. However, the primary insurer did not respond to the request, nor did it make a settlement offer prior to the commencement of trial. At the start of trial, the primary insurer finally made an offer to settle the case for a mere \$25,000.⁹⁸ The offer to settle, which was refused by the plaintiffs, was far less than the original settlement demand and the policy limit.

The jury, as previously predicted, returned a verdict for the plaintiff for a substantial sum of \$700,000, an amount more than double the primary insurance coverage. Though the matter was settled for \$690,000, the excess insurer was forced to pay \$390,000. The primary insurer was only obligated to pay the total amount of its policy limit.⁹⁹

Accordingly, the excess insurer filed suit against the primary insurer alleging that the primary insurer's bad-faith refusal to negotiate with the plaintiffs for a reasonable amount damaged them. The trial court awarded the excess insurer \$170,593.15, which included a jury verdict of \$100,000, as well as attorney's fees and prejudgment interest.¹⁰⁰

The appellate court upheld the verdict.¹⁰¹ The Florida District Court of Appeals reasoned that the cause of action for bad-faith refusal to settle was created to protect insurance policyholders, who have no control over the settlement, from excess judgment because of an insurance carrier's willingness to risk going to trial instead of negotiating claims.¹⁰² The

96. *Id.* In the letter, dated November 28, 1973, counsel wrote, "This case is taking overtones of a very serious exposure and I suggest that you carry the matter at your full reserve of \$300,000." *Id.*

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.* at 766.

102. *Id.* at 764.

court held that a primary insurer has a duty to negotiate the settlement of claims in “good faith” because it controls the defense of the claim.¹⁰³ The excess insurer does not assume the same duties because it does not have any control over the ensuing litigation.¹⁰⁴

The court further found that an offer to settle within policy limits by a claimant was a factor to be considered but was not determinative of an insurer’s bad-faith refusal to settle. While an offer to settle within policy limits may be an important factor in certain cases, it would not apply in circumstances where there is an excess insurance policy at issue or where the insured is not judgment-proof and is fully capable of paying an excess judgment.¹⁰⁵

If judicially-imposed sanctions had been within the realm of power for the trial court at an early stage of litigation for the insurer’s refusal to settle within the policy limits, the insurer may have been deterred from refusing to settle the claim and the subsequent litigation may have been avoided. There have been many other instances where a court’s time has been wasted by needless litigation due to insurers’ bad-faith refusals to settle.¹⁰⁶ Although there is a fine line as to what constitutes bad faith in the insurance settlement arena, it is arguable that the availability of judicially imposed sanctions for trial judges may substantially deter insurers from unreasonably refusing to settle where there is a clear indication of liability.

B. Insurance Carriers Should Be Considered Real Parties in Interest Even Though They Are Not Named Parties in Litigation

Rules of civil procedure across jurisdictions provide that all actions must be brought in the name of the real party in interest.¹⁰⁷ The question

103. *Id.* at 765.

104. *Id.*

105. *Id.*

106. *See, e.g.,* Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 26 (N.Y. 1993) (recognizing that insurers have a duty to defend and a duty to settle in good faith where they exercise exclusive control over such claims); Smith v. Gen. Accident Ins. Co., 697 N.E.2d 168, 171 (N.Y. 1998) (holding that insurers can be held liable for refusing a settlement offer in bad faith).

107. *See, e.g.,* GA. CODE ANN. § 9-11-17 (West 2005) (“Every action shall be prosecuted in the name of the real party in interest.”); IOWA CODE ANN. § 1.201 (West 2002) (“Every action must be prosecuted in the name of the real party in interest.”); WIS. STAT. ANN. § 803.01 (1) (West 2001) (“No action shall be dismissed on the ground that it is not prosecuted in the name of the real party in interest until [certain conditions are met].”). *See also* FED. R. CIV. P. 17(a), which provides that:

Every action shall be prosecuted in the name of the real party in interest. An executor, administrator, guardian, bailee, trustee of an express trust, a party with whom or in whose name a contract has been made for the benefit of another, or a party authorized by statute may sue in that person’s own name without joining the party for whose benefit the action is brought; and when a statute of the United States so provides, an action for

arises as to whether the insurance carrier should be considered the real party in interest for all purposes of litigation when it is not, in fact, the "named party." For example, according to the rules of civil procedure of various jurisdictions, sanctions may only be imposed on parties. However, the definition of parties is not always clear. Insurers, as a result, could engage in misconduct and not be punished or sanctioned in any way, because they are not the "named party" to the action. Courts have split on this contention.

Rules of civil procedure in most jurisdictions do not allow the imposition of sanctions on "non-parties."¹⁰⁸ Additionally, the rules do not specify an exception for real parties in interest who may not be named in the action. The fact that insurance carriers are in exclusive control of the litigation has been overlooked in many jurisdictions. Furthermore, although some courts have ruled that insurers are real parties in interest, they have been reluctant to bind the carriers by the same rules that bind the named litigants.¹⁰⁹

The appellate court in *David Leinoff, Inc. v. 208 West 29th Street Associates*¹¹⁰ took a step in the right direction. There, the court held that although insurance carriers are not parties, they are the real parties in interest in a civil action.¹¹¹ If this contention is not accepted, it could result in undesirable effects in our judicial system.¹¹² Since the insurance carrier has exclusive control over the litigation, the defendant policyholder only serves as a mask during the trial, allowing the insurance carrier to escape liability in the event of its misconduct.

