

DROPPING THE BATON:

**BAD FAITH CLAIMS BY EXCESS AGAINST PRIMARY
AND LOWER EXCESS LAYERS**

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I. INTRODUCTION

If the relationship between the policyholder, primary insurer, and excess insurers is analogous to a relay race, then the policyholder would be analogous to the baton. The primary insurer starts the race and passes the baton (the rights and interests of the policyholder) to the first level excess insurer, who then passes the baton to higher-level excess insurers as the race continues. The baton passing continues until there are no longer any runners left in the race.

Ideally, baton passing should be seamless and smooth; the transition of the policyholders' rights and interest should be orderly and towards a common purpose. However, what happens when a racer drops the baton or trips the next runner? What remedies are available?

This article discusses the potential liability of primary and lower level excess insurers for bad faith against higher level excess insurers.

A. The Implied Covenant of Good Faith and Fair Dealing

An insurance policy is nothing more than a contract. Common law implies a covenant of good faith and fair dealing in every contract, including insurance policies. Generally, the implied covenant of good faith and fair dealing imposes a duty upon the contracting parties to do everything that is necessary to perform their obligations under the contract or refrain from frustrating the other party's right to receive the benefit of the contract. Western Union Tel. Co. v. Shepard, 169 N.Y. 170, 60 N.E. 154 (1901).

But insurance policies differ from ordinary contracts in their unique nature and purpose. A policyholder does not purchase insurance to realize a profit, but rather to provide security against calamity. Egan v. Mutual of Omaha Ins. Co., 24 Cal.3d 809, 620 P.2d 141 (1979). Therefore the relationship between an insurance company and the policyholder is deemed as "special." Jurisdictions differ on the nature of the special relationship between an insurance company and the policyholder.¹ But in the insurance

¹The following jurisdictions describe the special relationship as "fiduciary:" 1) Florida (Allstate Ins. Co. v. American Southern Home Ins. Co., 680 So.2d 1114 (Fla. 1996); 2) Kansas (Stetler v. Fosha, 809 F.Supp. 1409 (D.Kan. 1992); 3) New Mexico (Chavez v. Chenoweth, 89 N.M. 423, 553 P.2d 703 (1976); 4) New York (United Nat. Ins. Co. v. Waterfront N.Y. Realty Corp., 948 F.Supp. 263 (S.D.N.Y. 1996); 5) Pennsylvania (Strutz v. State Farm Mut. Ins. Co., 415 Pa.Super. 371, 609 A.2d 569 (1992); 6) Washington (Truck Ins. Exchange v. Century Indem. Co., 76 Wash.App. 527, 887 P.2d 455 (1995); and 7) Wisconsin (Benke v. Makwonago-Vernon Mut. Ins. Co., 110 Wis.2d 356; 329 N.W.2d 243).

Colorado describes the relationship as "quasi-fiduciary." Lira v. Shelter Ins. Co., 913 P.2d 514 (Colo. 1996).

Other jurisdictions simply describe the relationship as special in contrast to a fiduciary relationship: California (Love v. Fire Ins. Exchange, 221 Cal.App.3d 1136 (Cal. (More)

context, the implied covenant of good faith and fair dealing is enhanced by the special relationship between an insurance company and the policyholder.

In the vernacular, a breach of the implied covenant of good faith and fair dealing is known as bad faith. Jurisdictions differ on the precise definition of bad faith, as set forth in case law, statutes and regulations. Despite their differences, bad faith in general can be characterized as an insurance company's failure to consider the policyholder's interests as much as its own.

B. Duty of Good Faith and Fair Dealing to Excess Insurers

Granted that a primary insurer owes a duty of good faith and fair dealing to the policyholder. But does a primary insurer owe a duty of good faith and fair dealing to an excess insurer? Can a primary insurer be liable for bad faith to an excess insurer? Consider the following hypotheticals:

1. A liability insurer does not accept a claimant's settlement offer, which is within policy limits. The policyholder suffers a judgment in excess of the primary insurer's policy limits.
2. A primary insurer does not provide benefits to the policyholder. Therefore, the excess insurer drops down and provides benefits.²
3. A liability insurer is confronted with several lawsuits against the policyholder. The liability insurer settles one or several lawsuits for an unreasonable amount to exhaust its policy and passes the defense of the remaining lawsuits to the excess insurer.

