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Restatement of the Law of Liability Insurance and the Duty to Settle

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THE RESTATEMENT OF THE LAW OF LIABILITY INSURANCE AND THE DUTY TO SETTLE

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Abstract

More than sixty years ago, Judge Robert Keeton authored what has come to be the definitive exegesis on the insurer's duty to settle.[1] *Judge Keeton was followed some twenty-five years later by Professor Kent Syverud with what has come to be the second definitive work on the insurer's duty to settle.*[2] *Since that time, a scattering of articles have addressed the duty to settle but none have done so in Syverud's comprehensive way. The occasion of the American Law Institute's ("ALI") project, the Restatement of the Law of Liability Insurance, initiated five years ago, provides the opportunity to revisit the insurer's "duty to settle."*

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* Albert Abramson Professor of Law, University of California, Hastings College of the Law. I am grateful to the Rutgers Center for Risk and Responsibility for hosting their fine Conference on the Restatement of the Law of Liability Insurance at which an early version of this Article was presented on February 27, 2015.

Special thanks to my friends: David Goodwin who is a partner in the San Francisco office of Covington & Burling for his patience with me regarding my understanding of insurance law; Douglas C. Richmond, Senior Vice President AON Risk Services, Inc., whose sense for nuances influences much of my work; my colleague Professor David Levine, for his remedies expertise; and Margie Lariviere who is a partner in the San Francisco Office of Gordon & Rees for contributing her wisdom. I gratefully acknowledge the diligent and able research assistance of Emalie Diaz Sundale, Hastings class of 2016. Errors are mine alone.

1. Robert E. Keeton, *Liability Insurance and Responsibility for Settlement*, 67 HARV. L. REV. 1136 (1954).

2. Kent D. Syverud, *The Duty to Settle*, 76 VA. L. REV. 1113 (1990); *see* Charles Silver, *A Missed Misalignment of Interests: A Comment on Syverud,* The Duty to Settle, 77 VA. L. REV. 1585, 1585 (1991) ("A single publication rarely makes an entire body of literature obsolete, but Professor Kent D. Syverud's article on the duty to settle arguably ha[d] that effect." (footnote omitted)); Chris Wood, Note, *Assignments of Rights and Covenants Not to Execute in Insurance Litigation*, 75 TEX. L. REV. 1373, 1409 n.192 (1997) (describing the Syverud article as a seminal piece). While I refer to Professor Syverud in this Article, he is now the president of Syracuse University after having completed successful stints as the dean of the law schools at Vanderbilt University and Washington University in St. Louis.

The ALI's aim for the Restatement of the Law of Liability Insurance is to "cover[] the law of contracts in the liability insurance context, liability insurance coverage, and the management of insured liabilities."[3] *Using Professor Syverud's piece as a baseline and Judge Keeton's piece as background, this Article focuses on the project's substantive changes to the existing rules regarding an insurer's "duty to settle."*

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INTRODUCTION

The "duty to settle" refers to the insurer's obligation to settle claims against its insured within the applicable policy limits when proceeding to trial could result in a judgment in excess of the policy limits.[4] This simple

3. *Projects: Restatement of the Law, Liability Insurance*, A.L.I., https://www.ali.org/projects/show/liability-insurance/ (last visited Oct. 19, 2015).

4. The Discussion Draft provides: "An insurer that breaches the duty to make reasonable settlement decisions is subject to liability for the full amount of damages assessed against the insured in the underlying suit, without regard to the policy limits." RESTATEMENT OF THE LAW OF LIAB. INS. § 27(1) (AM. LAW INST., Discussion Draft 2015); *see* Syverud, *supra* note 2, at 1117–26. The Discussion Draft talks in terms of the insurer's duty to make reasonable settlement decisions. While this is a more aptly descriptive title, I

explanation belies the complexity of the body of law surrounding the duty and does not capture the permutations that may affect the duty's scope and the consequences of its breach.

In 2010, the ALI initiated a project, the Principles of the Law of Liability Insurance. With the Principles project, the ALI expected to publish extensive recommendations for changes to areas of insurance law that were thought to need reform.[5]

On October 20, 2014, the ALI announced that its Council had made the project a Restatement of the Law of Liability Insurance.[6] In particular, the ALI's aim was to "cover[] the law of contracts in the liability insurance context, liability insurance coverage, and management of insured liabilities."[7]

This Article focuses on one aspect of the Restatement of the Law of Liability Insurance—the insurer's duty to settle and the possible effects on state substantive law that may be brought about by the Discussion Draft of the Restatement of the Law of Liability Insurance circulated on April 30, 2015 ("Discussion Draft").[8] In examining the Restatement approach to the duty to settle, I examine three salient points: the source of the duty to settle, the conduct of the insurer, and the remedies for breach. This Article will deal specifically with sections 24 and 27 of the ALI's Restatement of the Law of Liability Insurance.[9]

I. THE RESTATEMENT OF THE LAW OF LIABILITY INSURANCE

With the Restatement of the Law of Liability Insurance, the ALI expects to "cover[] the law of contracts in the liability insurance context, liability insurance coverage, and the management of insured liabilities."[10] Although this is an ambitious undertaking, the payoff can be enormous in terms of affecting the course of liability insurance law.

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adhere to the old "duty to settle" language as it is the nearly unanimous description used by courts.

5. *See generally About ALI: Institute Projects*, A.L.I., https://www.ali.org/about-ali/institute-projects/ (last visited Oct. 19, 2015) (describing the aim of "Principles" projects).

6. Although some citations will reflect the original designation, this Article will refer to all as the Restatement of the Law of Liability Insurance.

7. *Projects: Restatement of the Law, Liability Insurance*, *supra* note 3.

8. The Discussion Draft circulated by the ALI on April 30, 2015 follows Tentative Draft No. 2.

9. Discussion Draft sections 24 and 27 that are discussed herein were numbered 27 and 30 respectively in Tentative Draft No. 2. These will hereafter be referred to as section 24 and section 27.

10. *Projects: Restatement of the Law, Liability Insurance*, *supra* note 3.

The Restatements have had a profound influence on American common law. With uncharacteristic immodesty, the ALI recognizes that the Restatements have an "unparalleled reputation for excellence and objectivity"[11] in the undertaking to provide certainty in the law and "tell [the] judges and lawyers what the law [is]."[12] According to the ALI, this reputation is evidenced by the respect courts have accorded ALI publications.[13] By the first half of 2014, United States courts had cited various provisions of the Restatements and Principles of the Law 195,000 times.[14] These assertions are unsurprising, but perhaps do not fully capture the Restatements' influence on American common law.

Perhaps the most well-known example of the Restatements' effect on American law is Section 402A of the Restatement (Second) of Torts. The section imposed strict liability for tort injuries caused by products.[15] Although Section 402A was modeled after a single California case imposing strict liability for products injuries, it was rapidly adopted by many courts.[16] Eventually, faced with the difficulty of applying strict liability to products with little precedential guidance, courts began to question the universal applicability of strict liability to all products liability cases.[17] What resulted was a complex body of products liability law that examines nearly every facet of a product's inception through its production, distribution, and sale.[18]

The Restatements' effect on contract law, though perhaps more subtle, is no less substantial. A study of six sections of the Restatement (Second) of Contracts—15(1)(b), 86, 87(2), 89, 139, and 153—revealed that in 241 cases studied, all but eight cases simply deferred to the new rules.[19] The cases cited the sections as if they were citing a statute or code.[20] This represents a truth apparently accepted[21] within the legal

11. AM. LAW INST., ANNUAL REPORT 2013–2014, at 12 (2014), https://www.ali.org/media/filer_public/1a/1e/1a1e43dc-0141-4cf3-82df-3fd210cb0527/2013-2014_annual_report.pdf.

12. *About ALI: Institute Projects*, *supra* note 5.

13. AM. LAW INST., *supra* note 11, at 12.

14. *Id.* This number could be greater, as this only reflects published decisions. *Id.*

15. *See* David A. Logan, *When the Restatement Is Not a Restatement: The Curious Case of the "Flagrant Trespasser*,*"* 37 WM. MITCHELL L. REV. 1448, 1457–59 (2011).

16. *See id.*

17. *Id.* at 1458–59.

18. *See* Marshall S. Shapo, *In Search of the Law of Products Liability: The ALI Restatement Project*, 48 VAND. L. REV. 631, 637–38 (1995).

19. Gregory E. Maggs, *Ipse Dixit: The Restatement (Second) of Contracts and the Modern Development of Contract Law*, 66 GEO. WASH. L. REV. 508, 511–12 (1998).

20. *Id.* at 513.

21. That is, accepted as true but not necessarily accepted as desirable.

community at large: the Restatements affect substantive law.[22] This truism informs Professor Wolfram's perception that "[s]uch realizations should serve to caution a Restatement-drafter who may otherwise be tempted to boldness."[23]

With this backdrop, in formulating a Restatement, the Reporters—the Restatement-drafters—face a delicate task. The fifty states (not including the District of Columbia or United States territories such as Puerto Rico, the Virgin Islands, and Guam) that make judgments about a body of law will necessarily arrive at different results regarding each part of that body of law. That said, there is a surprisingly strong consensus among the states that a duty to settle is a firmly entrenched aspect of an insurer's obligations to an insured.[24] Thereafter, the views as to the source of the obligation, the precise extent of an insurer's obligations, and the remedies for breach diverge and there is a wide-ranging spectrum of approaches as to each.[25]

The Reporters' daunting responsibility is to select a solution that is defensible, that is likely to be (or has already been) adopted by a significant number of states, and that is correct. These are not

22. *Kulko v. Superior Court* is an example of the United States Supreme Court accepting the Restatement as settled law in the context of due process. 436 U.S. 84, 96 (1978) (citing RESTATEMENT (SECOND) OF CONFLICT OF LAWS § 37 (AM. LAW INST. 1971)).

Charles W. Wolfram provided evidence of this phenomenon in his article offering insight into the Restatement drafting process. *See* Charles W. Wolfram, *Bismarck's Sausages and the ALI's Restatements*, 26 HOFSTRA L. REV. 817 (1998). Wolfram recounts the attempts of the insurance industry to influence the Restatement's Reporters' inclusion of sections of the Restatement of the Law Governing Lawyers that were perceived as placing burdens on insurance companies' counsel. *Id.* at 821–24. This sort of lobbying would not be perceived as necessary if the Restatements did not affect substantive law.

At one point, in the Virgin Islands and the Commonwealth of the Northern Mariana Islands, the statutes implementing the Restatements as common law elevated the authority of the Restatements "to controlling authority in matters of first impression." Kristen David Adams, *The Folly of Uniformity? Lessons from the Restatement Movement*, 33 HOFSTRA L. REV. 423, 425–26 (2004). The Virgin Islands has since retreated from that position and now recognizes that its courts are free to craft common law. Banks v. Int'l Rental & Leasing Corp., 55 V.I. 967, 980 (2011).

23. Wolfram, *supra* note 22, at 817.

24. *See* David A. Hyman, Bernard Black & Charles Silver, *Settlement at Policy Limits and the Duty to Settle: Evidence from Texas*, 8 J. EMPIRICAL LEGAL STUD. 48, 49 (2011) ("[A]lmost all states impose a duty to settle on insurers."); Syverud, *supra* note 2, at 1120–21.

25. Professor Jay Feinman has noted the dearth of market and regulatory solutions to the problem of claims practices. Jay M. Feinman, *The Regulation of Insurance Claim Practices*, 6 U.C. IRVINE L. REV. (forthcoming 2016) (manuscript at 3–4) (on file with author). His observation applies equally to the duty to settle. Regulators are under-resourced and subject to capture. *Id.* (manuscript at 28). Information asymmetry necessarily limits any market solution. *Id.* (manuscript at 27, 30).

necessarily overlapping considerations. Thus, we must be especially diligent in the construction of the insurer's duty to settle within this current draft with an eye to the practical consequences and long-term effects of any change.