In contrast, in *Green v. Cunningham*,¹¹³ it was not enough that the insurance carrier had a duty to defend under its contract. The court determined that the insurer did not have the right of action and was entitled to no benefits from such right. Therefore, the court held it could not be considered the real party in interest.¹¹⁴

the use or benefit of another shall be brought in the name of the United States.

108. See *supra* notes 11-12 and accompanying text.

109. See, e.g., *Saastomoinen v. Pagano*, 278 A.D.2d 218, 218-19 (N.Y. App. Div. 2000).

110. 243 A.D.2d 418 (N.Y. App. Div. 1997). In this case, the plaintiff tenant filed a water damage claim with its insurer because of a leak in the defendant's sprinkler system that the plaintiff was leasing. A subrogation action was brought by the insurer against the defendant property owner on behalf of the plaintiff. The plaintiff did not comply with discovery demands, which resulted in the complaint being dismissed. The court held, on appeal, the case should not have been dismissed even if plaintiff did not comply with discovery demands, because the insurer was the real party in interest and it was likely to suffer though the noncompliance was not its fault. *Id.* at 418-20.

111. See *id.*

112. See *infra* Part IV.B.

113. No. 15-79-16, 1980 WL 351942, at *1 (Ohio Ct. App. Aug. 22, 1980).

114. *Id.* at *2.

1. Analysis of Jurisdictions That Do Not Name Insurers as Parties

In February 2000, Judge F. Dana Winslow of the Nassau County Supreme Court recognized that the ability of insurance carriers to continue their bad-faith litigation practices by refusing to settle could be a grave problem. In *Saastomoinen v. Pagano*,¹¹⁵ the trial court recognized that there was no authority in the State of New York which could characterize an insurance carrier as a real party in interest where it controlled the defense of claims against its policyholders.¹¹⁶ However, the court did identify that the insurer has an obligation to look out for its own financial interests when making settlement decisions, as well as a fiduciary duty of good faith to policyholders.¹¹⁷ Thus, the court held that an insurance carrier can appropriately be considered a real party in interest although it was not the named party.¹¹⁸

As a result of this ruling, the trial court imposed sanctions on the insurance carrier for frivolous misconduct because it continued its defense in bad faith and failed to settle.¹¹⁹ The trial court warned the insurance carrier on three occasions prior to the commencement of trial that the policyholder did not have a viable defense. Nonetheless, the insurer disregarded the court's warnings and refused to make an effort to settle the case.¹²⁰ The insurer had been urged by the court to concede liability. An attempt to settle the case would have resulted in the reduction of damages. The trial court instructed the insurer that costs and sanctions would be imposed on the insurance carrier, not the attorney or the named party, if a jury returned a verdict finding the defendant liable.¹²¹

The appellate court disagreed with the trial court and reversed the ruling.¹²² In a very short decision, the court held that the trial court erred in the imposition of sanctions on a non-party insurance carrier.¹²³ While the court did not deny that the insurance carrier can be considered a real party in interest for purposes of litigation, the statute that allowed for the imposition of sanctions¹²⁴ was strictly construed by the appellate

115. 183 Misc. 2d 781 (N.Y. Sup. Ct. 2000), *rev'd*, 278 A.D.2d 218 (N.Y. App. Div. 2000).

116. *Id.* at 783.

117. *Id.* at 785.

118. *Id.*

119. *Id.*

120. *Id.* at 782.

121. *Id.* at 782-83.

122. *Saastomoinen v. Pagano*, 278 A.D.2d 218, 218 (N.Y. App. Div. 2000).

123. *Id.* at 218-19.

124. The New York Rules provide:

The costs and fees awarded . . . shall be assessed either against *the party* bringing the

court.¹²⁵ The court held that the language of the statute did not permit the imposition of sanctions of nonparties or real parties in interest.¹²⁶

2. Analysis of Jurisdictions That Name Insurers as Parties

In *Patitucci v. Laverty*,¹²⁷ the court ultimately reached the same conclusion as *Saastomoinen v. Pagano*; however, the ruling had quite different implications. In *Patitucci*, the trial court sanctioned an insurance carrier, finding that it unreasonably refused to settle the underlying case under Philadelphia General Civil Rule 170.¹²⁸ The

action, claim, cross claim, defense or counterclaim or against *the attorney for such party*, or against both, as may be determined by the court, based upon the circumstances of the case. Such costs and fees shall be in addition to any other judgment awarded to the successful party.

N.Y. C.P.L.R. § 8303-a(b) (McKinney 1997) (emphasis added); *see also* N.Y. COMP. CODES R. & REGS. tit. 22, § 130-1.1(a) (1998) (providing that “[t]he court, in its discretion, may award to any party or attorney in any civil action or proceeding before the court . . . costs in the form of reimbursement for actual expenses reasonably incurred and reasonable attorney’s fees, resulting from frivolous conduct . . .”).