These scenarios are common. The complexity of litigation frequently creates tension between primary and excess insurers and lower and higher level excess insurers. As stated in Puritan Ins. Co. v. Canadian Universal Ins. Co., 775 F.2d 76, 79 (3rd Cir. 1985) (construing Pennsylvania law):

The obligations of the carriers to the insured are somewhat different. Because it had a duty to defend the insured and on average most claims are within its limits, the primary insurer charges a larger premium for an equivalent amount of coverage. In addition, the primary's policy generally gives it the right to decide when a claim shall be settled or tried. Because of its less frequent exposure the excess carrier generally charges lower premiums. Its obligation does not arise until primary limits are

1990); District of Columbia (Mesina v. Nationwide Mut. Ins. Co., 998 F.2d 2 (D.C.Cir. 1993); and Texas (Benefit Trust Life Ins. Co. v. Littles, 869 S.W.2d 453 (Tex. 1993).

² In theory, this scenario should also arise in the context of property insurance and first-party claims. However, there does not appear to be any published decisions in the context. The vast majority of decisions fall within the first scenario.

exhausted, and to some extent the excess carrier is at a disadvantage in dealing with a tightfisted or overly optimistic primary carrier, which has greater control over settlement.

Excess insurers are becoming increasingly more vigilant in monitoring the conduct of lower level insurers and more cognizant of their remedies against lower level insurers, including a cause of action for bad faith.

C. Split of Authority

The majority of jurisdictions allow an excess insurer to assert a cause of action for bad faith against a primary insurer under principals of subrogation. The minority allows a direct action for bad faith by an excess insurer against a primary insurer.

Jurisdictions which limit bad faith claims by excess insurers against lower level insurers do not impose any additional duties upon the lower level insurers beyond those owed directly to an insured. In other words, the majority of jurisdictions recognize bad faith liability to excess insurers as derivative of the insured's rights against his/her insurance company. However, the minority jurisdictions recognize a separate duty of good faith and fair dealing owned by primary or lower level excess insurers to higher-level excess insurers, which is independent of their contractual relationships with the insured.

II. THE MAJORITY VIEW

A. No Direct Action

The first decision to recognize a cause of action for bad faith against a primary insurer asserted by an excess insurer is American Fidelity & Cas. Co. v. All American Bus Lines, 190 F.2d 234 (10th Cir. 1951) (construing Oklahoma law). In All American Bus Lines, the insured bus company was a defendant in a personal injury lawsuit. The bus company was insured under a primary policy issued by American Fidelity & Casualty Company and an excess policy issued by Security Mutual Casualty Company. During the course of the litigation, the plaintiff made an offer within the limits of the primary policy, which was \$10,000. The offer was rejected, which resulted in a \$25,000 verdict and judgment in excess of the primary policy limits. During the pendency of the appeal, the personal injury lawsuit settled for \$17,500. The primary insurer contributed its policy limits, and the excess insurer paid the remainder (\$7,500).

At the behest of the excess insurer, the bus company filed a bad faith lawsuit against the primary insurer for unreasonable failure to accept a demand within its policy limits. The primary insurer raised various procedural objections, which became the genesis of the majority view. The court concluded that the insured was not the real party in interest in the bad faith lawsuit.³ Hence, the court substituted the excess insurer as the

³ This issue was resolved in an earlier appeal. American Fidelity & Cas. Co. v. All American Bus Lines (10th Cir. 1949) 179 F.2d 7.

party plaintiff. The action resulted in a verdict in favor of the excess insurer against the primary insurer in the amount of \$7,500.

The substance of the primary insurer's argument is “. . . American owed no contractual duty to Security; that Security's action was bottomed on the subrogation clause contained in its policy; that the right of subrogation does not obtain in favor of an insurance company discharging a debt in the performance of its own obligation. . . .” All American Bus Lines, *supra*, 190 F.2d 238. In rejecting the primary insurer's arguments, the court stated, without reliance upon any authority, “when Security reimbursed Bus Company for such outlay, it became subrogated to the rights of Bus Company to enforce such liability.” Id.