In the discussion that follows, I broadly outline the range of choices in each of three different aspects of the duty to settle. Within each of these aspects I describe the choice made by the Reporters in the Discussion Draft and my own evaluation of the Reporters' approach. My aim is to provide a scholarly and analytical explication of the insurer's duty to settle to help inform the crafting of the Restatement.

II. THE BOUNDARIES OF THE DUTY TO SETTLE

The boundaries of the duty to settle can be best described as inexact. Despite the well-settled nature of the duty, the duty is neither articulated in policy language nor addressed in any state statute.[26] This

26. The California Supreme Court has explained that an insurer has the duty to settle even when "express terms of the policy do not impose the duty." Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank) (citing Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1958) (in bank)); *see also* Paul E.B. Glad, Ronald D. Kent & Michael Barnes, *Understanding Liability Insurance*, *in* 3 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE: SEPARATE LINES OF INSURANCE § 30.02, at 30-15 to 30-16 (Jeffrey E. Thomas, Leo P. Martinez, Marc S. Mayerson & Douglas R. Richmond eds., 2015) ("The duties to investigate and to settle within the policy limits are not express duties in the insurance policy, but rather are implied from the principal duties to defend and to indemnify."); ROBERT H. JERRY, II & DOUGLAS R. RICHMOND, UNDERSTANDING INSURANCE LAW § 112, at 832 (5th ed. 2012) ("Liability insurance policies . . . do not by their terms impose a duty to settle . . . ."); James M. Fischer, *Insurer or Policyholder Control of the Defense and the Duty to Fund Settlements*, 2 NEV. L.J. 1, 3 n.6 (2002) ("The standard liability insurance contract does not contractually obligate the insurer to settle; rather, the obligation has been judicially imposed.").

Some aspects of the duty to settle are addressed by the Unfair Claims Settlement Practices Act. The duty to settle as defined in California case law is that "[w]hen there is great risk of a recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement which can be made within those limits, a consideration in good faith of the insured's interest requires the insurer to settle the claim." *Comunale*, 328 P.2d at 201. The duty to settle is formulated differently under the Unfair Claims Settlement Practices Act.

The Unfair Claims Settlement Practices Act provides that an insurer commits an unfair claims practice by "[n]ot attempting in good faith to effectuate prompt, fair and equitable settlement of claims submitted in which liability has become reasonably clear" and "[a]ttempting to settle or settling claims for less than the amount that a reasonable person would believe the insured or beneficiary was entitled by reference to written or printed advertising material accompanying or made part of an application." UNFAIR CLAIMS SETTLEMENT PRACTICES ACT § 4 (NAT'L ASS'N OF INS. COMM'RS 1997); *accord* CAL. INS. CODE § 790.03 (West 2013); N.Y. INS. LAW § 2601 (McKinney 2015); 28 TEX. ADMIN. CODE § 21.203(4) (West 1998).

lack of precision has likely contributed to courts' adoption of differing standards under which the duty to settle arises.

In examining the Discussion Draft's approach to the duty to settle, I examine three salient points: the source of the duty to settle, the conduct of the insurer, and the remedies for breach. Limiting my discussion to these few points is intentional. The analysis can be kept to a manageable length and, more importantly, the interrelationship among these aspects of the duty to settle can be explored without delving into undue complexity.

A. *The Source of the Duty to Settle*

The source of the duty to settle is not self-evident, although it raises interesting and divergent issues.[27] On the one hand, it could be argued that the source of the duty is irrelevant given the universal acceptance of the concept of a duty to settle—academics who argue otherwise are many angels dancing on the head of a pin. On the other hand, the precise source of the duty—whether it sounds in tort or contract—can have a significant effect on the range of remedies for breach of the duty. Thus, the danger of incorrect nomenclature emerges because the nature of the relationship defines the rights and duties of the parties, and it is therefore important not to mischaracterize the relationship.

Three distinct approaches emerge in ferreting out the source of the duty to settle. The first of these is based in contract, the second is based in tort, and the last is a hybrid of the two.

1. Contract theory

With the simplest approach, there is an explicit recognition that the duty to settle is a component of an insurer's contractual duty to

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In addition to the different formulation referencing advertising inducements, there is no mechanism for direct redress to an insured for an insurer's breach of the duty to settle. Violation of the proscriptions of the Unfair Claims Settlement Practices Act provides for a range of sanctions that would be easily dwarfed in most duty to settle cases. For example, even flagrant violations in conscious disregard of the Act trigger only a $25,000 penalty per violation. UNFAIR CLAIMS SETTLEMENT PRACTICES ACT § 6. While some states have adopted higher penalties, the amounts are small and the primary redress for breach of the duty to settle remains that which is provided by the common law of most states. *E.g.*, CAL. INS. CODE § 790.035 (allowing up to $10,000 for willful violations).

27. *See* JERRY & RICHMOND, *supra* note 26, § 112[c], at 832. The Reporters describe the duty to settle "as a special application of the general contract law duty of good faith and fair dealing in the context of insurance policies that granted the insurer some discretion over the settlement of an insured liability claim." RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. a (AM. LAW INST., Discussion Draft 2015).

indemnify and duty to defend.[28] In these cases, the focus is entirely on the contractual nature of the insurance policy.[29] According to this view, the action enforcing any consequent breach of the duty to settle is based on a breach of contract.[30] Implicit duties, such as the duty to settle, "merely seek to broaden the conduct which constitutes breach of contract" within the confines of the insurance contract.[31] Thus, a breach of the duty to settle, even if implicit, gives rise to contract remedies only and does not implicate tort remedies.[32]

2. Tort Theory

The duty to settle based in tort proceeds on the theory that because the duty to settle is not an express contractual duty, a breach of the duty must sound in tort as a sort of default position.[33] As one court explained:

> In an action for failure to settle within the policy limits, the insurance company is charged with acting in a fiduciary capacity as an attorney in fact representing the insured's interest in litigation. The company's interest comes into conflict with that of the insured's while representing him; and, arguably, acting in its own interests to the detriment of the insured's interest while acting in such a fiduciary capacity is a tort.[34]

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28. Mesmer v. Md. Auto. Ins. Fund, 725 A.2d 1053, 1060–64 (Md. 1999).

29. *See, e.g.*, Glenn v. Fleming, 799 P.2d 79, 89 (Kan. 1990) (quoting Gilley v. Farmer, 485 P.2d 1284, 1290 (Kan. 1971)).

30. *Id.* at 90 (citing Guarantee Abstract & Title Co. v. Interstate Fire & Cas. Co., 652 P.2d 665, 667 (Kan. 1982)).

31. *Id.* at 89 (quoting *Guarantee Abstract & Title Co.*, 652 P.2d at 669). In *Glenn*, the Kansas Supreme Court acknowledged its own role in creating some confusion:

> We have adopted . . . the principle that the insurer's duties are contractually based and then approved a tort standard of care for determining when the contract duty has been breached. Perhaps this contract/tort relationship has contributed to the confusion arising from our efforts to describe the duty of good faith and to identify the situations involving bad faith/negligent duty to settle and to defend.

Id. at 90.

32. *See id.* at 89; *see also infra* Section II.C.1.

33. *Mesmer*, 725 A.2d at 1063.

34. *Id.* (quoting Farris v. U.S. Fid. & Guar. Co., 587 P.2d 1015, 1018−19 (Or. 1978) (en banc)).

One well-respected and prolific author argues that contract law has traditionally been free of fiduciary relationships—insurance law should be similarly treated in this view. Douglas R. Richmond, *Trust Me: Insurers Are Not Fiduciaries to Their Insureds*, 88 KY. L.J. 1, 5–6 (1999–2000) (characterizing the insured/insurer relationship as a fiduciary

More precision is possible. An insured who has given up her right to defend a claim and her control over settlement puts the insurer in a fiduciary capacity. Thus the exercise of judgment by the insurer must be based on thorough evaluation and informed interaction with the insured.[35] The nature of the tort is that the insurer has acted improperly in defending its insured.[36] This was Judge Keeton's view. He long ago saw the duty to settle as a tort concept.[37]

Some courts suggest that the tort involved need not necessarily be limited to a breach of such fiduciary duty.[38] Where the insurer's conduct is the equivalent of "dishonesty, fraud, and concealment,"[39] liability for its breach of the duty to settle is also possible.[40] Nonetheless, it is also clear that such seemingly intentional conduct is not a predicate to finding an insurer has breached its duty to settle—that is, conduct short of dishonesty, fraud, and concealment may suffice.[41] The larger point is that

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relationship might well deprive the insurer of its reasonable inclination to protect its own interests).

As the courts in Utah recognize:

> An insurer's failure to act in good faith exposes its insured to a judgment and personal liability in excess of the policy limits. In essence, the contract itself creates a fiduciary relationship because of the trust and reliance placed in the insurer by its insured. The insured is wholly dependent upon the insurer to see that, in dealing with claims by third parties, the insured's best interests are protected. In addition, when dealing with third parties, the insurer acts as an agent for the insured with respect to the disputed claim. Wholly apart from the contractual obligations undertaken by the parties, the law imposes upon all agents a fiduciary obligation to their principals with respect to matters falling within the scope of their agency.

Beck v. Farmers Ins. Exch., 701 P.2d 795, 799−800 (Utah 1985) (citations omitted) (distinguishing first party actions but acknowledging the insured's exposure in third party claims).

35. Michael F. Aylward, *Understanding Bad Faith*, *in* 1 NEW APPLEMAN INSURANCE LAW PRACTICE GUIDE: COVERAGE ANALYSIS AND PRELITIGATION PROCEDURES § 6.08[2], at 6-26 (Jeffrey E. Thomas, Leo P. Martinez, Marc S. Mayerson & Douglas R. Richmond eds., 2015); *see* Asermely v. Allstate Ins. Co., 728 A.2d 461, 464 (R.I. 1999) (per curiam) ("An insurance company's fiduciary obligations include a duty to consider seriously a plaintiff's reasonable offer to settle within the policy limits."); Prosser v. Leuck, 592 N.W.2d 178, 182 (Wis. 1999) ("By . . . taking control of settlement or litigation the insurer assumes a fiduciary duty on behalf of the insured.").

36. *Mesmer*, 725 A.2d at 1063 (quoting Allstate Ins. Co. v. Campbell, 639 A.2d 652, 658 (Md. 1994)).

37. Keeton, *supra* note 1, at 1138 n.5.

38. *See, e.g.*, Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank).

39. *Id.* (first citing Critz v. Farmers Ins. Grp., 41 Cal. Rptr. 401 (Dist. Ct. App. 1964); then citing Palmer v. Fin. Indem. Co., 30 Cal. Rptr. 204, 208 (Dist. Ct. App. 1963); and then citing Davy v. Pub. Nat'l Ins. Co., 5 Cal. Rptr. 488, 492–93 (Dist. Ct. App. 1960)).

40. *Id.* at 176–77.

41. *Id.* at 177.

by grounding the duty to settle in tort, a court has a different, and possibly broader, range of remedies to consider when the duty is breached.[42]

3. Hybrid Contract/Tort Theory

The last approach, best described as a hybrid, seeks to ground an insurer's duty to settle in terms of both contract and tort.[43] There is, however, scant explanation for this hybrid approach. A series of well-known California cases on the subject seem to state the hybrid nature of the duty to settle as a matter of fact.[44] While the cases do not say as much, one is left with the impression that the hybrid approach is less doctrinally defensible than it is a means to expand the range of remedies for breach of the duty to settle. This tendency is understandable if the overwhelming sentiment is informed by a strong public policy to protect against harm.[45]

4. The Reporters' Choice

The Reporters' choice of underlying theory in the Restatement of the Law of Liability Insurance is made tacitly. Although the text of section 24, the Comment, and the Reporters' Note are all silent as to the

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42. *See infra* Section II.C.2.

43. Whiting-Turner Contracting Co. v. Liberty Mut. Ins. Co., 912 F. Supp. 2d 321, 340–41 (D. Md. 2012); *Crisci*, 426 P.2d at 179.

44. *Crisci*, 426 P.2d at 178–79 (holding that the duty to settle sounds in contract and "breach [of the duty to settle] also constitutes a tort"); Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 203 (Cal. 1958) (in bank) (holding that a breach of the duty to settle sounds in both contract and tort).