125. *See Saastomoinen*, 278 A.D.2d at 218.

126. *Id.*

127. 576 A.2d 992 (Pa. Super. Ct. 1990).

128. *Id.* at 996. As quoted by the court, select sections of the Philadelphia General Civil Rule 170 provide:

A. “A party” under this regulation shall mean *a named party and/or his insurance carrier*.

B. If [sic] any action tried by a jury in which the sole relief sought is money damages, the Trial Judge on his/her own motion or on motion of any party may direct the attorneys for the parties to appear for settlement conference.

....

E. Should the case be tried to verdict and prior to the verdict one of the parties has agreed to accept or pay the amount recommended by the Trial Judge, then, if the final judgment is twenty percent (20%) or more than the Trial Judge’s evaluation and the plaintiff has agreed to accept the Trial Judge’s recommendation . . . *then the Trial Judge may, within ten (10) days after the final judgment, schedule a hearing to determine whether or not any sanctions shall be ordered against the party who had refused to settle.*

F. *The Trial Judge shall determine whether or not sanctions shall be ordered under this Rule.*

....

H. In exercising discretion as to whether or not sanctions should be imposed under this rule, the Trial Judge shall be guided by the following factors and criteria:

....

3. Whether there was any substantial merit to the plaintiff’s claim or any *substantial merit to the defense of the action*.

insurance carrier claimed that the rule should be rendered unconstitutional. In the initial settlement negotiations, the plaintiff in the underlying suit made a settlement demand of \$25,000. In return, the defendant made a settlement offer of \$2000. The court, in turn, made a recommendation of \$19,500 for settlement.¹²⁹

After the insurance carrier was put on notice that the court would impose Rule 170 sanctions, the insurer made a subsequent offer of \$10,000 to settle the case. Patitucci, the plaintiff, did not accept the offer and stated that he would accept an offer in the amount of the court's recommendation. Patitucci was awarded damages in an amount exceeding \$80,000. The parties subsequently settled the case in the amount of \$60,000—\$35,000 in excess of the insurance policy coverage. Consequently, the court imposed a Rule 170 sanction on the insurer for being unreasonable in its settlement negotiations.¹³⁰

However, the Pennsylvania Superior Court reversed the ruling, holding that there was no evidence supporting the contention that the insurer was unreasonable.¹³¹ In fact, there was evidence to the contrary. The insurer maintained throughout the duration of the case that the case was defensible due to the Patitucci's contributory negligence. The court noted that the purpose of Rule 170 was to "encourage settlement in cases where, if the parties were *reasonable*, settlement in lieu of trial should occur."¹³² The court's ruling did not render Rule 170 unconstitutional.

If New York State had enacted a comparable rule to Philadelphia General Civil Rule 170, it is arguable that *Saastomoinen v. Pagano* would have resulted in the opposite ruling. In *Saastomoinen*, the trial court found that there was no defense to liability in the case.¹³³ In addition, the court warned that it would impose sanctions in the event a verdict was rendered "finding the defendant *solely* liable."¹³⁴ The trial court was not reversed because the insurer attempted to make reasonable settlement attempts, but because the New York statute relied upon by the trial court did not grant the court power to impose sanctions on insurance carriers, which are non-parties.¹³⁵ The appellate court did not appreciate the materiality of finding the insurer to be the "real party in interest" because such a ruling did not allow the imposition of sanctions under the

Id. at 995 (emphasis added).

129. *Id.* at 994.

130. *See id.* at 994-96.

131. *Id.* at 998.

132. *Id.*

133. *Saastomoinen v. Pagano*, 183 Misc. 2d 781, 782 (N.Y. Sup. Ct. 2000), *rev'd*, 278 A.D.2d 218 (N.Y. App. Div. 2000).

134. *Id.* at 783 (emphasis added).

135. *Saastomoinen v. Pagano*, 278 A.D.2d 218, 218 (N.Y. App. Div. 2000).

applicable statute.¹³⁶ If *Saastomoinen* had been adjudicated by the *Patitucci* court, the sanctions would have been affirmed.

III. INSURER'S GOOD-FAITH DUTY TO SETTLE CLAIMS

Insurance carriers, like any other business organization, are in business to make profits.¹³⁷ Insurance carriers earn such profits by making safe investments in people who are risk-averse. Claims made against their policyholders are not easily estimated or projected.¹³⁸ Thus, when a claim is brought against one of their policyholders, the insurers' purpose of making profits is frustrated. When third-party claimants file suit, if the claims are viable, the insurance carrier chooses to undertake the litigation of the case. Additionally, their obligation to settle cases undermines their profit making scheme. The objective of the insurance carrier is to reach maximum profitability, which it does by collecting premiums without making any payouts.¹³⁹

It is widely accepted that insurers have an obligation to settle within policy limits when their policyholders are liable or the harm complained of is clearly within the language of the policy.¹⁴⁰ Refusing to settle within policy limits in such situations is considered "bad faith" on the part of the insurance carriers.¹⁴¹ Some commentators have even gone as far as expecting insurance carriers to *initiate* settlement negotiations even when the adversary has not made an offer to settle.¹⁴² Though it is unclear as to how far this fiduciary duty to settle in good faith should extend, there is no doubt that the insurance carrier does have a duty to settle within policy limits when an offer is made by the adversary.¹⁴³ Additionally, though most states agree that the duty does exist, whether a cause of action is available to victims differs from jurisdiction to jurisdiction.