The present view that an excess insurer is equitably subrogated to the rights and remedies of its insured (including a cause of action for bad faith) against a primary insurer resulted from the implicit recognition that there is no privity of contract between excess and primary insurers (or between higher and lower level excess insurers). In Universal Underwriters Ins. Co. v. Dairyland Mutual Ins. Co., 102 Ariz. 518, 433 P.2d 966, 968 (1967), the Arizona Supreme Court reasoned “[t]here is no privity [sic] of contract between these two insurance companies nor is there any principle of law which we are aware that would give [the excess carrier] such a windfall because of [the primary carrier's] mistreatment of its assured.”

The implied covenant of good faith and fair dealing is rooted in the contract (insurance policy) between the insurer and the policyholder. Primary and excess insurers do not contract amongst themselves. Therefore without privity, there is no basis for an excess insurer to sue a primary insurer for bad faith. Such privity must be derived for the insured under principals of equitable subrogation.

Indeed, the All American Bus Lines court did not address the primary insurer's lack of privity argument, because it believed that the same remedies (including a cause of action for bad faith) would be available to an excess insurer under subrogation principals. See Peter v. Travelers Ins. Co., 375 F.Supp. 1347, 1350 (C.D.Cal. 1974) (construing California law). (“In considering whether it will settle a claim, the primary insurer may consider its own interests, but it must equally consider the interests of the insured, which become the interests of the excess insurer by subrogation.”)

B. The Rationale of Equitable Subrogation

The rationale in favor of subrogation was articulated by the Minnesota Supreme Court in Continental Casualty Co. v. Reserve Ins. Co., 307 Minn. 5, 238 N.W.2d 862, (1976). “If the insured purchases excess coverage, he in effect substitutes an excess insurer for himself. It follows that the excess insurer should assume the rights as well as the obligations of the insured.” Continental Casualty Co., *supra*, 238 N.W.2d 864.

Likewise, in Commercial Union Assurance Companies v. Safeway Stores, Inc., 26 Cal.3d 912, 610 P.2d 1039 (1980), the California Supreme Court explained:

It has been held in California and other jurisdictions that the excess carrier may maintain an action against the primary carrier for [] [wrongful] refusal to settle within the latter's policy limits [Citations.] This rule, however, is based on the theory of equitable subrogation: Since the insured would have been able to recover from the primary carrier for a judgment in excess of policy limits caused by the carrier's wrongful refusal to settle, the excess carrier, who discharged the insured's liability as a result of this tort, stands in the shoes of the insured and should be permitted to assert all claims against the primary carrier which the insured himself could have asserted [citation.] Hence, the rule does not rest upon the finding of any separate duty owed to an excess insurance carrier. Commercial Union Assurance Companies, *supra*, 26 Cal.3d 917-918 (citations omitted.)

The majority jurisdictions' reluctance to depart from the view an excess insurers' cause of action for bad faith as derivative of the insured's rights was discussed by Judge Richard Posner in Twin City Fire Ins. Co. v. Country Mutual Ins. Co., 23 F.3d 1175 (7th Cir. 1994) (construing Illinois law). Twin City Fire Ins. Co. was a bad faith case, brought by an excess insurer against a primary insurer, which alleged that the primary insurer failed to settle a claim within policy limits. Illinois follows the majority view and does not recognize a direct action by an excess insurer against a primary insurer. The issue before Judge Posner was whether or not to create such an independent duty.

Should courts strain to create novel tort duties on behalf of insurance companies? Do insurance companies need the protection of tort law against their own insureds and other insurance companies? We need not answer these questions. It is enough that the arguments in favor of the direct duty are not so compelling that we could reasonably predict that the Supreme Court of Illinois would buck the national trend and declare that underlying common law of Illinois a primary insurer has a direct duty, actionable in tort, against the excess insurer. *Id.* at 1180-1181.

