

Bad Faith Failure to Settle: Where Are We Now and Where Do We Go From Here?

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One frequently litigated issue in the insurance-coverage world is whether an insurer has committed bad faith by failing to settle a third-party claim. This article reviews the recent appellate decisions, the direction in which the law may continue to develop, and the practical lessons that attorneys representing plaintiffs and policyholders can draw from these new authorities.

The duty of good faith requires liability insurers to settle claims within their policy limits when settlement opportunity and potential exposure of the insured to an amount greater than the policy exists. *Communale v. Traders & Gen. Ins. Co.*, 50 Cal. 2d 654, 659 (1958). This is because an insurance policy is not simply a commitment by an insurer to pay liability on behalf of another. Rather, paramount “[a]mong the considerations in purchasing liability insurance, as insurers are well aware, is the peace of mind and security it will provide in the event of an accidental loss.” *Crisci v. Sec. Ins. Co. of New Haven, Conn.*, 66 Cal. 2d 425, 434 (1967). The peace of mind provided by liability insurance includes the expectation that insurers will settle claims to avoid exposing policyholders to the risk of catastrophic, personal liability. *Id.* at 431. That is why California has adopted a legal regime that imposes harsh consequences on insurers who fail to settle claims covered by their policies.

Insurers that turn down settlement opportunities face significant liability if results later prove the decision is incorrect. This includes bad faith tort liability, attorney’s fees, and a possible award of punitive damages. However, the most significant consequence that an insurer faces when it rebuffs settlement and refuses to take its policyholder out of harm’s way, is that the insurer’s policy limits are ignored. The insurer is held responsible for paying the value of any judgment entered against its policyholder, despite how large the judgment may be and how comparably small the insurer’s policy limits may be. *Archdale v. Am. Int’l Specialty Lines Ins. Co.*, 154 Cal. App. 4th 449, 465-66 (2007).



A long-standing dispute between insurers and insureds exists on what triggers an insurer’s duty to settle. Unsurprisingly, insurers and policyholders have rarely agreed on the legal standard. Insurers argue that the duty to settle is not triggered until a claimant makes an actual settlement offer within policy limits. Policyholders argue actual settlement offers by claimants are unnecessary and insurers have the affirmative duty to initiate settlement negotiations, even when a claimant makes no settlement offer.

In 2012, the Ninth Circuit tried to end this long-standing dispute by siding with policyholders. In *Yan Fang Du v. Allstate Insurance Co.*, 681 F.3d 1118 (9th Cir. 2012), Deerbrook Insurance Company issued an automobile liability policy with limits of \$100,000 for each claim and an aggregate of \$300,000 for any one accident. The policyholder crashed into another vehicle with four passengers in June 2005. All four passengers were injured, including Yan Fang Du, who suffered serious injury. Deerbrook acknowledged liability but could not secure medical information from Du. In June 2006, plaintiffs’ counsel made a global settlement demand of \$300,000 for Du and the three other passengers. Deerbrook was told Du had medical bills over \$100,000. Deerbrook’s adjuster informed counsel it had no information about the medical bills of the three remaining injured persons, but, Deerbrook would settle Du’s claim separately for \$100,000. In August 2006, Du’s counsel rejected Deer-

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brook's \$100,000 offer to settle Du's claim separately. Du sued the policyholder and secured a judgment of approximately \$4.1 million. Deerbrook paid \$100,000 to satisfy the judgment partially, and then Du sued Deerbrook for the unpaid balance based on the policyholder's assigned bad-faith claim. Du lost the ensuing jury trial against Deerbrook. The Ninth Circuit upheld the jury's decision. However the Ninth Circuit explained that while Du's bad-faith claim failed, insurers have a general "a duty to effectuate settlement where liability is reasonably clear, even in the absence of a settlement demand." *Id.* at 1122. This was a sea change in California insurance law.

Predictably, the reaction from the insurance industry was swift and harsh. Insurers argued the Ninth Circuit had waded into a controversial topic that should have been left to state court judges, and the operative reasoning was dicta because Deerbrook had tendered to Du its policy limits (which Du rejected). Faced with this pressure, the Ninth Circuit republished *Du*, removing all discussion about an insurer's affirmative duty to effectuate settlement. *Yan Fang Du v. Allstate Ins. Co.*, 697 F.3d 753 (9th Cir. 2012).