136. *Id.*; see also N.Y. COMP. CODES R. & REGS. tit. 22, § 130-1.1(b) (1998) ("The court, as appropriate, may make such award of costs or impose such financial sanctions against either *an attorney or a party* to the litigation or against both.") (emphasis added); N.Y. C.P.L.R. § 8303-a(b) (McKinney 1997).

137. See *Economics of Insurance*, *supra* note 32.

138. *Id.*

139. See *id.*

140. See *supra* note 46; see also Syverud, *supra* note 20, at 1116-17.

141. See Syverud, *supra* note 20, at 1116-17.

142. See McMahon, *supra* note 14, para. 1 (noting that courts are divided on whether an insurer's good-faith duty mandates that it initiate a settlement negotiation).

143. See *supra* notes 65-69 and accompanying text.

A. *Cause of Action for the Contractual Breach of a Duty to Settle*

Historically, many jurisdictions treated insurance policies as contracts and thus adhered to strict contract interpretation.¹⁴⁴ Under this interpretation, the express terms of the insurance contract controlled any possible compensation of policyholders.¹⁴⁵ Moreover, policyholders could only receive the limited damages available in breach of contract claims plus any applicable interest.¹⁴⁶ However, in the late 1800s, many courts began to realize that labeling such actions as contractual claims could lead to unjust results and determined that an “implied covenant of good faith and fair dealing” existed in every insurance contract.¹⁴⁷

Although not in the majority, Utah does abide by such a rule.¹⁴⁸ In *Beck v. Farmers Insurance Exchange*,¹⁴⁹ plaintiff Wayne Beck brought suit against his automobile insurance carrier for a bad-faith refusal to settle a claim for uninsured motorist benefits. Beck was the victim of a hit-and-run accident when an automobile crashed into his car and consequently injured his knee. The owner of the hit-and-run vehicle maintained that her car had been stolen and refuted responsibility for the accident. Her insurer also denied liability.¹⁵⁰

Beck, whose vehicle was covered under the defendant insurer’s policy, had both no-fault and uninsured motorist insurance benefits. While Beck was awaiting an answer from his claim against Kirkland, he filed a claim against the defendant insurer for no-fault benefits. Beck was paid \$5000 for his medical expenses under the no-fault policy limit and \$1,299.43 for his lost wages. He then filed a claim against the defendant for \$20,000, the policy limit of the uninsured motorist benefits. Beck’s counsel contended that his damages were worth significantly more than \$20,000. However, the settlement offer was rejected by an adjuster of the defendant insurance carrier.¹⁵¹

144. Willy E. Rice, *Judicial Bias, The Insurance Industry and Consumer Protection: An Empirical Analysis of State Supreme Courts’ Bad-Faith, Breach-of-Contract, Breach-of-Covenant-of-Good-Faith and Excess-Judgment Decisions, 1900-1991*, 41 CATH. U. L. REV. 325, 332 (1992).

145. *Id.*

146. *Id.*

147. *Id.*

148. *See Beck v. Farmers Ins. Exch.*, 701 P.2d 795, 798 (Utah 1985) (holding that “the good faith duty to bargain or settle under an insurance contract is only one aspect of the duty of good faith and fair dealing implied in all contracts and . . . a violation of that duty gives rise to a claim for breach of contract”). *Cf. Freeman v. Leader Nat’l Ins. Co.*, 58 S.W.3d 590, 597 (Mo. Ct. App. 2001) (“The duty of a liability insurer to defend pursuant to its agreement is determined by comparing the language of the insurance contract and the allegations set forth in the petition.”) (citing *Moore v. Commercial Union Ins. Co.*, 754 S.W.2d 16, 18 (Mo. Ct. App. 1998)).

149. 701 P.2d 795 (Utah 1985).

150. *Id.* at 796.