Judge Posner concluded that in light of the contractual remedies available under the excess policies, the interests of excess insurers are sufficiently accounted for to mitigate against the imposition of a new tort duty upon primary and lower level excess insurers.

C. The Mechanism of Equitable Subrogation

“Initially, it is important to recognize that subrogation is of two kinds, ‘legal’ and ‘conventional’. The former is grounded in equity and arises by operation of law, which gives to a third person who has been compelled to pay a remedy against one who, in justice, ought to pay. ‘Conventional’ subrogation is grounded upon contract, express or implied.” Ins. Co. of North America v. Medical Protective Co., 768 F.2d 315 (10th Cir. 1985) (construing Kansas law.) In other words, equitable subrogation is not a distinct

cause of action, but rather it is a doctrine, which effects an assignment of rights by operation of law in lieu of contract.⁴

The elements of an insurer's cause of action based upon equitable subrogation are these: (1) The insured has suffered a loss for which the party to be charged is liable, either because the latter is a wrongdoer whose act or omission caused the loss or because he is legally responsible to the insured for the loss caused by the wrongdoer; (2) the insurer, in whole or in part, has compensated the insured for the same loss for which the party to be charged is liable; (3) the insured has an existing, assignable cause of action against the party to be charged, which action the insured could have asserted for his own benefit had he not been compensated for his loss by the insurer; (4) the insurer has suffered damages caused by the act or omission upon which the liability of the party to be charged depends; (5) justice requires that the loss should be entirely shifted from the insurer to the party to be charged, whose equitable position is inferior to that of the insurer; and (6) the insurer's damages are in a stated sum, usually the amount it has paid to its insured, assuming the payment was not voluntary and was reasonable. Patent Scaffolding Co. v. William Simpson Constr. Co., 256 Cal.App.2d 506 (1967).

Although specific jurisdictions may differ on the precise elements of equitable subrogation, it is nevertheless an equitable remedy. Hence courts tend to focus upon the respective equities of the parties. “In general, subrogation is applied to avoid unjust enrichment when one party, other than a volunteer, has discharged an obligation which should have been satisfied by another.” Hocker v. New Hampshire Ins. Co., 922 F.2d 1476, 1485 (10th Cir. 1991) (construing Wyoming law).

As applied in All American Bus Lines, *supra*, the primary insurer “was allegedly guilty of bad faith while Security was at most guilty of breach of contract; and that, as between the two, it would be just and equitable for American to bear the loss occasioned by its own misconduct.” All American Bus Lines, *supra*, 190 F.2d 238.

In contrast, the Hocker court did not permit equitable subrogation where an excess insurer refused to drop down and defend the insured after the primary insurer

⁴ As observed by one court: “It is hard to imagine another set of legal terms with more soporific effect than indemnity, subrogation, contribution, co-obligation and joint tortfeasorship.” Herrick Corp. v. Canadian Ins. Co. of California, 29 Cal.App.4th 753, 756 (1994). Significantly, some courts have used the terms “subrogation,” “contribution” and “indemnity” interchangeably, even though they are distinct concepts with different consequences. For example, under California law, an excess insurer cannot maintain a cause of action for equitable contribution against a primary insurer, because both insurers cover different risks. Fireman’s Fund Ins. Co. v. Maryland Casualty Company, 65 Cal.App.4th 1279 (1998).

wrongfully refused to defend. Under such circumstances, the excess insurer lacked the “clean hands” or superior equities required for equitable subrogation.

Similarly, in Certain Underwriters of Lloyd’s v. General Accident Ins. Co. of America, 699 F.Supp. 732, 741 (S.D. Ind. 1988) (construing Indiana law), the court recognized that an excess insurer could waive its right to bring a bad faith claim against a primary insurer, as the equitable subrogee of the insured, by participating directly in the defense of the insured. However, under the facts of the case, the mere retention of counsel by the excess insurer to monitor the action against the insured was not sufficient to prevent equitable subrogation.