In October 2013, the California Court of Appeal entered the fray in *Reid v Mercury Insurance Co.*, 220 Cal. App. 4th 262 (2013). Mercury issued an automobile liability policy with limits of \$100,000 per person and \$300,000 per accident. In June 2007, its policyholder caused a crash in which four passengers were injured. One day after the accident, Mercury's adjuster recommended accepting all liability. That same day, the claimant's son, Paul Reid, asked Mercury to disclose its policy limits. Mercury responded that it could not disclose policy information without its policyholder's written consent. Mercury disclosed its limits in August 2007, four weeks later, after obtaining the policyholder's permission. Reid made no settlement demand following disclosure. In October 2007, approximately four months after the accident, Reid sued. In May 2008, Mercury tendered its policy limits to Reid, which Reid rejected as "too little, too late." Reid went to trial, securing a judgment of approximately \$5.9 million. Reid obtained an assignment of rights from the policyholder and sued Mercury for bad faith. The trial court granted Mercury's motion for summary judgment on the ground that no

liability for bad faith failure to settle existed because Reid had never made a settlement demand within policy limits.

The threshold issue on appeal was whether Mercury had a duty to settle even though Reid had not made a settlement demand. The Court of Appeal answered this question: "In the absence of a settlement demand or any other manifestation the injured party is interested in settlement, when the insurer has done nothing to foreclose the possibility of settlement, . . . there is no liability for bad faith failure to settle." *Id.* at 266. The Court of Appeal also rejected the Ninth Circuit's reasoning in *Du*, noting that bad-faith liability does not "attach if an insurer fails to initiate settlement discussions, or offer its policy limits, as soon as an insured's liability in excess of policy limits has become clear." *Id.* at 277.

The Reid court upheld the summary judgment in Mercury's favor. The court noted that Reid made no settlement demand, and nothing showed Mercury "had an arbitrary rule or engaged in other conduct that prevent[ed] settlement opportunities from arising." *Id.* at 278. The court explained that Reid's "bare request" for information about the policy is not a settlement demand. The court also explained that Mercury's letters to Reid requesting medical information and asking to interview the claimant (who was in intensive care) did not discourage Reid from making a settlement demand. The court concluded no evidence "allows an inference that [Reid] at any time conveyed to [Mercury] any interest in settlement, at policy limits or otherwise, at any time before Mercury offered its full policy limits." *Id.* at 278-79.

One year later, the Court of Appeal issued *Graciano v. Mercury General Corp.*, 231 Cal. App. 4th 414 (2014), which, on the surface, looks like straightforward application of *Reid*, but perhaps is not. In October 2007, Saul Alaya drove the car injuring Graciano in a car accident. California Automobile Insurance Company ("CAIC") issued an automobile policy to Saul Alaya, with policy limits of \$50,000. CAIC also issued an automobile liability to someone else named Jose Saul Alaya. Jose's

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policy was previously canceled. Three days after the accident, Saul reported the crash to CAIC. Within 10 days of the accident, the adjuster handling Saul's claim had determined that Saul was completely at fault and there was potential excess liability. Apparently CAIC did not know the identity of the injured party. Three days after Saul reported the accident to CAIC, Graciano contacted CAIC to report she had been injured by a CAIC insured. Graciano incorrectly identified the driver as "Saulay Ala." CAIC assigned a different adjuster to the file and this adjuster incorrectly identified Jose (and not Saul) as the driver. CAIC contacted Graciano to inform her that CAIC could not locate Jose and that CAIC was investigating a cancelled policy "coverage problem" for Jose.