This lack of support for the hybrid approach regarding the duty to settle does not suggest a lack of well-developed material on the marriage of contracts and torts generally. *See generally* Jay M. Feinman, *The Jurisprudence of Classification*, 41 STAN. L. REV. 661 (1989) (discussing the problem of classification of doctrine and the boundary between contract and tort); Jay Feinman & Marc Feldman, *Pedagogy and Politics*, 73 GEO. L.J. 875, 883–84 (1985) (explaining generally that in certain factual scenarios, "contract and tort [have] merged to an extent that it would be useful to combine them theoretically and pedagogically . . . [, specifically,] a situation for which either contractual or delictual responsibility seems appropriate"); Matthew J. Barrett, Note, *"Contort": Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing in Noninsurance, Commercial Contracts—Its Existence and Desirability*, 60 NOTRE DAME L. REV. 510, 510 (1985) (explaining that courts have recognized these factual mergers, or "contorts," specifically in the realm of insurance contracts because "[b]reach of [the] implied covenant [of good faith and fair dealing] creates a cause of action in contract" and that "[b]eginning twenty-five years ago, some courts also recognized a cause of action in tort for breach of this implied covenant in insurance contracts").

45. *Crisci*, 426 P.2d at 178–79.

underlying theories, section 24(3) seems to adopt a purely contractual approach by limiting an insurer's obligation to the liability limits of the policy.[46]

The Reporters are more explicit in the Comment to section 27 in which they note that although they are agnostic as to the doctrinal underpinnings of the section, the principles in section 27 are compatible with a more expansive foreseeability approach that more nearly resembles a tort approach.[47] Essentially, the Reporters have chosen, for section 27 at least, a one-size-fits-all approach, differentiating torts and contracts by the differing notions of proximate cause and reasonable foreseeability. Nevertheless, the Reporters have not explicitly identified the doctrinal foundation of their approach.

A big-picture perspective is useful at this point. The importance of remedies cannot be overstated; indeed, the available remedies are often the primary reason for litigation. The availability and scope of a given remedy flow directly from the substantive right violated.[48] Thus, the way one perceives breach of the duty to settle informs the choice of the consequent remedy.

With that limitation in mind, if one views the breach of the duty to settle as a contract breach, one set of remedies suggests itself. If the breach of the duty to settle is a tort, or if breach of the contract's implied covenant of good faith and fair dealing is a tort, a different set of remedies arises. As a general proposition, those jurisdictions that subscribe to a tort theory of the breach of the duty to settle expose the insurer to a wider array of damages, including punitive damages. Contract remedies are significantly more restrictive. These are discussed in the following sections.

B. The Insurer's Conduct

According to a treatise for which I serve as an editor, "[w]here a primary insurer assumes the defense of its insured, it must exercise due care in the conduct of that defense, including a duty to act reasonably in response to settlement offers."[49] While the treatise articulates pro-insurer

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46. RESTATEMENT OF THE LAW OF LIAB. INS. § 24(3) (AM. LAW INST., Discussion Draft 2015).

47. Section 27, comment b provides: "Although this Section is agnostic as to the doctrinal label, the broader approach to whether a loss is foreseeable, which is most commonly associated with the tort-law label, is the proper approach." *Id.* § 27 cmt. b.

48. 1 DAN B. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION § 1.6, at 25 (2d ed. 1993).

49. Aylward, *supra* note 35, § 6.08[2], at 6-26. The pro-insured description of the insurer's obligation is that an insurer has a fiduciary obligation "to act in the best interests

and pro-insured views of that duty, it does not provide an explanation or even a rationale for such positions. Moreover, the treatise seems to adopt a tort remedy approach to breaches of the duty to settle.[50] This Article is an opportunity, if nothing else, to acknowledge the distinction and highlight its implications.

For the moment, I will put aside the tort/contract distinction. I will instead devote this part of the Article to describing the range of possible insurer behavior that will constitute a breach of the duty to settle whether in tort or in contract. Defining the behavior that constitutes a breach of the duty to settle has proven remarkably elusive. This lack of clear definition seems to trace its roots to the fact that the duty to settle is an implicit one.[51]

To begin, it bears mention that there is nothing sinister in allowing an insurer a certain amount of discretion in effectuating settlements.[52] By allowing the insurer such freedom of action, the insured is discouraged from entering into collusive agreements with third parties, and the insurer's expertise and experience can be used to the fullest advantage in a cost-effective way. Indeed, it is often the insurer's money that is in play.[53]

Still, as Dean Jerry and Douglas Richmond have observed, "the insurer's discretion is limited in substantial ways by judicially-created rules."[54] The fuzziness in this area is a result of the wide range and variety of these judicially-created rules.[55] A short discussion of these reveals that some of these rules may well be deficient in substantial respects. For the purposes of this Article, I have arbitrarily created three categories of limitations/insurer behavior that I use as a proxy for the

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of its insureds in order to protect the insured from excess liability" and "to refrain from conduct that demonstrates 'greater concern for the insurer's monetary interest than the financial risk attendant to the insured's situation.'" *Id.*

50. This tacit assumption that breach of the duty to settle sounds in tort is adopted by Kent Syverud's article. Syverud, *supra* note 2, at 1117–18.

51. Typically, the duty to settle arises from insurance contract provisions that require the insurer to both assume defense of the claim and control the settlement decision. Aylward, *supra* note 35, § 6.08[2], at 6-26; Glad, Kent & Barnes, *supra* note 26, § 30.02, at 30-15 to 30-16; Syverud, *supra* note 2, at 1118–19.

52. KENNETH S. ABRAHAM, DISTRIBUTING RISK: INSURANCE, LEGAL THEORY, AND PUBLIC POLICY 188 (1986) ("Insurers are entitled to settle, even against the wishes of the insured, and they are entitled to refuse to settle even if the insured desires the case against him settled."); JERRY & RICHMOND, *supra* note 26, at 832 (stating that insurers have "a right to settle, or not to settle, as the insurer in the exercise of its discretion sees fit").

53. JERRY & RICHMOND, *supra* note 26, at 832–33 (outlining a similar set of reasons to allow insurer control over settlement); Syverud, *supra* note 2, at 1137–38 (same).

54. JERRY & RICHMOND, *supra* note 26, at 832.

55. Keeton, *supra* note 1, at 1139 ("Courts have disagreed regarding the standard used in defining [the] duty to settle . . . ."); Syverud, *supra* note 2, at 1122.

spectrum of possibilities. I do this to both simplify the analysis as well as to highlight the difficulty of ascribing precise standards for insurer behavior—a matter that the Reporters take very much to heart.

1. The Pro-Insurer Approach

One end of a spectrum of insurer behavior can be represented by the decidedly pro-insurer view that "failure to settle is not actionable in the absence of subjective culpability."[56] Thus, an insurer's behavior must be either intentional or reckless in order to constitute a breach of the duty to settle.[57] This more nearly describes conduct necessary to ascribe the label "bad faith" to an insurer's conduct—the "arbitrary, reckless, indifferent, or intentional disregard of the interests of the person owed a duty."[58] Thus, in states that adopt the pro-insurer view, an insured faces a significant hurdle to recovery. For example, an insured seeking recovery beyond the policy limits for an insurer's breach of the duty to settle must show the insurer acted with "conscious or knowing indifference" as to the insured's interests.[59]

2. The Middle Approach

In the large middle between a nearly strict liability standard and an intentional/reckless conduct standard of behavior lie a number of different approaches which, for present purposes, I somewhat lump together in an undifferentiated mass. In this large middle, an insurer breaches its duty to settle and "is liable only if its behavior in failing to settle departs from some norm by a margin a jury can fairly label 'negligent,' 'bad faith' (a standard purportedly more onerous than negligence), or some combination of the two."[60]

Some courts in this large middle adopt a distinction between an insurer's bad faith failure to settle and an insurer's decision to continue to defend a claim that has a "real and substantial" chance of a judgment

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56. Aylward, *supra* note 35, § 6.08[2], at 6-26.

57. *Id.*

58. JERRY & RICHMOND, *supra* note 26, at 168.

59. Pavia v. State Farm Mut. Auto. Ins. Co., 626 N.E.2d 24, 27–28 (N.Y. 1993) ("[E]stablished precedent clearly bars a 'bad faith' prosecution for conduct amounting to ordinary negligence.").

60. Syverud, *supra* note 2, at 1122; *accord* Keeton, *supra* note 1, at 1140 ("The distinction between the 'bad faith rule' and the 'negligence rule' is less marked than these terms would suggest.").

within the policy limits.[61] There are also any number of formulations that rely on a determination of "reasonableness" without undertaking any kind of definition of what constitutes reasonableness.[62]

Other courts, again in this broad middle, employ a negligence standard to determine whether an insurer has breached its duty to settle.[63] The Supreme Judicial Court of Massachusetts held that the test for an insurer's negligence "is not whether a reasonable insurer might have settled the case within the policy limits, but rather whether *no* reasonable insurer would have failed to settle the case within the policy limits."[64] Under this test, the insured must "prove that the plaintiff in the underlying action would have settled the claim within the policy limits and that, assuming the insurer's unlimited exposure[,] . . . no reasonable insurer would have refused the settlement offer or would have refused to respond to the offer."[65] Under the language of this test, it is not difficult to see why many authorities conclude that the difference between the bad faith standard and the negligence standard exists in name only.[66]

3. The Pro-Insured Approach

The other end of this wide spectrum is a pro-insured approach—a strict liability norm. This approach would find the insurer liable for all unsuccessful settlements.[67] This approach would be untenable because a corollary of the idea that an insurer has some discretion in discharging its duty to settle is that the insurer cannot be held to a strict liability standard if it is unsuccessful in settling. A strict liability standard would imply no discretion at all in settling. At the time of Kent Syverud's article

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61. DeWalt v. Ohio Cas. Ins. Co., 513 F. Supp. 2d 287, 296 (E.D. Pa. 2007); *see also* Anglo-Am. Ins. Co. v. Molin, 670 A.2d 194, 197–98 (Pa. Commw. Ct. 1995) (holding that an insurer may "reject a settlement offer and insist on litigation if it has a bona fide belief that it has a good possibility of succeeding on the merits" (citing Cowden v. Aetna Cas. & Sur. Co., 134 A.2d 223 (Pa. 1957))).

62. "Where a primary insurer assumes the defense of its insured, it must exercise due care in the conduct of that defense, including a duty to act reasonably in response to settlement offers." Aylward, *supra* note 35, § 6.08[2], at 6-26.

63. *Id.* § 6.08[3][b], at 6-29.

64. Hartford Cas. Ins. Co. v. N.H. Ins. Co., 628 N.E.2d 14, 18 (Mass. 1994) (emphasis added).

65. *Id.*; *see also* Carrier Express, Inc. v. Home Indem. Co., 860 F. Supp. 1465, 1478–79 (N.D. Ala. 1994) ("If the insurer fails to exercise such reasonable or ordinary care, then it has breached its duty and is guilty of negligence.").

66. *See* Bollinger v. Nuss, 449 P.2d 502, 509–10 (Kan. 1969).