151. *Id.*

Beck next filed a lawsuit against the insurance carrier.¹⁵² In addition to an ordinary breach of contract claim for failure to pay the uninsured motorist benefits, Beck also alleged that the defendant insurer breached its implied duty of good faith and fair dealing by “acting in bad faith in refusing to investigate the claim, bargain with [plaintiff], or settle the claim”¹⁵³ Beck sought damages in excess of his insurance policy limits and sought punitive damages of \$500,000. Beck’s counsel communicated with defendant insurer his willingness to settle the entire suit for \$20,000. However, the defendant rejected this offer and moved to strike the prayer for punitive damages from the complaint because this was simply a suit for breach of contract. The trial court granted the motion and determined that the breach of contract and the breach of implied covenant of good faith and fair dealing claims would be tried separately.¹⁵⁴ Beck immediately revoked his previous offer to settle both counts for \$20,000 and offered to settle only the breach of contract claim for that amount. Beck wished to reserve the implied covenant claim and try it separately.¹⁵⁵

Both parties agreed to settle the breach of contract claim for \$15,000. Beck sought to have the claim for an implied duty of good faith and fair dealing recognized as a tort claim and to have precedent from the State of Oregon overruled.¹⁵⁶ However, although the court agreed that in some situations policyholders should have some redress, the court held that such a duty gave rise to a breach of contract claim.¹⁵⁷ The court feared that adopting a tort remedy would warp the principles of contract law that were so widely accepted.¹⁵⁸

B. Cause of Action for the Breach of Duty to Settle in Tort

A majority of jurisdictions recognize a tort cause of action against insurance carriers for bad-faith refusals to settle or their denials of payment for claims covered under insurance policies.¹⁵⁹ Policyholders may benefit more by having a tort cause of action instead of a cause of

152. *Id.*

153. *Id.* at 797.

154. *Id.*

155. *Id.*

156. *Id.*

157. *Id.* at 798.

158. *Id.*

159. *See, e.g.*, *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1036, 1038 (Cal. 1973) (en banc); *White v. Unigard Mut. Ins. Co.*, 730 P.2d 1014, 1016 (Idaho 1986); *U.S. Fid. & Guar. Co. v. Peterson*, 540 P.2d 1070, 1071 (Nev. 1975); *Hoskins v. Aetna Life Ins. Co.*, 452 N.E.2d 1315, 1319 (Ohio 1983); *Christian v. Am. Home Assurance Co.*, 577 P.2d 899, 901 (Okla. 1977); *McCullough v. Golden Rule Ins. Co.*, 789 P.2d 855, 858 (Wyo. 1990).

action in contract. Damages for causes of action in contract are limited compared to damages arising for a cause of action in tort. Minnesota applies a two-prong test to the tort action of the insurer's bad-faith refusal to settle: An insurance carrier cannot be held liable unless it can be established (1) that the policyholder is "clearly liable" and (2) that the insurer had a "good faith [belief] upon reasonable grounds" that effecting a settlement for the amount proposed would be excessive.¹⁶⁰

In *Northfield Insurance Co. v. St. Paul Surplus Lines Insurance Co.*,¹⁶¹ a primary insurer was sued by the policyholder's excess insurance carrier for not effectuating a settlement in good faith. The underlying suit was comprised of two claims: one for medical malpractice against a hospital and the plaintiff's doctor, and another for products liability against the manufacturer of the product used in the medical procedure.¹⁶² The parties to the litigation were the primary and excess insurance carriers for Intertech, the manufacturer.¹⁶³ Both Intertech and the defendant, its primary insurance carrier, assessed that there was a seventy-five to ninety percent chance that the company would not be held liable at trial. Accordingly, they rejected a one million dollar settlement offer. However, all parties conceded that defendant's policy limit would be exceeded by several million dollars if damages were ultimately awarded.¹⁶⁴

After the trial was bifurcated into separate actions, the hospital settled the medical malpractice action. The plaintiff in the underlying suit for products liability then made a settlement offer for a mere \$50,000.¹⁶⁵ However, defendant refused to offer any amount for settlement and refused to participate in any further settlement negotiations. Upon concluding the liability phase at trial, the jury found Intertech liable and a settlement for \$2.7 million ensued. The court held that although defendant acted in bad faith¹⁶⁶ in its assessment of damages and refusal to settle, it could not be held liable because earlier investigations verified that the policyholder, Intertech, was not "clearly

160. *Northfield Ins. Co. v. St. Paul Surplus Ins. Co.*, 535 N.W.2d 57, 60-61 (Minn. 1996).

161. 535 N.W.2d 57 (Minn. 1996).

162. *Id.* at 58.

163. *Id.* Defendant St. Paul, the primary insurer, had a policy limit of \$1 million and plaintiff Northfield had a policy limit of \$5 million in excess of the primary insurance policy.

164. *Id.* at 59.

165. *Id.* This amount was only five percent of the primary insurance policy coverage.

166. The court noted that, since a prior assessment of damages in the event of a liability verdict was significantly greater than the amount covered under the primary insurance policy, and since the differential between the settlement offer and the eventual judgment was so great, the refusal to settle constituted bad faith. *Id.* at 61.

liable.”¹⁶⁷

C. “Bad Faith” in the Insurance Context

The duty of good faith is generally implied in every insurance contract in the context of defending and settling claims. Different jurisdictions apply a variety of public policy reasons for imputing a duty of good faith into insurance contracts. For example, Illinois courts have recognized that the duty of good faith is implicated because the insurer exercises exclusive control over the litigation settlement negotiations. In *Haddick v. Valor Insurance*,¹⁶⁸ the court noted that the purpose of the implied good faith duty to settle was instituted to protect insurance policyholders from being exposed to liability in excess of the policy limits because of an insurer’s decision to “gamble” with the policyholder’s fate.¹⁶⁹ If the insurer does breach the good-faith duty to settle, the insurance carrier must be held liable for the entire judgment against the insured, even if the amount exceeds the policy limit.¹⁷⁰