D. Limitations on Equitable Subrogation

As set forth above, equitable subrogation is an assignment by operation of law. Therefore, an excess insurer, as the equitable subrogee of the insured, does not have any greater rights than the insured and is subject to any defense, which could be asserted against the insured.⁵ In Commercial Union Ins. Co. v. Medical Protective Co., 426 Mich. 109, 393 N.W.2d 479, 483-486 (1986), the Michigan Supreme Court identified three tenets of subrogation: (1) an excess insurer has to greater or lesser rights than those of the insured; (2) an insured’s breach of the obligations owed to the primary insurer can defeat the subrogation claim of the excess carrier; (3) active participation by the excess carrier in settlement negotiations may estop the excess carrier from recovery.

For example, if the insured’s claims against the primary insurer are barred by the statute of limitations, the excess insurer’s claims may be barred as well. Great American Ins. Co. v. United States, 575 F.2d 1031 (2d. Cir. 1978) (construing New York law); Williams v. Globe Indem. Co., 507 F.2d 837 (8th Cir. 1974) (construing Arkansas law).⁶

Therefore, the excess insurer is at the mercy of the insured, who controls whether the excess insurer can maintain a bad faith lawsuit against the primary insurer. In Puritan

⁵ Some jurisdictions adopted the “triangular reciprocity” approach. In situations where an insured breaches an obligation imposed by the primary policy (for example, the cooperation clause), an excess insurer, as an equitable subrogee of the insured, would be vulnerable the same defense that the primary insurer could have asserted against the insured. “Triangular reciprocity” provides that improper conduct by an insured will not bar an excess insurer’s claim for bad faith. See Transit Casualty Co. v. Spink Corp., 94 Cal.App.3d 124 (1979) (overruled on other grounds in Commercial Union Assurance Companies, *supra*). “Triangular reciprocity” imposes a duty of reasonable care upon each party—the insured, primary insurer and excess insurer—, which respect to each other.

⁶ See Smith v. Parks Manor, 197 Cal.App.3d 872 (1987) for contrary authority. Under California law, a liability insurer’s right equitable subrogation claim accrues upon payment of a judgment or settlement against the insured. Therefore the statute of limitations defense, though viable against an insured, may not be viable against the insured’s equitable subrogee.

Ins. Co., supra, an excess insurer initiated a bad faith lawsuit against a primary insurer following an excess verdict against the policyholder. The excess insurer's bad faith claim was barred, because the policyholder agreed with the primary insurer to reject a demand within the primary policy limits. Therefore, the primary insurer was not in bad faith, because the insured consented. The excess insurer has other remedies, for example in Twin City Fire Ins. Co., supra:

We can imagine cases in which the issue of direct versus derivative might make a difference. Suppose the insured *wanted* a trial, even though there was a danger, which materialized, of a verdict in excess of the primary insurer's policy limit. If the excess carrier's right to complain of negligence by the primary carrier is derivative, it would be barred by the insured's decision to roll the dice. [Citation.] And so what? If the insured was acting irresponsibly in pressing the case to trial, the excess insurer, depending on the terms of the policy, would have a contract defense to the insured's claim against it. Twin City Fire Ins. Co., supra, 23 F.3d 1180 (citation omitted).⁷

III. THE MINORITY VIEW

The minority view allows a direct action in addition to equitable subrogation.⁸ New York has taken the lead in this area of jurisprudence. In St. Paul Fire and Marine Ins. Co. v. United States Fidelity and Guaranty Company, 43 N.Y.2d 977, 375 N.E.2d 733 (1978), an excess insurer initiated an action for bad faith against a primary insurer. The action originated from an underlying personal injury action, which resulted in an excess judgment against the insured. Following the verdict in the personal injury action, the excess and primary insurers attended a settlement conference, whereby the primary insurer rejected several offers to settle within its policy limits. The Court held that the primary insurer's breach of the implied covenant of good faith and fair dealing justified the imposition of the excess judgment upon the primary insurer.