Graciano made a policy limits demand to CAIC on November 5, 2007. Graciano's demand misidentified Jose as the insured and Jose's policy as the policy number. The demand asked CAIC to respond within 10 days and noted the offer would expire and would not be renewed. The demand also required "payment" and a copy of CAIC's declarations page. CAIC received the demand and asked for an extension of time. Graciano refused to give an extension of time. By November 12, 2007, CAIC had identified Saul as the driver, but CAIC was apparently unaware that Saul was insured by CAIC. That same day, CAIC tried to contact Graciano without success. On November 14, 2007, CAIC responded to Graciano's demand (which had referenced only Jose's policy) by noting that Jose's policy was not in force, that CAIC could not accept the policy limits demand, that CAIC was still investigating coverage, and that Graciano should contact her own insurer about uninsured motorist coverage. On November 15, 2007, the CAIC adjuster handling the Graciano's claim figured out that Saul was also insured by CAIC. CAIC immediately tendered its policy limits, \$50,000, to Graciano under Saul's policy. The parties stipulated at trial that Graciano received this offer before the self-imposed 10-day deadline expired (CAIC also alleged that Graciano undertook efforts to avoid receiving the offer, like avoiding phone calls and unplugging a fax machine). CAIC did not, as requested by Graciano, include a check or a copy of the declarations page of Saul's policy. Graciano

rejected CAIC's offer as non-conforming. Graciano proceeded to trial against Saul, securing a judgment of over \$2 Million. Graciano then sued CAIC for bad faith based on Saul's assigned rights. Graciano won and CAIC appealed. The Court of Appeal reversed the verdict.

Citing *Reid*, the court explained that an insurer is not liable for bad faith if a claimant communicates no settlement demand within policy limits. While Graciano made a settlement demand, the court explained that the demand was directed to the wrong insured and wrong policy, and that Graciano never offered to settle its claims against Saul. While CAIC may have "bungled" its investigation by confusing its insured, this, according to the court, did not support bad faith because the delay was minor and Graciano had contributed to CAIC's error. Interestingly, *Graciano* did not mention the other aspect of *Reid* that bad faith liability exists when there is some "manifestation the injured party is interested in settlement," or the insurer "foreclose[s] the possibility of settlement."

The court also found that CAIC could not have committed bad faith because CAIC tendered its limits to Graciano. The court explained that while CAIC's response did not mirror the terms of Graciano's offer, "perfection is not required." What matters is that CAIC offered to pay in full, and it did so within the time frame selected by Graciano. Interestingly, *Graciano* used imprecise language suggesting bad faith liability does not exist as a matter of law when an insurer offers full limits to settle a third party claim even if the response is untimely, non-conforming, or otherwise unreasonable.

It is unclear where the law goes from here. While *Reid* indicated that a formal settlement demand was not needed to support bad faith where a manifestation of settlement interest by the claimant exists or where the insurer's conduct foreclosed the possibility of settlement, *Graciano* seemed to retreat from this approach. Yet *Graciano* expressed no disagreement with *Reid*. Second, while *Graciano* used language suggesting that an insurer is immune from liability anytime it tenders its limits, other portions

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of the opinion discussing whether CAIC's decision to pay its limits was timely and reasonable qualifies this position. While it seems unlikely that future courts will extend *Graciano* to create a broad rule of bad-faith immunity, it would not be surprising to see insurers make this argument.

Practical lessons can be learned from *Du*, *Reid* and *Graciano*. First, and perhaps most obvious, claimants should make an actual settlement demand within policy limits. Although *Reid* suggests ways to establish bad-faith liability without a formal settlement offer, the rule could be in jeopardy following *Graciano*. Second, claimants should phrase a settlement demand more broadly than the one in *Graciano*. The settlement demand should, at a minimum, request the limits of *all* policies the insurer issued to *any* insured for *any* year and at *any* level of coverage that may apply to the third-party claim. The result in *Graciano* might have been different had the claimant used more comprehen-

sive language. Third, avoid playing games. A common thread running through *Du*, *Reid* and *Graciano* is that the claimants were less interested in accepting a policy limits settlement and more interested in setting up the insurer for a bad faith lawsuit. While seeking maximum recovery for injured clients is understandable, particularly where the policyholder's only asset is insurance, courts see through such ploys.

An insurer's obligation is to take the policyholder out of harm's way to avoid the possibility of an excess judgment. Before imposing extra-contractual liability for bad faith failure to settle, courts want to know that the insurer rolled the dice with someone else's money. If a court is convinced that an insurer tried to do the right thing, even if imperfectly, claimants may find themselves in the same position as the claimants in *Du*, *Reid* and *Graciano*.

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