Some courts have recognized that an implied good faith duty to settle must be imposed because policyholders purchase insurance for “peace of mind,” in addition to their desire to ensure sufficient funds to cover their liability in the event of an accident. In *Campbell v. State Farm Mutual Auto Insurance Co.*,¹⁷¹ the court noted that, in addition to recovering the excess judgment itself from the insurance carrier, an aggrieved policyholder may also recover tort damages for emotional distress and punitive damages as a result of the insurance carrier’s breach of duty to settle in good faith.¹⁷² Additionally, some courts have reasoned that if insurers are not subject to “bad faith” claims in tort, they would have little incentive to engage in faithful and prompt attempts to settle claims because they would only be required to pay the upper limit of the insurance policies.¹⁷³ In effect, insurance carriers would be encouraged to opportunistically breach their insurance contract because they would not be subject to further liability in the event of their

167. *Id.* The court stated that the excess insurer’s claim was essentially a claim of negligence in considering a reasonable settlement offer against the insurer. *Id.* In adopting the bad faith standard, the Supreme Court of Minnesota specifically rejected the negligence standard in such causes of action. *Id.* at 63.

168. 735 N.E.2d 132 (Ill. Ct. App. 2000).

169. *Id.* at 134.

170. *Id.*

171. 840 P.2d 130 (Utah Ct. App. 1992).

172. *Id.* at 139.

173. See, e.g., *Gruenberg v. Aetna Ins. Co.*, 510 P.2d 1032, 1038 (Cal. 1972); *Bibeault v. Hanover Ins. Co.*, 417 A.2d 313, 318-19 (R.I. 1980).

breach.¹⁷⁴

IV. ECONOMIC INCENTIVES NOT TO SETTLE VERSUS JUDICIAL INTEREST IN WEEDING OUT NON-MERITORIOUS CLAIMS

It is widely accepted that insurance carriers may often have a tendency to conduct business in bad faith. Countless internet websites are dedicated to the fight against bad-faith insurers.¹⁷⁵ The FBIC¹⁷⁶ has even ranked insurers in its “Hall of Shame” according to their bad-faith practices of refusing to pay claims.¹⁷⁷ However, the insurance industry has expressed great opposition to the availability of bad-faith claims against insurance carriers.¹⁷⁸ As a result of the bad-faith breach of duty to settle cases, the insurance industry may have responded with hikes in insurance premiums.¹⁷⁹ This is circular reasoning, however, because there would be a significantly lesser implementation of bad-faith claims if insurance carriers would abide by their express and implied contractual duties.

A. *What Do They Get Out of It?: Reasons Insurance Carriers Are Reluctant to Settle*

Insurance carriers have several incentives not to settle. First, insurance carriers must maintain a certain reputation.¹⁸⁰ In order to do so, they cannot yield to everyone that brings claims against them.¹⁸¹ Second, they also seek to protect their finances against wrongful claims.¹⁸² Insurers often take advantage of the litigation process,¹⁸³

174. See *supra* notes 34-38 and accompanying text.

175. See, e.g., FBIC: Fight Bad Faith Insurance Carriers, FBIC Ranks Insurers Non-Payment of Claims and Improper Practices; <http://www.badfaithinsurance.org> (last visited Sept. 6, 2006) [hereinafter FBIC Ranks Insurers]; Robert W. Battin, Insurance Bad Faith Claims Specialist, http://www.badfaithclaims.com/ibfc_main.html (last visited Sept. 6, 2006).

176. Fight Bad Faith Insurance Company. See FBIC Ranks Insurers, *supra* note 175.

177. See FBIC: Fight Bad Faith Insurance Companies, “FBIC Ranking 100”: Ranking Group Insurers Claims Payment Records, <http://www.badfaithinsurance.org/indexdetailist.html> (last visited Sept. 6, 2006). The “FBIC Ranking 100” also ranks the insurers engaged in good faith practices. *Id.*

178. See, e.g., Ron Lent, *Industry Speaks out Against Third-Party Bad-Faith Claims Bills*, A REPORT ON CLAIMS (David Morse & Associates, Glendale, CA), May 1997, available at <http://www.davidmorse.com/archives2/1997-may-aroc.pdf>.