67. Of course, lack of success is in the eye of the beholder and I concede the imprecision of this observation. This imprecision is partially addressed in the succeeding Part II.C of this Article.

twenty-five years ago, no state had held an insurer to a standard of strict liability for an unsuccessful settlement, remaining a trend that has held up through the more recent past.[68]

There is another pro-insured interpretation of the insurer's obligation that is just shy of a strict liability approach. Under this approach, the insurer has a fiduciary obligation "'to act in the best interests of its insureds in order to protect the insured from excess liability' and to refrain from conduct that demonstrates 'greater concern for the insurer's monetary interest than the financial risk attendant to the insured's situation.'"[69] This is the approach generally taken in California.[70]

California's formulation is the result of a multi-step process. In California, an insurer's duty to settle is traced to the implied covenant of good faith and fair dealing present in all contracts.[71] The implied covenant of good faith and fair dealing requires parties to a contract to refrain from acting in any way that would inhibit the other party from receiving the benefits of their agreement.[72] Because settlement of claims without litigation is one of the ways an insured receives one of the benefits of an insurance policy—indemnification—the implied covenant of good faith and fair dealing imposes the duty to settle the claim within the policy limits.[73] A claim based on a failure to settle generally requires that the insurer is defending or has defended the underlying case and that the policy covers the subject matter of the settlement.[74] Further, the cause of action requires that a third-party claimant make an offer or demand settlement at or below the policy limits, that the insurer's refusal of that offer was unreasonable, and that a judgment in excess of the policy limits

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68. Syverud, *supra* note 2, at 1122; *accord* JERRY & RICHMOND, *supra* note 26, at 837. It has been observed that there have been close calls. JERRY & RICHMOND, *supra* note 26, at 837 n.272 (describing one court's flirtation with strict liability and pointing to California's near strict liability approach).

69. Aylward, *supra* note 35, § 6.08[2], at 6-26. Although the *Asermely v. Allstate Insurance Co.* court essentially used the California formulation of the insurer's duty, the per curiam opinion states "the insurer is liable for the amount that exceeds the policy limits, unless it can show that the insured was unwilling to accept the offer of settlement." 728 A.2d 461, 464 (R.I. 1999) (per curiam). Dean Jerry and Douglas Richmond did not unreasonably construe this statement as almost adopting, without explicitly saying, a strict liability standard. JERRY & RICHMOND, *supra* note 26, at 838.

70. *Asermely*, 728 A.2d at 464. Reliance on California law is not misplaced in this instance given that it "is not materially different in any systematic sense from the common law of other jurisdictions." TOM BAKER & KYLE D. LOGUE, INSURANCE LAW AND POLICY: CASES, MATERIALS, AND PROBLEMS 507 (3d ed. 2013).

71. Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank) (citing Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1958) (in bank)).

72. *Id.* (citing *Comunale*, 328 P.2d at 201).

73. *Id.* (citing *Comunale*, 328 P.2d at 201).

74. Aylward, *supra* note 35, § 6.08[3], at 6-27.

was entered against the insured.[75] However, the inquiry usually centers on whether the insurer's refusal of an offer was unreasonable.[76]

In assessing reasonableness, the California standard asks whether the insurer refused settlement in bad faith and requires insurers to "give the interests of the insured at least as much consideration as it gives to its own interests."[77] To determine whether the insurer gave as much consideration to the insured's interests as to its own interests, "the test is whether a prudent insurer *without policy limits* would have accepted the settlement offer."[78] Many states adopt essentially the same formulation.[79] It deserves mention that this formulation lies at the end of the spectrum nearest the strict liability approach.

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75. *Id.* The Reporters theoretically take a more expansive view by imposing liability for an insurer's failure to make a reasonable settlement decision. *See* RESTATEMENT OF THE LAW OF LIAB. INS. § 24 cmt. a (AM. LAW INST., Discussion Draft 2015).

76. Syverud, *supra* note 2, at 1123.

77. *Crisci*, 426 P.2d at 176 (citing *Comunale*, 328 P.2d at 201). In *Wade v. EMCASCO Insurance Co.*, the Tenth Circuit explained that the relevant question in determining bad faith centers on "the degree of consideration which an insurer must give to those interests of the insured which conflict with its own." 483 F.3d 657, 666 (10th Cir. 2007) (quoting Bollinger v. Nuss, 449 P.2d 502, 510 (Kan. 1969)). The court echoed *Crisci* and held that good faith execution of an insurer's duty to settle allows an insurer to consider "its own interests, but [the insurer] must also give at least equal consideration to the interests of the insured." *Id.* (quoting *Bollinger*, 449 P.2d at 510); *see also* Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co., 690 P.2d 1022, 1026 (N.M. 1984) ("[F]or the jury to find bad faith, it must believe that [the insurer], in failing to settle within policy limits, was motivated by self-interest or ill will.").

78. *Crisci*, 426 P.2d at 176 (emphasis added).

79. *See, e.g.*, Contreras v. U.S. Sec. Ins. Co., 927 So. 2d 16, 21 (Fla. Dist. Ct. App. 2006); Short v. Dairyland Ins. Co., 334 N.W.2d 384, 387–88 (Minn. 1983) ("This duty to exercise 'good faith' includes an obligation to view the situation as if there were no policy limits applicable to the claim, and to give equal consideration to the financial exposure of the insured."); Eastham v. Or. Auto. Ins. Co., 540 P.2d 364, 367 (Or. 1975) ("Good faith requires the insurer . . . to treat the conflicting interests of itself and the insured with impartiality, giving equal consideration to both interests . . . [and, in this respect,] act as if there were no policy limits applicable to the claim and as if the risk of loss was entirely its own."); Tex. Farmers Ins. Co. v. Soriano, 881 S.W.2d 312, 314 (Tex. 1994) (holding that "under Texas law insurers must 'exercise "that degree of care and diligence which an ordinarily prudent person would exercise in the management of his own business" in responding to settlement demands within policy limits'" (quoting Am. Physicians Ins. Exch. v. Garcia, 876 S.W.2d 842, 848 (Tex. 1994)). Kent Syverud recognized that this so-called "disregard the limits" approach so pervades case law surrounding the duty to settle "that some commentators tacitly assume [it] is universally accepted," notwithstanding that it has not been adopted by the majority of states. Syverud, *supra* note 2, at 1122 n.23.

4. The Reporters' Approach

The Discussion Draft changes the landscape of the duty to settle in several significant and not necessarily desirable ways. Section 24(2) provides a formulation that is very close to the California formulation. It provides that "[a] reasonable settlement decision is one that would be made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment."[80]

The mischief in the Discussion Draft is subtle. It is done in the Comments and Reporters' Notes. The Reporters begin by suggesting that an insurer "take into account the realistically possible outcomes of a trial and, to the extent possible, weigh those outcomes according to their likelihood."[81] While acknowledging the difficulty of this task, the Reporters contrast this difficulty with the undesirability of a strict liability standard.[82] This is a false choice. There are sound and defensible reasons to eschew strict liability in this context. The better comparison would be with the insured-friendly California approach that is dominant, rather than an approach that no court has actually adopted.

Thereafter the Reporters sprinkle a number of factors to consider in determining the reasonableness of an insurer's decision throughout the Comments. These include consideration of expert testimony,[83] consultation with the lawyer(s) involved in the underlying claim,[84] the insurer's failure to make settlement offers and counteroffers,[85] "failure to conduct negotiations in a reasonable manner or to follow the recommendation of its adjuster or chosen defense lawyer (including not seeking the defense lawyer's recommendation)[,] . . . failure to keep the insured informed of within-limits offers or the risk of excess judgment, and the provision of misleading information."[86]

The Reporters are not alone in making this choice. Both courts and commentators have resorted to a list of relevant factors for a jury to consider.[87] For example, the Tenth Circuit explained that the jury could consider the following factors:

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80. RESTATEMENT OF THE LAW OF LIAB. INS. § 24(2) (AM. LAW INST., Discussion Draft 2015).

81. *Id.* § 24 cmt. d.

82. *Id.*

83. *Id.*

84. *Id.*

85. *Id.* § 24 cmt. e.

86. *Id.* § 24 cmt. i.

87. *See* O'Neill v. Gallant Ins. Co., 769 N.E.2d 100, 106–09 (Ill. App. Ct. 2002) (listing "seven factors pertinent to the assessment of bad faith").

> (1) [T]he strength of the injured claimant's case on the issues of liability and damages; (2) attempts by the insurer to induce the insured to contribute to a settlement; (3) failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured; (4) the insurer's rejection of advice of its own attorney or agent; (5) failure of the insurer to inform the insured of a compromise offer; (6) the amount of financial risk to which each party is exposed in the event of a refusal to settle; (7) the fault of the insured in inducing the insurer's rejection of the compromise offer by misleading it as to the facts; and (8) any other factors tending to establish or negate bad faith on the part of the insurer.[88]

Twenty-five years ago, Kent Syverud saw that juries were provided "a thorough description of how attorneys and claims adjustors evaluate the value of a lawsuit." Syverud, *supra* note 2, at 1126. According to him, juries said that the evidence considered in their evaluation included:

> the insurance company's claims file; evaluations of the case value by claims adjustors, the attorneys in the underlying tort action, and the original trial judge; loss reserves established by insurance companies to cover the claim; and testimony about the apparent strength of the plaintiff's case and the insured's defenses (including the credibility of witnesses, the severity of injuries, and the likely legal rulings).

Id. at 1124–26 (footnotes omitted).

88. Wade v. EMCASCO Ins. Co., 483 F.3d 657, 667 (10th Cir. 2007) (quoting Bollinger v. Nuss, 449 P.2d 502, 512 (Kan. 1969)); *accord* Mid-Am. Bank & Tr. Co. v. Commercial Union Ins. Co., 587 N.E.2d 81, 84 (Ill. App. Ct. 1992) (holding, in part, that where the insurer was aware of an offer to settle within the limits, the possibility of its own bad faith, the personal liability of the insured, the risk of an excess judgment, and a significant amount of time to settle within the policy limits, there was enough evidence for a jury to determine the insurer acted in bad faith in failing to settle).

Dean Jerry and Douglas Richmond cite a similar list. The factors include:

> (1) the insured's probable liability; (2) the policy limits; (3) the extent of the claimant's damages; (4) the adequacy of the insurer's investigation; (5) the quality of the defense provided by the insurer; (6) whether the insurer heeded defense counsel's advice concerning settlement; (7) whether the insurer heeded its own adjusters' advice concerning settlement; (8) the insurer's willingness to engage in settlement negotiations; (9) whether the insurer advised the insured of all settlement offers; (10) whether the insured made any misrepresentations that may have misled the insurer with respect to settlement negotiations; and (11) any other conduct by the insurer reasonably reflecting greater concern for its financial interests than for its insured's financial risk.

JERRY & RICHMOND, *supra* note 26, at 841.

It should not be lost that the California approach essentially jettisons the first ten factors on the Jerry/Richmond list in favor of reliance on the last factor by simply asking whether the insurer has "give[n] the interests of the insured at least as much consideration as it [has given] to its own interests" and "whether a prudent insurer without policy limits

The effect of such lists is twofold. First, some lists include consideration of the policy limits.[89] Such lists, perhaps unintentionally so, effectively convert analysis to a *regard*-the-limits rule. Second, the compilation of factors unnecessarily complicates matters for insureds. While I appreciate that the Reporters' intent might have been to flesh out what is meant by the language "whether a prudent insurer *without policy limits* would have accepted the settlement offer," the practical effect of resorting to a list of factors may be to dilute the focus on the answer to the single inquiry.

In *Wade v. EMCASCO Insurance Co.*, the Tenth Circuit explained that the relevant question in determining bad faith centers on "the degree of consideration which an insurer must give to those interests of the insured which conflict with its own."[90] The *Wade* court echoed *Crisci* and held that good faith execution of an insurer's duty to settle allows an insurer to consider "its own interests, but [the insurer] must also give at least equal consideration to the interests of the insured."[91] Courts have essentially collapsed the multifactor inquiry into one step to simplify the analysis. In *Wade*, the use of multiple factors focused on the single inquiry at one end of the insurer-behavior spectrum.

By deemphasizing focus on a single factor, in contrast to what is done in California and a host of other states, an insurer is given significantly more latitude to show a lack of untoward behavior. In doing so, the Reporters necessarily arrive at a more pro-insurer position than would otherwise be the case. By contrast, case law has aligned itself nearer to the California end of the spectrum. This is not to advocate a strict

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would have accepted the settlement offer." Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank).

The treatise for which I serve as an editor also cites a list of factors to consider. These include:

- the probability of the insured's liability;
- the extent of the damages claimed;
- the amount of the policy limits;
- the adequacy of the insurer's investigation; and
- the openness of communications between the insurer and the insured.

Aylward, *supra* note 35, § 6.08[3][b], at 6-29.