Although an insurance company in exclusive control of its insureds' defense cannot be compelled to concede liability and settle a questionable claim before proof has been developed on all sides [citation], the

⁷ Judge Posner's observation is not entirely persuasive. If the insured suffers an excess judgment and its excess insurer refused to indemnify the insured, regardless of insured's negligence in evaluating its own potential liability, the insured would certainly initiate an action for benefits against the excess insurer. An excess insurer defending against a bad faith lawsuit against its own insured, and confronted with extra-contractual liability, is different than an excess insurer suing a primary insurer for bad faith.

⁸ New York (Home Ins. Co. v. Royal Indemnity Company, 327 N.Y.S.2d 745 (1972)); Colorado (United States Fire & Marine Ins. Co. v. Commercial Union Ins. Co., 751 F.Supp. 345 (1990)); Florida (Colonial Ins. Co. v. Assuranceforeningen Skuld, 599 So.2d 1009 (1991)); and New Jersey (Western World Ins. Co. v. Allstate Ins. Co., 150 N.J.Super 481, 376 A.2d 177 (1977)).

defendant in this case refused to settle a claim in excess of its policy limits after liability had already been determined solely on factual issues by a jury [citation]. **Under these circumstances, with liability having been established at trial, the excess carrier alone was placed at further risk due to the defendant's intractable opposition to any settlement of the claim.** St. Paul Fire and Marine Ins. Co., *supra*, 43 N.Y.2d 978 (citations omitted; emphasis added.)

The last sentence (in **bold**) was the genesis of New York's adoption of a direct action against primary insurers by excess insurers.

Hartford Accident and Indemnity Co. v. Michigan Mutual Ins. Associates, Inc., 61 N.Y.2d 569, 463 N.E.2d 608 (1984) (hereinafter referred to as "Hartford II"), arose from a workers' compensation claim. The primary and excess insurers covered three affiliated companies, one of which employed the injured worker. The injured employee sued two of the affiliated companies and did not sue his own employer. The excess insurer requested that the primary insurer direct its defense counsel to implead the worker's employer. The primary insurer refused, which escalated into a bad faith action brought by the excess insurer against the primary insurer. In reliance upon St. Paul Fire and Marine Ins. Co., *supra*, the court held that "Michigan Mutual as the primary liability insurer owed to Hartford as the excess carrier the same duty to act in good faith which Michigan owed to its own insureds, DeFoe and L.A.D." Hartford II, *supra*, 61 N.Y.2d at 574; see also New England Ins. Co. v. Healthcare Underwriters Mutual Ins. Co., 295 F.3d 232 (2d Cir. 2002) (construing New York law) (an excess insurer's bad faith lawsuit against a primary insurer for failure to settle a medical malpractice action within the primary insurer's policy limit.)⁹

Significantly, Hartford II, expanded the type of bad faith conduct. In the vast majority of cases, a primary insurer's bad faith liability was based upon its unreasonable refusal to accept a settlement offer within its policy limits, which resulted in an excess judgment. However, in Hartford II, the primary insurer's bad faith liability to an excess insurer was premised upon its handling of the insured's defense.¹⁰

⁹ In Pavia v. State Farm Mutual Auto. Ins. Co., 82 N.Y.2d 445, 452, 626 N.E.2d 24, 27 (1993), a bad faith case brought by an insured against his primary insurer, the New York Court of Appeals reiterated rule in St. Paul Fire and Marine Ins. Co. v. United States Fidelity and Guaranty Company, *supra*.

¹⁰ Some jurisdictions refuse to recognize a malpractice action by an excess insurer, as the equitable subrogee of the insured, against defense counsel appointed by the primary insurer. Continental Casualty Co. v. Pullman, Comley, Bradley & Reeves, 929 F.2d 103 (2d. Cir. 1991) (construing Connecticut law) American Employers' Ins. Co. v. Medical Protective Co., 165 Mich.App.657, 419 N.W.2d 447 (1988) (construing Michigan law). However, Texas permits an excess insurer to sue defense counsel for malpractice. American Centennial Ins. Co. v. Canal Ins. Co., 843 S.W.2d 480 (1992).