179. See *id.*

180. See Ellison, *supra* note 22, at 237; see also Syverud, *supra* note 20, at 1161-62.

181. See Ellison, *supra* note 22, at 237; Syverud, *supra* note 20, at 1161-62.

182. See Ellison, *supra* note 22, at 237.

183. See *id.* at 249-53; see also Anderson & Fournier, *supra* note 48, at 398 (“Insurance companies may violate a policyholder’s reasonable expectations of coverage for purely financial

knowing that they have nothing to lose because their liability is capped at their policy limits.¹⁸⁴ As a result, policyholders are the ones at risk of paying an amount in excess of the capped amount.¹⁸⁵ This leads to great dilemmas; the policyholder is unprotected and helpless when the insurance carrier unreasonably refuses to pay claims.¹⁸⁶ Third, insurance carriers are fully aware that policyholders are often ignorant to the inner workings of the insurance industry and that they do not have the information, money, or resources that the carriers have.¹⁸⁷

Not only do insurers profit from collecting policy premiums while refusing to pay claims, but they also profit from litigation.¹⁸⁸ When insurance carriers refuse to pay claims, it may often be for purely economic reasons.¹⁸⁹ Generally, the money collected by insurance carriers is invested and remains there until the suit is completed.¹⁹⁰ By not settling the cases at the onset, the insurer collects interest and profits from its investments.¹⁹¹

Additionally, insurers' litigation costs are often lower than one might think because they repeatedly use the same resources in every comparable claim that may arise.¹⁹² While insurance carriers are profiting, the insured may be subject to excess liability. This may result in a verdict in excess of the insurance coverage where the policyholder will be responsible for paying any amount over the policy limit.

B. *An Interest in Judicial Efficiency*

According to FRCP Rule 1, federal civil trials are supposed to be "just, speedy, and efficient."¹⁹³ Most jurisdictions have a mirror image of this rule.¹⁹⁴ However, the refusal of insurance carriers to settle, which

reasons. This is because insurance companies profit by prolonging a coverage dispute rather than paying a claim—even when they know the claim is valid.”)

184. See, e.g., Ellen S. Pryor & Charles Silver, *Defense Lawyers' Professional Responsibilities: Part I—Excess Exposure Cases*, 78 TEX. L. REV. 599, 632 (2000).

185. See Kathryn A. Sampson, *The Mouse in the Annotated Bibliography: An Insurance Law Primer*, 2000 ARK. L. NOTES 85, 107.

186. See Anderson & Fournier, *supra* note 38, at 336-37.

187. *Id.* at 401-06.

188. *Id.* at 398-401.

189. *Id.* at 398.

190. *Id.*; see also THE ECONOMICS OF INSURANCE: HOW INSURERS CREATE VALUE FOR SHAREHOLDERS 35-40, 37-38 (2001), available at [http://www.swissre.com/INTERNET/pwswilpr.nsf/vwFilebyIDKEYLu/BBER-5B4K5E/\\$FILE/The_economics_of_insurance_en.pdf](http://www.swissre.com/INTERNET/pwswilpr.nsf/vwFilebyIDKEYLu/BBER-5B4K5E/$FILE/The_economics_of_insurance_en.pdf) (last visited Sept. 15, 2007).

191. See Anderson & Fournier, *supra* note 38, at 398.

192. Insurance carriers are sometimes defined as “institutional litigators,” meaning they are regularly and extensively involved in litigation. *Id.* at 383, 407-08.

193. See FED. R. CIV. P. 1.

194. See *supra* note 10 and accompanying text.

creates endless litigation, impedes this effort. The continuation of the insurance carriers' defense, though not viable, could potentially set off a chain of events that adversely affects the judicial system as a whole.¹⁹⁵ If the insurers were to directly pay out the meritorious claims, litigation for that particular case would cease. However, when they refuse to do so, it needlessly prolongs litigation. As a result, parties must engage in additional discovery because the case was not disposed of as early as it could have been.

Trial can be very time consuming since both parties must prove their legal theories.¹⁹⁶ Even where the defendant knows he is clearly liable, he is powerless to settle the claim if the insurance carrier does not concede liability; it is the insurance carrier who is in sole control of the litigation.¹⁹⁷ Juries must deliberate and render a verdict, which can be a lengthy process. In such cases, it may be likely that the jury will return a verdict for the plaintiff who has brought suit against the policyholder.¹⁹⁸ It is also very likely that the damages awarded will be greater than the insurance policy.¹⁹⁹ As a result, in some instances the verdict may be questioned by motion for judgment notwithstanding the verdict. If such motion fails, because insurers are only responsible for the monetary limits of the policy, policyholders will be legally bound to pay the excess.²⁰⁰

As soon as policyholders realize that their insurance carrier could have settled within policy limits before trial, they may sue for damages in excess of the policy because they have been wrongly subjected to such damages.²⁰¹ This will result in another trial, further lengthening the ordeal. Depending on the verdict rendered in this subsequent action, parties may choose to appeal. This could possibly result in years of superfluous, costly, and nonsensical litigation that could have been avoided from the very beginning.

195. See *supra* Part II.A.2.

196. See Douglas N. Walton, *A Pragmatic Model of Legal Disputation*, 73 NOTRE DAME L. REV. 711, 714 (1998) ("Central to the fair trial is that there is a conflict of opinions that should be resolved in a dialogue where both sides bring forward the strongest evidence to support their contentions.").

197. See *supra* text accompanying notes 15-22.

198. The National Center for State Courts conducted a study to develop a profile of litigation and jury trials in state courts. Its findings for 1992 concluded that although plaintiffs won forty-nine percent of all jury cases, in automobile negligence cases, plaintiffs won sixty percent of the time. Neil Vidmar, *The Performance of the American Civil Jury: An Empirical Perspective*, 40 ARIZ. L. REV. 849, 851-52 (1998) (citing Brian Ostrom et al., *A Step Above Anecdote: A Profile of the Civil Jury in the 1990s*, 79 JUDICATURE 223 (1996)).