89. Dean Jerry, Douglas Richmond, and the *New Appleman Insurance Law Practice Guide* include the policy limits as a factor. JERRY & RICHMOND, *supra* note 26, at 841; Aylward, *supra* note 35, § 6.08[3][b], at 6-29.

90. *Wade*, 483 F.3d at 666 (quoting *Bollinger*, 449 P.2d at 510).

91. *Id.* (quoting *Bollinger*, 449 P.2d at 510); *see also* Ambassador Ins. Co. v. St. Paul Fire & Marine Ins. Co., 690 P.2d 1022, 1026 (N.M. 1984) ("[F]or the jury to find bad faith, it must believe that [the insurer], in failing to settle within policy limits, was motivated by self-interest or ill will.").

liability approach—again, there are sound reasons not to do so—but the possibility of a strict liability approach should not be used as a basis for moving the needle closer to the middle of the spectrum than is reflected in the case law. The subtle move to a range of factors rather than one—the California approach—has the effect of moving the needle closer to the middle.

The existence of such a wide range invites a view of insurer conduct that may be too generous to insurers at the expense of insureds. It should be possible to make a conscious choice to opt for a regime that more clearly resembles the existing California approach. While the recognition of this broad middle does exactly that, there is little justification to depart from what has worked in the majority of states that have recognized the plight faced by insureds who turn over control of litigation and settlement to insurers.

While the California approach may require an inquiry into one or more of the factors that are outlined above, all of these factors are aimed at the single determination of whether a prudent insurer without policy limits would have accepted the settlement offer. The California approach is preferable because it is more predictable and balances the interests of the parties. It also puts the insurer in the insured's shoes, the effect of which encourages courts to consider the insured's interest no matter the expected value of the claim. This kind of clarity is good. As Professor Jay Feinman observes, this "standard provides a substantial guide for insurer's behavior."[92]

Section 24(1) provides that "[t]he duty [to make reasonable settlement decisions] is owed only with respect to claims that expose the insured to . . . liability in excess of the policy limits."[93] The explanation for this approach is that the insurer is already motivated to settle claims of the insurer's existing contractual liability for those claims.[94] Implicit in this explanation may also be the idea that any judgment within the policy's limits, whether the insurer settles the suit or opts to try the case, is "of no concern to the insured."[95]

However, not imposing a duty to act reasonably in this context seems to go too far. One might ask whether an insurer can act unreasonably but

92. Feinman, *supra* note 25 (manuscript at 31).

93. RESTATEMENT OF THE LAW OF LIAB. INS. § 24(1) (AM. LAW INST., Discussion Draft 2015).

94. *Id.* § 24 cmt. a.

95. Milroy v. Allstate Ins. Co., 151 P.3d 922, 928–29 (Okla. Civ. App. 2006) (quoting A.W. Huss Co. v. Cont'l Cas. Co., 735 F.2d 246, 250 (7th Cir. 1984)). In *Milroy*, the court found that the insured had incurred minimal harm and that the insurer had acted diligently without bad faith in taking the case to trial. *Id.* at 929.

nonetheless escape liability through the accident of settlement within the policy limits. Moreover, the possibility of an insurer being motivated in the way suggested is subject to serious question. This last point can be illustrated by a number of points.

First, a basic tenet of contract law is that neither party should act in a way to deprive the other of their bargain.[96] One part of that bargain is the implied covenant of good faith and fair dealing.[97] This is implicit in the cases that recognize that the duties owed by an insurer that breaches are different than those of an insurer that meets its obligation. There is a significant trend of courts broadening the range of possible remedies for breach of the duty to settle. Indeed most states subscribe to the notion that an insurer will certainly be liable for any excess verdict that results from a breach of its duty to settle,[98] although the existence of an excess judgment is *not required* in order to maintain a case against a breaching insurer.[99]

Second, the interests of insurer and insured are not necessarily aligned. An insurer can be motivated by its desire to maintain its reputation for taking hard stances, by the size of its reserves, and by its desire to keep its money from being paid out to claimants. In all events these might well work to the detriment of an insured.

Third, peace of mind is part of the bargain. Litigation that results in a judgment within the limits takes its toll, even on the sophisticated insureds. The harm to insureds is not necessarily limited to the settlement amount—even though within the policy limits.[100] A majority of the New York Court of Appeals in *Bi-Economy Market, Inc. v. Harleysville Insurance Co. of New York* explained that an insurance contract is distinguished from "pure 'agreements to pay'" because an insured bargains not just for indemnification, but also for the insurer's good faith handling of claims.[101] In surrendering defense and control of settlement negotiations to the insurer, an insured also contracts to

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96. Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank) (citing Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 200 (Cal. 1958)); *see* Leo P. Martinez, *A Unified Theory of Insurance Risk*, 74 U. PITT. L. REV. 713, 735–38, 758 (2013).

97. *Crisci*, 426 P.2d at 176.

98. Aylward, *supra* note 35, § 6.08[2], at 6-27.

99. *Id.* § 6.08[3], at 6-27. Still, lack of an excess judgment may go to the question of harm.

100. The Reporters seem to ascribe to the logic articulated in the dissent of a recent New York case. According to the dissent in *Bi-Economy Market, Inc. v. Harleysville Insurance Co. of New York*, "in insurance contracts . . . the parties have already told us what damages they contemplated; . . . it is payment equal to the losses covered by the policy." 886 N.E.2d 127, 134 (N.Y. 2008) (Smith, J., dissenting).

101. *Id.* at 130 (majority opinion).

receive a performance-based benefit. Limiting an insurer's obligation to act in good faith and restricting the range of remedies when recovery is less than the policy's liability limits jeopardizes an insured's receipt of all of the benefits for which it contracted.

Fourth, and related to the last point, there are a myriad of implicit obligations in any insurance policy. For an insurer that is relieved of its obligation to act reasonably in the context of the duty to settle, it may be too tempting to act unreasonably in other areas.

Finally, by allowing the policy limits to affect the standards by which insurer behavior is judged and to play a role in the remedy that is available to the insured, the Reporters seem to discount, at least in this regard, the salutary "disregard-the-limits" approach championed by Judge Keeton in his own influential work.[102]

The "disregard-the-limits" concept provides a workable standard by which fact-finders can assess the insurer's settlement behavior.[103] Originally articulated by Judge Keeton, the standard seeks to address the question of *how much* consideration an insurer must give to the interest of its insured.[104] In jurisdictions that examine the insurer's conduct under a negligence standard, the "disregard-the-limits" rule aligns the parties' interests by requiring the insurer to "use such care as would have been used by an ordinarily prudent insurer with no policy limit applicable to the claim."[105] An insurer then, is liable for failing to settle "only if[] such ordinarily prudent insurer would consider that choosing to try the case (rather than to settle . . .) would be taking an unreasonable risk—that is, trial would involve chances of unfavorable results out of reasonable proportion to the chances of favorable results."[106] In jurisdictions employing a bad faith framework, the standard can be articulated as requiring the insurer to "in good faith view the situation as it would if there were no policy limit applicable to the claim."[107]

The California Supreme Court adopted Judge Keeton's "disregard-the-limits" rule in *Crisci*.[108] The *Crisci* court held that the relevant

102. Keeton, *supra* note 1, at 1147–48.
103. *See id.* at 1142–48.
104. *Id.* at 1142.
105. *Id.* at 1147.
106. *Id.*
107. *Id.* at 1148.
108. Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 176 (Cal. 1967) (in bank). The Reporters also cite to the following cases applying Keeton's articulation of the "disregard-the-limits" rule: *Herges v. Western Casualty & Surety. Co.*, 408 F.2d 1157, 1163–64 (8th Cir. 1969) and *Koppie v. Allied Mutual Insurance Co.*, 210 N.W.2d 844, 848 (Iowa 1973).

inquiry when considering "whether an insurer has given consideration to the interests of [its] insured . . . is whether a prudent insurer without policy limits would have accepted the settlement offer."[109] In the New Jersey Supreme Court's view, "both interests can be served justly only if the insurer treats any settlement offer as if it had full coverage for whatever verdict might be recovered, regardless of policy limits, and makes its decision to settle or to go to trial on that basis."[110] The Second Circuit explained that "the insurer must conduct itself as though it alone were liable for the entire amount of the judgment."[111] Under the Second Circuit's articulation of the standard, the insurer is not only precluded from considering the policy's limits, but also from considering the potential for reducing future settlement amounts or acting on the insurer's belief that the policy does not confer coverage.[112] Whether the insurer met this standard is a question for the fact-finder.[113]

As the Reporters note in their extensive discussion, the "disregard-the-limits" formulation is the most widely used by courts to assess the reasonableness of an insurer's decision to settle or not.[114] By circumscribing an insurer's behavior only if there is a recovery beyond the policy limits, the Reporters seem to opt for an approach that requires consideration of the limits.[115] They effectively repeat this view with

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RESTATEMENT OF THE LAW OF LIAB. INS. § 24 reporters' note c (AM. LAW INST., Discussion Draft 2015).

109. *Crisci*, 426 P.2d at 176. Professor Syverud indicated that at the time of his article "Keeton's 'disregard the limits' standard . . . gained its most prominent endorsement from [*Crisci*, which] so dominates case law on duty-to-settle doctrine that some commentators tacitly assume the 'disregard the limits' standard is universally accepted." Syverud, *supra* note 2, at 1122 n.23. The Reporters recognize the dominance of *Crisci* in the Reporters' Notes as well. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 reporters' note c (AM. LAW INST., Discussion Draft 2015). Professor Syverud noted, however, that the "disregard-the-limits" approach has been endorsed by courts in sixteen states, not fifty. Syverud, *supra* note 2, at 1122 n.23.

110. Bowers v. Camden Fire Ins. Ass'n, 237 A.2d 857, 862 (N.J. 1968).

111. Schwartz v. Liberty Mut. Ins. Co., 539 F.3d 135, 142 (2d Cir. 2008) (quoting Johansen v. Cal. State Auto. Ass'n Inter-Ins. Bureau, 538 P.2d 744, 748 (Cal. 1975) (in bank)).

112. *Id.* (quoting *Johansen*, 538 P.2d at 748).

113. *See Crisci*, 426 P.2d at 176.

114. RESTATEMENT OF THE LAW OF LIAB. INS. § 24 reporters' note c (AM. LAW INST., Discussion Draft 2015).

115. Section 24, comment c is the only comment that discusses the "disregard the limits" rule. The comment indicates that an insurer may reject unreasonable settlement demands.

> A reasonable settlement demand or offer is one that would be accepted or made by a reasonable person who bears the sole financial responsibility for the full amount of the potential judgment. . . . This application of the reasonableness standard to settlement decisions is sometimes referred to by courts and commentators as the

respect to limiting the range of available remedies for recoveries when there is a settlement within the policy limits. As Judge Keeton long ago observed, "[t]he difficulty is that at the time decisions must be made by the parties there is uncertainty both as to whether [the insurer] is guilty of a wrong in failing to settle and also as to whether any harm will result from such failure."[116]

C. Remedies for Breach of the Duty to Settle

1. General

Because the duty to settle involves an implicit promise, the remedy is not so easy to divine. In this part of the Article, I assume that the base remedy for breach of the duty to settle, whether based in tort or contract, is that the insurer will be held liable for breach of either its twin explicit promises to both indemnify the insured up to the policy limits and to defend the insured against any covered claim.[117] Insurer liability is not a given under the Reporters' formulation.[118] That is, section 24(1) does not impose a duty to settle or, in the Reporters' parlance, the duty to make reasonable settlement decisions, unless the insured is exposed to claims beyond the policy limits. Only in such cases does the base remedy under section 27 include the amount of any judgment in excess of the policy limits.

Very broadly, "[t]he fundamental question in damages, subject to many limits and exceptions, is how much a plaintiff lost, comparing what actually happened to what would have happened but for the wrong."[119]

> "disregard the limits" rule, since a reasonable person is defined as one who makes settlement decisions in disregard of the policy limits.

Id. § 24 cmt. c. Beyond this reference, the Reporters' Note on comment c only underscores the importance and usefulness of the standard.