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The minority view takes into account the practical limitations of equitable subrogation. Hartford Accident & Indemnity Company v. Michigan Mutual Ins. Co., 462 N.Y.S.2d 175, 93 A.D.2d 337 (1993) (hereinafter “Hartford I”). In Hartford I, the court observed that “[a]s primary insurer, it acts as a fiduciary and is held to an exacting standard of utmost good faith. Any such right of action arises as a result of the independent and direct duty to the excess insurer and is not dependent upon equitable principles of subrogation (see *Medical Malpractice Ins. Assn. v. Medical Liab. Mut. Ins. Co.*, 86 AD2d 476, 479-480.)” Hartford I, *supra*, 462 N.Y.S.2d 175, 178.

Medical Malpractice Ins. Assn., *supra*, was **not** a lawsuit involving excess versus primary insurers. The case involved a medical malpractice action arising from a surgical procedure performed at a state university medical center resulted in brain damage to a patient. The medical center's insurer defended the malpractice action, which only named the State of New York as a defendant. The medical center's insurer settled the malpractice claim and commenced a contribution action against the doctors' insurer. The court held that neither contribution nor subrogation permitted recovery against the doctors' insurer. Although this decision does not stand for the proposition that a primary insurance owes an independent duty of good faith to an excess insurer, it nevertheless illustrates that the Hartford I court was deeply concerned that the doctrine of equitable subrogation has limitations. Therefore, rather than joining a minority of jurisdictions, which rely upon the doctrine of “triangular reciprocity,”¹¹ the Hartford I and Hartford II courts placed an independent duty of good faith and fair dealing upon primary insurers, which is owed to excess insurers.

IV. AN EXCESS INSURER’S BAD FAITH LIABILITY TO A PRIMARY INSURER?

Certain jurisdictions recognize that the implied covenant of good faith and fair dealing is a reciprocal obligation.¹² If the duty of good faith and fair dealing is reciprocal, does it follow that an excess insurer (whether owed a derivative or independent duty of good faith and fair dealing by the primary insurer) is likewise under a similar duty flowing to the primary insurer? Although cases addressing this issue are scarce to nonexistent, the answer is probably “no” under the majority view.

This issue is related to whether the jurisdiction in question recognizes an excess insurer’s direct claim against a primary insurer, the substantive law on subrogation and assignment of choses in action. Since subrogation is an assignment by operation of law, a legal malpractice action may be considered to personal to the insured to permit transferring it to an excess insurer as the insured’s equitable subrogee.

¹¹ See footnote 4 above.

¹² California (Commercial Union Assurance Companies, *supra*); Illinois (Twin City Fire Ins. Co., *supra*); Iowa (Johnson v. Farm Bureau Mutual Ins. Co., 533 N.W.2d 203, 207 (1995)); Massachusetts (Parker v. D’Avolio, 40 Mass.App.Ct. 394, 664 N.E.2d 858 (1995)); and Mississippi (Andrew Jackson Life Ins. Co. v. Williams, 566 So.2d 1172 (1990)).

A. Under the Majority View

Under the majority view an excess insurer right to pursue a bad faith action against a primary or lower level excess insurer is derivative of the insured's right to seek such relief. As the insured's equitable subrogee, the excess insurer does not have any greater rights or liabilities than the insured.

Therefore, the first hurdle towards the recognition of a duty flowing to the primary insurer is whether the jurisdiction in question recognizes a claim for bad faith against an insured. Some courts refer to this as "reverse" or "comparative" bad faith. This issue has raised considerable controversy. Jurisdictions, which recognize this claim, have severely limited the insured's liability for "reverse" or "comparative" bad faith. For example California, the first state to recognize a claim for "comparative" bad faith,¹³ has significantly limited its application. In Kransco v. American Empire Surplus Lines Ins. Co., 23 Cal.4th 390, 2 P.3d 1 (2000), the California Supreme Court stated:

The scope of the insured's duty of good faith and fair dealing in turn is confined by the express contractual provisions of the policy. [Citation.] An insured's reciprocal duty of good faith and fair dealing does not always necessitate reciprocal conduct. [Citation.] Because an insured's breach of the covenant does not sound in tort, the insured's contractual breach of an express policy provision cannot be raised by the insurer as a defense in a bad faith action brought against it by the insured. It would be illogical to allow the insurer in such a suit to instead interpose as a defense the insured's contractual breach of an implied policy provision (i.e., the covenant of good faith and fair dealing) based on those same express policy terms. Kransco, *supra*, 23 Cal.4th 405.