199. See *supra* notes 88-106 and accompanying text.

200. See *supra* notes 185-86 and accompanying text.

201. See *supra* notes 65-69 and accompanying text.

If the trial court had the power to sanction insurance carriers for their bad-faith refusals to settle, the carriers would feel obliged to take part in settlement negotiations. Reaching a settlement in actions where there is no viable defense would substantially reduce the number of cases that go to trial. Courts would be relieved of the burden of hearing cases based on an insurer's refusal to settle meritorious claims. Though insurers believe that their decision to litigate may deter third-party claimants²⁰² from bringing complaints against them and their policyholders, this contention is illogical. The case may result in a higher jury verdict than the possible settlement.²⁰³ As such, claimants will be encouraged to bring claims, whether meritorious in nature or not. Consequently, insurers are encouraging the very behavior they wish to deter.

V. CONCLUSION

The most important—and maybe sole—reason most policyholders obtain insurance policies is to ensure indemnification for contingent harms they may suffer in the event the insured engages in any wrongful conduct covered under the policy.²⁰⁴ Unlike ordinary contracts, an “opportunistic breach” is a fallacy in the insurance context because the only party benefiting from such a breach is the insurer.²⁰⁵ Nevertheless, insurers continue to breach their contracts by refusing to defend claims in good faith and failing to effectuate good faith settlements even when their policyholders are clearly liable.

Generally, insurance carriers are less inclined to breach their duty to defend than their duty to settle a claim in good faith.²⁰⁶ Furthermore, the duties to defend and to effectuate a good-faith settlement are only owed to policyholders, not to third-party claimants.²⁰⁷ Various standards and tests are applied by courts of different jurisdictions in allowing bad-faith claims against insurers.²⁰⁸ The availability of remedies for insurance policyholders may seem to be beneficial at first glance. However, the remedies can prove to be detrimental because policyholders are forced to expend much time and money litigating suits that would have never occurred had the insurance carriers conformed to

202. Third party claimants in the insurance context refer to persons who bring claims against an insurance carrier due to the wrongful conduct of the insurer's policyholder.

203. See *supra* notes 73-77 and accompanying text.

204. See *supra* text accompanying notes 30-33.

205. See Anderson & Faurier, *supra* note 38, at 377-78.

206. See *supra* text accompanying notes 49-72.

207. See *supra* Part II.A.3.

208. See *supra* Part III.

their duties in good faith. As a result, the court system is also tied up in the litigation of unnecessary claims.

At least one court has attempted to solve this problem in hopes of relieving the judicial inefficiency created by such a system. However, this court's efforts have been rejected.²⁰⁹ This Note contends that the court's novel attempt to solve this problem should be reconsidered. The Nassau County Supreme Court, in *Saastomoinen v. Pagano*,²¹⁰ correctly recognized that insurance carriers should be considered "parties" for purposes of imposition of sanctions because they are the real parties in interest. The recognition of insurers as "parties" for all purposes of litigation would greatly relieve the judicial system of unwarranted and avoidable litigation. The *Saastomoinen* court was not troubled by the fact that the insurance carrier was not a "named party," recognizing the important role the insurer played and the control the carrier maintained over the litigation of the claim.

Allowing courts to sanction insurers in the underlying suit, where the insurer is not a named party, would greatly reduce, and possibly eliminate, the number of bad-faith lawsuits against insurers. Aggrieved policyholders would not have to rely on bringing subsequent bad-faith lawsuits, whether in contract or in tort, because the judicially-imposed sanctions would most likely pressure insurers to settle. The "just, speedy, and efficient"²¹¹ determination of civil actions in the insurance context can become a reality, and no longer a myth.

Imposing sanctions on insurance carriers is the correct action for courts to take when dealing with insurers who act in bad faith. Insurance carriers are the real parties in interest, in the sense that they control the litigation process.²¹² Policyholders and attorneys should not be the only "parties" subject to sanctions when their names are just mere masks behind which the insurers hide in order to escape certain procedural rules.

The American judicial system should not endorse such an inconsistency. Rules of civil procedure and the courts interpreting them are ignoring the role insurance carriers play in the litigation of claims against their policyholders. While most courts recognize that insurance carriers are real parties in interest, they strictly construe rules of civil procedure, allowing the imposition of sanctions against only "named" parties. Insurance carriers, who are not named parties, should not hide behind policyholders and continue to engage in wrongful litigation

209. See *supra* notes 115-126 and accompanying text.

210. 183 Misc. 2d 781 (N.Y. Sup. Ct. 2000), *rev'd*, 278 A.D.2d 218 (N.Y. App. Div. 2000).

211. See FED. R. CIV. P. 1.

212. See *supra* text accompanying notes 173-74.

practices. However, by only sanctioning named parties in such actions, courts are encouraging insurance carriers to continue to act in bad faith.

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