116. Keeton, *supra* note 1, at 1162.

117. *E.g.*, EDO Corp. v. Newark Ins. Co., 898 F. Supp. 952, 955 (D. Conn. 1995); Nw. Pump & Equip. Co. v. Am. States Ins. Co., 925 P.2d 1241, 1243 (Or. Ct. App. 1996) (in banc).

118. Section 24(1) provides:

> When an insurer has the authority to settle a claim brought against the insured, or when the authority to settle a claim rests with the insured but the insurer's prior consent is required for any settlement to be payable by the insurer, the insurer has a duty to the insured to make reasonable settlement decisions. The duty is owed *only with respect to claims that expose the insured to liability in excess of the policy limits*.

RESTATEMENT OF THE LAW OF LIAB. INS. § 24(1) (AM. LAW INST., Discussion Draft 2015) (emphasis added).

119. Douglas Laycock, *Restoring Restitution to the Canon*, 110 MICH. L. REV. 929, 938 (2012).

"This means that the plaintiff should be fully indemnified for his loss, but that he should not recover any windfall."[120] While this captures the basic idea, the play in the joints is considerable. That play in the joints is especially problematic depending on whether the breach of the duty to settle is a tort or a breach of contract.

First, the principles underlying contract and tort remedies are very different. Justice Holmes famously observed that it was not immoral to breach a contract—a breach of contract, in his view, meant that damages had to be paid to the non-breaching party and nothing else.[121] At bottom, contract remedies are aimed at "compensation" of the plaintiff with "compensation" defined squarely by the "parties' own promises and the risks they undertook."[122] Laying aside for the moment the possibility of consequential damages, non-pecuniary damages—including punitive damages—are rare in contract cases as they are rarely contemplated by the parties' promises.[123]

This last observation does not mean that punitive damages are outside the scope of contracts. Section 205 of the Restatement (Second) of Contracts states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[124]

The Comment following section 205 provides some enlightenment for interpretation:

> *d. Good faith performance.* Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. . . . A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.
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> . . . .

120. DOBBS, *supra* note 48, § 3.1; *see generally* 3 DAN B. DOBBS, DOBBS LAW OF REMEDIES: DAMAGES-EQUITY-RESTITUTION § 12.1(1), at 3–14 (2d ed. 1993).

121. The exact quote is: "The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it—and nothing else." Oliver Wendell Holmes, *The Path of the Law*, 10 HARV. L. REV. 457, 462 (1897).

122. DOBBS, *supra* note 120, § 12.1(1), at 6.

123. *Id.*; *see also* E. Allan Farnsworth, *Legal Remedies for Breach of Contract*, 70 COLUM. L. REV. 1145, 1146–47 (1970).

124. RESTATEMENT (SECOND) OF CONTRACTS § 205 (AM. LAW INST. 1981).

> *e. Good faith in enforcement.* The obligation of good faith and fair dealing extends to the assertion, settlement and litigation of contract claims and defenses. The obligation is violated by dishonest conduct such as conjuring up a pretended dispute, asserting an interpretation contrary to one's own understanding, or falsification of facts. It also extends to dealing which is candid but unfair . . . . Other types of violation have been recognized in judicial decisions: harassing demands for assurances of performance, rejection of performance for unstated reasons, willful failure to mitigate damages, and abuse of a power to determine compliance or to terminate the contract.[125]

With the foregoing in mind, contract and tort become inextricably entwined as "[a]n insurer's breach of the implied covenant of good faith and fair dealing 'will provide the basis for an action in tort.'"[126] Accordingly, "[b]ecause breach of the implied covenant is actionable as a tort, the measure of damages for tort actions applies and the insurance

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125. *Id.* § 205 cmts. d, e (citation omitted).

126. PPG Indus., Inc. v. Transamerica Ins. Co., 975 P.2d 652, 655 (Cal. 1999) (quoting Foley v. Interactive Data Corp., 765 P.2d 373, 390 (Cal. 1988) (in bank)); *accord* Douglas R. Richmond, *Bad Insurance Bad Faith Law*, 39 TORT TRIAL & INS. PRAC. L.J. 1, 4 (2003).

Several influential scholars have predicted a decline in tort actions for breach of the covenant of good faith and fair dealing because they saw the area as having matured and because of the deterrent effect of punitive damages. *See* Kenneth S. Abraham, *The Natural History of the Insurer's Liability for Bad Faith*, 72 TEX. L. REV. 1295, 1297–98 (1994); Robert H. Jerry, II, *The Wrong Side of the Mountain: A Comment on Bad Faith's Unnatural History*, 72 TEX. L. REV. 1317, 1343 (1994); Richmond, *supra*. While bad faith law has matured, the size and number of bad faith verdicts have increased. Richmond, *supra*, at 1–3. Anticipating the *State Farm v. Campbell* case, which follows in the text below, this increase has occurred despite the susceptibility of large bad faith awards to reduction or reversal on appeal. *Id.* at 2.

Over the years, there has been some curtailing of bad faith actions outside of the insurance context. For example, in *Freeman & Mills, Inc. v. Belcher Oil Co.*, 900 P.2d 669, 679–80 (Cal. 1995), the California Supreme Court overruled an earlier case, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co. of California*, 686 P.2d 1158 (Cal. 1984) (in bank), which held that an action in tort may lie when a defendant seeks to defend himself from liability by denying, in bad faith, the existence of a contract between the parties. *Seaman's Direct*, 686 P.2d at 1167. The *Freeman* court held that, in the general commercial context, a tort action would not lie for bad faith denial of contract. 900 P.2d at 679–80. However, the court explicitly noted that "nothing in this opinion should be read as affecting the existing precedent governing enforcement of the implied covenant [of good faith and fair dealing] in insurance cases." *Id.* at 680. This precedent is based on the "special relationship" between the insured and the insurer, which is based on elements of adhesion, public interest, and fiduciary responsibility. *Id.* at 672.

company generally is liable for 'any damages which are the proximate result of that breach.'"[127]

Tort remedies impose civil liability for harmful wrongdoing in order to compensate the victim for harm suffered.[128] More specifically, tort remedies are aimed at protecting a person's interest in her physical, emotional, and financial security—not only her promises—and thus non-pecuniary damages are more common in tort actions.[129] While both contract and tort remedies are motivated by a desire to compensate the non-breaching party or the victim, torts, by contrast, contain an element of wrongdoing—wrongdoing that deserves punishment.[130] Jerome Hall, the great criminal scholar, centered criminal sanctions around a theory of responsibility or accountability.[131] My point in mentioning this stance is not to suggest that breach of the duty to settle is criminal in nature, but rather to emphasize that tort remedies, like criminal sanctions, exist to hold a bad actor responsible or accountable for his actions.[132] Such is not the case with contract remedies.

As noted above, the availability and scope of a given remedy flows directly from the substantive right violated.[133] The Reporters' starting point is that "[a]n insurer that breaches the duty to make reasonable settlement decisions is subject to liability for the full amount of damages assessed against the insured in the underlying suit, without regard to the policy limits."[134] This baseline recognizes the apparent consensus.

The Reporters go further and differentiate torts and contracts by the differing notions of proximate cause and reasonable foreseeability.[135] These differences are significant. For example, in tort actions, a victim's recovery for emotional distress requires that the harm is proximately

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127. *PPG Indus., Inc.*, 975 P.2d at 655 (quoting Neal v. Farmers Ins. Exch., 582 P.2d 980, 988 (Cal. 1978)).

128. 1 DAN B. DOBBS, PAUL T. HAYDEN & ELLEN M. BUBLICK, THE LAW OF TORTS § 1 (2d ed. 2011).

129. *Id.* § 3; *see also* DOBBS, *supra* note 120, § 12.5(1), at 108–10.

130. *See* Bi-Econ. Mkt, Inc. v. Harleysville Ins. Co. of N.Y., 886 N.E.2d 127, 131 (N.Y. 2008); Ronen Perry, *The Role of Retributive Justice in the Common Law of Torts: A Descriptive Theory*, 73 TENN. L. REV. 177, 183–86 (2006). *But see* Dorit Rubinstein Reiss, *Compensating the Victims of Failure to Vaccinate: What Are the Options?*, 23 CORNELL J.L. & PUB. POL'Y 595, 598 (2014) (adopting a compensation model of tort remedy).

131. JEROME HALL, GENERAL PRINCIPLES OF CRIMINAL LAW 296 (2d ed. 1947).

132. *See* DOBBS, HAYDEN & BUBLICK, *supra* note 128, § 13. Indeed, this was the suggestion made by the California Supreme Court in *Crisci v. Security Insurance Co. of New Haven*. 426 P.2d 173, 177 (Cal. 1967) (in bank) (suggesting elementary justice required an insurer to be held accountable for its decisions).

133. DOBBS, *supra* note 48, § 1.6, at 25.

134. RESTATEMENT OF THE LAW OF LIAB. INS. § 27(1) (AM. LAW INST., Discussion Draft 2015).

135. *Id.* § 27 cmt. b.

caused by the tortious injury.[136] Proximate cause rules aim to impose liability for the kinds of harms risked by the tortfeasor's conduct.[137] That is, the tortfeasor's liability is circumscribed by the scope of risk his actions created.[138] Thus, if the tortfeasor's conduct created the risk of emotional distress, his actions are the proximate cause of the victim's emotional distress.[139]

The scope of the remedy available to the tort victim, then, is dependent on the tortfeasor's conduct. Compensatory damages for emotional distress, though difficult to evaluate, seek "to redress the concrete loss that the plaintiff has suffered by reason of the defendant's wrongful conduct."[140] And while compensatory damages are presumed to make the tort victim whole, punitive damages are appropriate "if the defendant's culpability, after having paid compensatory damages, is so reprehensible as to warrant the imposition of further sanctions to achieve punishment or deterrence."[141] The reprehensibility of the tortfeasor's conduct is one factor that guides this inquiry.[142]

Conversely, a plaintiff who suffers emotional distress as a result of a breach of contract is limited to damages that "would naturally arise from the breach or which might have been reasonably contemplated or foreseen by the parties at the time they contracted, as the probable result

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136. DOBBS, HAYDEN & BUBLICK, *supra* note 128, § 479. Here, I do not recognize the distinction between intentional and negligent infliction of emotional distress. Both torts contain a proximate causation element. *See* John A. Gebauer, Rachel M. Kane & Sonja Larsen, *Distinction Between Negligent and Intentional Infliction of Emotional Distress*, *in* 46 CAL. JURIS. 3D NEGLIGENCE § 85 (1972) ("A cause of action for intentional infliction of emotional distress exists when there is: (1) extreme and outrageous conduct by the defendant with the intention of causing, or reckless disregard of the probability of causing, emotional distress; (2) the plaintiff's suffering severe or extreme emotional distress; and (3) actual and proximate causation of the emotional distress by the defendant's outrageous conduct. On the other hand, a cause of action for negligent infliction of emotional distress under California law requires that plaintiff show serious emotional distress, actually and proximately caused by wrongful conduct by a defendant who should have foreseen that the conduct would cause such distress." (footnotes omitted)).

137. DOBBS, HAYDEN & BUBLICK, *supra* note 128, § 198.

138. *Id.* § 205.

139. California goes further. In *Crisci v. Security Insurance Co. of New Haven*, the court stated: "The general rule of damages in tort is that the injured party may recover for all detriment caused whether it could have been anticipated or not." 426 P.2d 173, 178 (Cal. 1967) (in bank).

140. State Farm Mut. Auto. Ins. Co. v. Campbell, 538 U.S. 408, 416 (2003) (quoting Cooper Indus., Inc. v. Leatherman Tool Grp., Inc., 532 U.S. 424, 432 (2001)); *see also* DOBBS, HAYDEN & BUBLICK, *supra* note 128, § 479 (discussing the extent, limitations, and elements of compensatory damages).

141. *State Farm*, 538 U.S. at 419 (citing BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 575 (1996)).

142. *Id.* (citing *Gore*, 517 U.S. at 575).

of the breach."[143] Except where the "contract[] . . . so affect[s] the vital concerns of the individual that severe mental distress is a foreseeable result of breach," courts do not generally consider mental distress a foreseeable result of breach at the time of contracting.[144] In this way the potential for emotional distress damages in contract is restricted. While the tortfeasor is liable for all harms foreseeably risked by his actions, the breaching party of a contract is liable only for those damages contemplated or foreseen as probable at the time of contracting.

The Reporters elide these differences with a seemingly innocuous statement. They state:

> Although this Section is agnostic as to the doctrinal label, the broader approach to whether a loss is foreseeable, which is most commonly associated with the tort-law label, is the proper approach. Taking the broader approach to foreseeability promotes more efficient and fair settlement decisions by placing the insurer in the position of the insured, responsible for the full potential loss facing the insured, consistent with the core objective of the duty: mitigating the conflict between insurer and insured that would otherwise be present whenever there is a significant risk of a judgment that is excess of the policy limits.[145]

The problem is that this may be too nuanced an approach. In attempting to include the contract law approach within the duty to settle, there is room for the uncritical to adhere to the restrictive contract law view of remedies.

2. The Tort Remedies

When an insurer breaches its duty to settle within the policy limits, it is likely liable in tort for any excess judgment (that is, in excess of the policy limits) against the insured.[146] Such extra-contractual liability seems to be "the majority rule in the United States."[147] This approach is

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143. Allen v. Jones, 163 Cal. Rptr. 445, 448 (Ct. App. 1980).

144. *Id.*

145. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 cmt. b (AM. LAW INST., Discussion Draft 2015).

146. Highlands Ins. Co. v. Cont'l Cas. Co., 64 F.3d 514, 517 (9th Cir. 1995) (citing Commercial Union Assurance Cos. v. Safeway Stores, Inc., 610 P.2d 1038, 1040 (Cal. 1980)); Chandler v. Am. Fire & Cas. Co., 879 N.E.2d 396, 399 (Ill. App. Ct. 2007); Doe v. S.C. Med. Malpractice Liab. Joint Underwriting Ass'n, 557 S.E.2d 670, 674 (S.C. 2001) (citing Trotter v. State Farm Mut. Auto. Ins. Co., 377 S.E.2d 343, 349 (S.C. Ct. App. 1988)).

147. Besel v. Viking Ins. Co. of Wis., 49 P.3d 887, 890 (Wash. 2002) (en banc).

apparently grounded in the idea that the policy limits determine the extent of an insurer's liability only when it actually meets its contractual obligations. In cases of breach of the duty to settle, a different limit should apply. As one court has explained:

> There is an important difference between the liability of an insurer who performs its obligations and that of an insurer who breaches its contract. The policy limits restrict only the amount the insurer may have to pay in the performance of the contract as compensation to a third person for personal injuries caused by the insured; they do not restrict the damages recoverable by the insured for a breach of contract by the insurer.[148]

Courts and commentators explain that this rule is justified because the cause of action for bad faith failure to settle sounds in both contract and tort.[149] Moreover, in the iconic *Crisci* case, the California Supreme Court held that because bad faith failure to settle is a tort, the insurer could also be held liable for damages for mental suffering proximately caused by the insurer's misconduct.[150] The *Crisci* court, however, implied that even if the action sounded in contract, damages for mental suffering would still be appropriate because "insurers are well aware" that an insured purchases liability insurance "to protect herself against the risks of accidental losses, *including* the mental distress which might follow from the losses."[151]

Of course, construing the breach of the duty to settle either as a substantive tort or as a tort by reason of breach of the covenant of good faith and fair dealing raises the specter of punitive damages. The lure of punitive damages unquestionably provides the impetus to inflate the breach of an implied contract promise of fair dealing into a full-fledged "tort" of bad faith. By calculating the deterrent factors of the award as even a minuscule fraction of the extraordinary "gross (or net) worth" of insurance companies—even those with cash flow difficulties—a significant prize is possible.[152] In the overall commotion about tort

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148. Comunale v. Traders & Gen. Ins. Co., 328 P.2d 198, 201 (Cal. 1958).

149. Whiting-Turner Contracting Co. v. Liberty Mut. Ins., 912 F. Supp. 2d 321, 340–41 (D. Md. 2012); Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 178 (Cal. 1967) (in bank); Mark I. Harrison & Samuel Langerman, *Actions Against Insurer for Bad Faith Failure to Settle Claim*, *in* 21 AM. JURIS. TRIALS § 229 (1974).

150. *Crisci*, 426 P.2d at 178–79.

151. *Id.* at 179 (emphasis added). This result harmonizes with the idea that such damages are appropriate where they would be likely to arise.

152. As justified as an award for punitive damages in failure to settle actions may be, *State Farm Mutual Automobile Insurance Co. v. Campbell* reminds lower courts that

reform, punitive damage awards against insurers for bad faith have had the effect of encouraging higher settlements for insureds than would otherwise be the case.[153] In my judgment this is not a bad thing. It is something individual states may choose to do, and the Restatement should acknowledge as much.

The Discussion Draft, however, does not address remedies comprehensively, or discuss the potential for punitive damages assessed on the insurer.[154] Considering the substantial case law awarding punitive damages in failure-to-settle cases, the Reporters might consider referencing the potential for punitive damages and relevant considerations in awarding punitive damages in such cases in section 27. At minimum, section 27 should include a cross reference to the imminent section on remedies, if the latter will address awards of punitive damages against insurers.

3. Contract Remedies

The general rule regarding contract remedies is deceptively simple. Adopting the classic *Hadley v. Baxendale*[155] case, most jurisdictions adhere to a version of the following: "Damages recoverable for breach of contract include both general damages, *i.e.*, those flowing naturally from the breach, and consequential damages, *i.e.*, those reasonably within the contemplation of, or reasonably foreseeable by, the parties at the time the contract was made."[156] The questions of availability of general damages, provision of a defense, and payment within the policy limits for contract breach of the duty to settle raise little issue.

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awards for punitive damages must not be excessive. 538 U.S. 408, 426 (2003). Rather, courts must consider "(1) the degree of reprehensibility of the defendant's misconduct, (2) the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award, and (3) the difference between the punitive damages awarded by the jury and the civil penalties authorized or imposed in comparable cases," when awarding punitive damages. *Id.* at 409 (citing BMW of N. Am., Inc. v. Gore, 517 U.S. 559, 575 (1996)).

153. An empirical study of first-party actions that covers more than 2000 claims in thirty-eight jurisdictions verifies the intuition that the existence of a bad-faith cause of action has the result of producing higher settlements—even in cases in which the insured is not represented by an attorney. Mark J. Browne, Ellen S. Pryor & Bob Puelz, *The Effect of Bad-Faith Laws on First-Party Insurance Claims Decisions*, 33 J. LEGAL STUD. 355, 376–85 (2004). Of course, breach of the duty to settle is at heart a third-party action.

154. As noted below, my hope is that this lack is addressed at some point.

155. (1854) 156 Eng. Rep. 145, 145; 9 Ex. 341.

156. Beck v. Farmers Ins. Exch., 701 P.2d 795, 801 (Utah 1985) (citing Pac. Coast Title Ins. Co. v. Hartford Accident & Indem. Co., 325 P.2d 906, 907 (Utah 1958) (citing *Hadley*, 156 Eng. Rep. 145)).

The second avenue for recovery is found in the possibility of consequential damages. Consequential damages very well can exceed general damages for breach of contract.[157] In *Bi-Economy Market, Inc. v. Harleysville Insurance Co. of New York*, the Court of Appeals of New York employed contract damages principles to find an insurer liable for consequential damages resulting from an insurer's failure to fulfill its contractual obligations in good faith.[158] The *Bi-Economy* court explained that consequential damages, those not flowing directly from the breach, are appropriate when the "unusual or extraordinary damages [are] . . . within the contemplation of the parties as the probable result of a breach at the time of or prior to contracting."[159] Whether the parties reasonably contemplated consequential damages depends on "the nature, purpose and particular circumstances of the contract known by the parties" and "what liability the [insurer] fairly may be supposed to have assumed consciously, or to have warranted the [insured] reasonably to suppose that it assumed, when the contract was made."[160]

Even if an excess judgment could be considered as *not* directly flowing from an insurer's breach of the duty to settle, then undoubtedly, such a consequence fits the *Bi-Economy*'s requirement of pre-contemplation by the parties. An excess judgment resulting from the insurer's failure to settle a claim within the policy limits certainly seems within the purview of at least the insurer at the time the contract is formed.

Finally, contract remedies are generally more limited than tort remedies. Specifically and germane to breach of the duty to settle,

> [t]he traditional rule, adopted by the *Restatement (Second) of Contracts* and followed in a majority of states, does not allow punitive damages in the absence of an independent tort, even if the breach is opportunistic [(the breaching party attempts to get

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157. *Id.* at 801–02 (citing *Pac. Coast Title Ins. Co.*, 325 P.2d at 908).

158. 886 N.E.2d 127, 129–32 (N.Y. 2008).

159. *Id.* at 130 (quoting Kenford Co. v. County of Erie, 537 N.E.2d 176, 178 (N.Y. 1989)); *see also* Panasia Estates, Inc. v. Hudson Ins. Co., 886 N.E.2d 135, 137 (N.Y. 2008) (decided the same day as *Bi-Economy*, and holding that "consequential damages resulting from a breach of the covenant of good faith and fair dealing may be asserted in an insurance contract context" (quoting *Bi-Econ.*, 886 N.E.2d at 130)). This is the classic *Hadley v. Baxendale* formulation of consequential damages. 156 Eng. Rep. 145.

160. *Bi-Econ.*, 886 N.E.2d at 130 (quoting *Kenford*, 537 N.E.2d at 179).

> more than she bargained for at the expense of the nonbreaching party)].[161]

As noted above, the exceptions to this rule apply when the breach is also a tort, a breach of fiduciary duty, or a bad faith breach of an insurance contract.[162]

4. The Reporters' Formulation

As noted above, section 24 requires that insurers make reasonable settlement decisions when handling their insured's claims.[163] The section aims to address the apparent conflict of interest between an insured's aversion to trial and a potential excess judgment and an insurer's proclivity to proceed to trial. This aligns with the California formulation of the duty. Section 24, however, does little to encourage an insurer to meaningfully consider the insured's interest because under section 24(3), an insurer's duty to accept reasonable settlement demands never obligates an insurer to pay any amount exceeding the policy limits.[164]

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161. William S. Dodge, *The Case for Punitive Damages in Contracts*, 48 DUKE L.J. 629, 653–54 (1999).

162. *Id.* at 636–37. Professor Dodge avers that punitive damages should be awardable in any willful breach of contract action for both the sake of deterring breaches of contract and efficiency. *Id.* at 637. Cases awarding punitive damages for an insurer's breach of its duty to settle reflect the above exceptions. *Cain v. State Farm Mutual Automobile Insurance Co.* held that punitive damages are appropriate "in an action arising out of a breach of the covenant of good faith and fair dealing which is implied in every liability insurance policy." 121 Cal. Rptr. 200, 206 (Ct. App. 1975) (citing Fletcher v. W. Nat'l Life Ins. Co., 89 Cal. Rptr. 78 (Ct. App. 1970)). The Supreme Court of Oklahoma held that in failure to settle cases, "[t]he availability of a punitive damages award is not automatic, but rather is governed by the standard applicable in other tort cases. The plaintiff must show that the defendant acted with oppression, malice, fraud or gross negligence or wantonness." Newport v. USAA, 11 P.3d 190, 204 (Okla. 2000) (alteration in original) (quoting Buzzard v. Farmers Ins. Co., 824 P.2d 1105, 1115 (Okla. 1991)). The Appellate Court of Illinois explained that punitive damages are appropriate for an insurer's failure to settle because the insurer owes a fiduciary obligation to the insured in the settlement of its claims. O'Neill v. Gallant Ins. Co., 769 N.E.2d 100, 109–11 (Ill. App. Ct. 2002).

163. Specifically, section 24(3) provides: "An insurer's duty to make reasonable settlement decisions includes a duty to accept reasonable settlement demands made by claimants, subject to the following limitation: the amount, if any, that an insurer is obligated by this duty to contribute to a settlement is never greater than its policy limits." RESTATEMENT OF THE LAW OF LIAB. INS. § 24(3) (AM. LAW INST., Discussion Draft 2015).

164. *Id.* Beyond this limitation, however, section 24 and its corresponding Comment scarcely address the insured's available remedies. Comments a, e, and h cursorily mention that an insurer's breach of its duty to make reasonable settlement decisions renders it liable for excess judgments entered on its insureds. *Id.* § 24 cmts. a, e, h.

Section 24(3) seems to suggest that the liability of the insurer is limited. Section 27 addresses this shortcoming in part.[165] Section 27 describes consequences an insurer faces if it fails to make reasonable settlement decisions. Section 27(1) provides that an insurer is liable for any excess judgment entered against the insured due to the insurer's failure to make reasonable settlement decisions.[166] Moreover, section 27(2) gives the insured the right to recover all reasonably foreseeable (consequential) damages "[i]f, and only if, [the] insured is entitled to recover from an insurer under [section 27(1)]."[167]

Read together, sections 24 and 27 fall short. First, consequential damages are excluded if there is no excess judgment. Section 27's Comment reiterates the limitation by stating that "[n]o damages are available under this Section if the insurer's breach of the duty to make reasonable settlement decisions *does not produce an excess judgment in the underlying lawsuit*."[168]

As a result, under section 27, consequential damages are unavailable when the insurer's behavior is somewhere past "unreasonable" but not quite reaching "bad faith." Section 24's Comment points out that the "reasonableness" standard section 24 establishes is analogous to the negligence standard in tort law. Section 24 and commentators alike agree, however, that there is little functional difference between courts that use a "negligence" standard and courts that use a "bad-faith" standard to determine whether an insurer had breached its duty to settle. So on the one hand, section 24 collapses the standards in favor of a "reasonableness" inquiry, and on the other, section 27 limits an insured's recovery in absence of an excess judgment to when an insurer's

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165. It would be useful to include within section 24 either a cross-reference to section 27 or a caveat that it is subject to other provisions.

166. RESTATEMENT OF THE LAW OF LIAB. INS. § 27(1) (AM. LAW INST., Discussion Draft 2015). Section 27(1) provides: "An insurer that breaches the duty to make reasonable settlement decisions is subject to liability for the full amount of damages assessed against the insured in the underlying suit, without regard to the policy limits." *Id.* While it does not say as much, implicit in section 27 is liability for the policy limits as well.

167. *Id.* § 27(2). The full text of section 27(2) reads: "If, and only if, an insured is entitled to recover from an insurer under subsection (1) for an amount in excess of the policy limits, the insured is also entitled to recover for other foreseeable loss." *Id.*

168. *Id.* § 27 cmt. b. (emphasis added). Comment b goes on to explain that this limitation is one of practicality and that any aggravation, inconvenience, or expenses incurred by the insurer's unreasonable settlement behavior are likely to be minor. *Id.* Comment b further posits that allowing such damages in absence of an excess judgment would result in uncertainty for insurers and higher premiums for policyholders. *See id.* The comment concedes, however, that insureds should still be able to recover if an insurer's behavior amounts to bad faith or if such recovery is authorized by statute. *Id.*

settlement behavior amounted to bad faith. This has the effect of roiling already muddy waters.

The common law contains numerous examples of courts' willingness to award consequential damages resulting from an insurer's failure to settle without an excess judgment.[169] While the entry of an excess judgment will almost always be "[t]he most telling evidence of foreseeable damage," the insured need only "show that he has suffered actual injury proximately caused by the insurer's failure to settle the suit within a reasonable time after settlement was possible."[170] As one court has explained, while an excess judgment supports the inference that an insurer has breached its duty to settle, it is not required.[171] Rather, an insured can recover damages "to compensate for all detriment proximately resulting [from an insurer's unreasonable settlement behavior], including the economic loss as well as emotional distress resulting from the conduct or from the economic losses caused by the conduct."[172]

Going further, it is not difficult to imagine that an insurer's unreasonable behavior surrounding claim settlement can cause an insured emotional distress *before* the final disposition of the claim.[173]

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169. Delancy v. St. Paul Fire & Marine Ins. Co., 947 F.2d 1536, 1552 (11th Cir. 1991) (explaining that Georgia law does not require an excess judgment to allow bad faith recovery for breach of the duty to settle); Landow v. Med. Ins. Exch. of Cal., 892 F. Supp. 239, 241 (D. Nev. 1995) (finding that excess judgment is not required for breach of the duty to settle); Howard v. Am. Nat'l Fire Ins. Co., 115 Cal. Rptr. 3d 42, 48 (Ct. App. 2010) ("An insurer's wrongful failure to settle may be actionable even without rendition of an excess judgment."); Perera v. U.S. Fid. & Guar. Co., 35 So. 3d 893, 902 (Fla. 2010) (holding, on certification from the Eleventh Circuit, that Florida law does not require an excess judgment to find that an insurer breached its duty to settle).

170. *Delancy*, 947 F.2d at 1552. The California Court of Appeal has explained that "where the insurer's misconduct goes beyond a simple failure to settle within policy limits or the insured suffers consequential damages apart from an excess judgment" an insured may recover for an insurer's failure to settle even in the absence of an excess judgment. *Howard*, 115 Cal. Rptr. 3d at 68; *see also* Bodenhamer v. Superior Court, 238 Cal. Rptr. 177, 181 (Ct. App. 1987) (suggesting that an insurer's unreasonable delay in effecting settlement of its insured's claims may permit recovery of consequential damages resulting from the delay).

171. *Landow*, 892 F. Supp. at 241 (quoting Camelot by the Bay Condo. Owners' Ass'n v. Scottsdale Ins. Co., 32 Cal. Rptr. 2d 354, 362 (Ct. App. 1994)).

172. *Id.* (quoting Fletcher v. W. Nat'l Life Ins. Co., 89 Cal. Rptr. 78, 94 (Ct. App. 1970)).

173. Larraburu Bros. v. Royal Indem. Co., 604 F.2d 1208, 1215 (9th Cir. 1979) ("[U]nreasonable conduct can be a proximate cause of injury before the final disposition as well as after. An unreasonable refusal to accept a settlement offer causes the insurer to be liable for consequential damages, such as mental suffering or economic loss . . . ."). *Crisci v. Security Insurance Co. of New Haven* points out that in addition to indemnity, insureds purchasing liability insurance consider, "as insurers are well aware, . . . the peace of mind and security [the insurance] will provide in the event of an accidental loss, and recovery of damages for mental suffering has been permitted for breach of contracts which directly

There is no reason to treat breach of the duty to settle any differently than breach of any other contract.

These cases stand in opposition to section 27's contention that consequential damages resulting from an insurer's unreasonable settlement behavior are necessarily minor.[174] It is not unforeseeable that an insured would face catastrophic consequences as a result of an insurer's breach of its duty to settle—in such cases "damages for losses well in excess of the policy limits, such as for a home or a business, may therefore be foreseeable and provable."[175] As noted above, peace of mind for the insured is very much a part of the insurance bargain.[176] It is not for nothing that insurers spend considerable sums to tell us that we are in good hands or that, like a good neighbor, they are there. To sum up, section 27's limitation on consequential damages and non-pecuniary harm unjustifiably limits an insured's remedies where courts have recognized legitimate bases for recovery. The Reporters' response is that this limitation is grounded in practicality where such costs or harm are likely minor.[177] This position is taken without citing any authority. Again, this departure from even restrictive contract remedies seems unjustified.

Finally, neither section 24 nor section 27 mentions the potential for an award of punitive damages to insureds for an insurer's failure to settle. The implication that punitive damages are not available in this context is another departure from the norm in the United States.[178]

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concern the comfort, happiness or personal esteem of one of the parties." 426 P.2d 173, 179 (Cal. 1967) (in bank) (citing Chelini v. Nieri, 196 P.2d 915 (Cal. 1948) (in bank)).

174. In *Delancy*, the insured's health so deteriorated as a result of the insurer's settlement behavior, he ultimately suffered a stroke and died. 947 F.2d at 1543. The insured in *Howard* suffered substantial financial hardship due to his insurer's settlement behavior. 115 Cal. Rptr. 3d at 68. The insureds in *Bodenhamer* suffered pecuniary losses and damage to their jewelry store's reputation. 238 Cal. Rptr. at 181. Objectively, these consequences are *not* minor.

175. Beck v. Farmers Ins. Exch., 701 P.2d 795, 802 (Utah 1985) ("[B]ecause bankruptcy was a foreseeable consequence of fire insurer's failure to pay, insurer was liable for consequential damages flowing from bankruptcy." (citing Reichert v. Gen. Ins. Co. of Am., 428 P.2d 860, 864 (Cal. 1967) (in bank), *vacated on other grounds*, 442 P.2d 377 (Cal. 1968) (in bank))).

176. *Id.*

177. RESTATEMENT OF THE LAW OF LIAB. INS. § 27 cmt. b (AM. LAW INST., Discussion Draft 2015).

178. *E.g.*, Bi-Econ. Mkt., Inc. v. Harleysville Ins. Co. of N.Y., 886 N.E.2d 127, 131 (N.Y. 2008). Punitive damages "'are not measured by the pecuniary loss or injury of the plaintiff as compensation' but are 'assessed by way of punishment to the wrongdoer and example to others.'" *Id.* Further, in assessing punitive damages, "[t]here is no rigid formula by which the amount of punitive damages is fixed, although they should bear some reasonable relation to the harm done and the flagrancy of the conduct causing it." *Id.* (alteration in

Removing the possibility for punitive damages and consequential damages for an insurer's breach of the contractual duty to settle severely undermines the insured's interest and exacerbates existing perverse incentives of the insurer. This approach cannot be as effective as threatening the breaching party with bad faith and punitive damages and forcing a negotiation with the other party for a release of the contract.[179] As Professor William Dodge has argued, because of high costs associated with litigation and errors of judgment resulting from contract breaches, protecting contractual obligations with expectation damages is less efficient than protecting them with punitive damages because the threat of punitive damages for willful breach will push the party who wants to avoid the contract to negotiate a release of her obligations, a less expensive alternative to litigation.[180] The Reporters' approach to damages implies that they see the duty as sounding only in contract. With the foregoing in mind, the consequent limitation on damages is problematic.

The appropriate remedy for breach of the duty to settle is important. In this respect, the duty to settle as described in sections 24 and 27 remains incomplete. The Discussion Draft does not yet address remedies comprehensively nor does it discuss the potential for punitive damages assessed on the insurer. My hope is that the final product will ultimately align with the dominant approach first advanced by Judge Keeton, adopted by California, and accepted by many other states.

CONCLUSION

The California Supreme Court long ago articulated the values that underlie a robust enforcement mechanism regarding an insurer's duty to settle. In language that seems uncannily oriented to a Restatement of the Law of Liability Insurance, they eloquently stated:

> Fundamental in our jurisprudence is the principle that for every wrong there is a remedy and that an injured party should be compensated for all damage proximately caused by the wrongdoer. Although we recognize exceptions from these fundamental principles, no departure should be sanctioned unless there is a strong necessity therefor.[181]

original) (quoting I. H. P. Corp. v. 210 Cent. Park S. Corp., 228 N.Y.S.2d 883, 889 (App. Div. 1962)).

179. Dodge, *supra* note 161, at 663–64.

180. *Id.* at 675.

181. Crisci v. Sec. Ins. Co. of New Haven, 426 P.2d 173, 178 (Cal. 1967) (in bank).

The Restatement of the Law of Liability Insurance should not be a departure from existing norms where such is not needed. Indeed any such departure signals a long and costly spate of litigation. Judge Keeton and later, Kent Syverud, were the architects of a duty to settle regime that has actually worked. The Restatement of the Law of Liability Insurance should in fact be a restatement of the law—particularly in areas of the law that are well settled and not obviously wrong. Ultimately, an insurer that breaches its duty to settle should not be spared the consequences of its actions.