Although the implied covenant of good faith and fair dealing has been described as a reciprocal obligation, the California Supreme Court made it clear that the insured enjoys considerable latitude in its dealings with its insurer.

Addressing the other side of the issue, are there circumstances where a primary insurer can derive, from the insured, the right to sue an excess insurer for bad faith? In other words, is there a situation where primary insurer 1) acts in good faith and distributes benefits the insured, 2) is equitably subrogated to the insured's bad faith claim, and 3) initiates a bad faith action against an excess insurer, which unreasonably denies benefits to the insured? This raises a second conceptual hurdle. Under such circumstances, the insured has the right to initiate a bad faith claim against the excess insurer as the real party in interest, because the insured is exposed to an excess judgment. Under such circumstances, the insured would most likely name the primary insurer as a co-defendant.

¹³ Fleming v. Safeco Ins. Co. of America, 160 Cal.App.3d 31 (1984).

However, if the insured is exposed to an excess judgment, the primary insurer does have the option of indemnifying the insured for the excess judgment and seeking indemnity from the excess insurer. This raises another conceptual hurdle, exhaustion.

It is widely accepted that an excess insurer does not have a duty to defend and/or indemnify the insured, until the primary (lower level) policy limits have been exhausted. Valentine v. Aetna Ins. Co., 564 F.2d 292, 298 (9th Cir. 1977) (construing California law). Therefore, until an excess insurer's duty to the insured has accrued, the excess insurer does not owe a duty of good faith and fair dealing to the insured.¹⁴

Furthermore, an excess insured retains the right to settle claims against the insured, for an amount in excess of the primary insurer's policy limits, and initiate a bad faith claim against the primary insurer as the insured's equitable subrogee. In Continental Casualty Co., *supra*, an excess insurance carrier settled a liability case during trial over the express objections of the primary carrier, and then sued the primary carrier. The Minnesota Supreme Court held that:

[T]he excess insurer again is in the same position as its subrogor, the insured. In such a case the insured should certainly be able to protect itself by settling a claim against it within primary policy limits, and then recovering from its primary insurer who refused to settle in bad faith. In that lawsuit the primary insurer could claim that the insured was not liable or liable for less than its policy limits and those questions could be tried by the jury along with the general issue of bad faith. Since bad-faith failure to settle occurs prior to trial, and the relevant standard involves evaluation of the insurer's decision at the time it is made and not from hindsight, we see no reason to allow the primary insurer to force a trial of the principal action. [Citation.] Continental Casualty Co., *supra*, 307 Minn. 13-14 (footnotes omitted).¹⁵

Continental Casualty Company illustrates the obstacles preventing the recognition of a primary insurer's right to initiate a bad faith claim against an excess insurer. It appears that under the majority view, the duty of good faith and fair dealing is owed by a primary insurer to an excess insurer, as the insured's equitable subrogee, without reciprocity.

¹⁴ Several jurisdictions allows an insured to sue an excess insurer before the primary policy has exhausted in order to determine whether the insured will sustain a loss sufficient to penetrate its excess layers. Zeig v. Massachusetts Bonding & Ins. Co., 23 F.2d 665 (2nd Cir. 1928) (construing New York law); Ludgate Ins. Co. v. Lockheed Martin Corp., 82 Cal.App.4th 592 (2000) (construing California law). However, it is unlikely that a court would permit an insured to maintain a bad faith action against an excess insurer, before the excess insurer has an obligation to indemnify the insured.

¹⁵ This decision has been cited with approval in California. See Fortman v. Safeco Ins. Co. of America, 221 Cal.App.3d 1394 (1990).

B. Under the Minority View

The minority view recognizes an independent duty of good faith and fair dealing flowing from a primary insurer to an excess insurer. Although there are no known decisions from the minority jurisdictions which recognize a duty flowing from the excess insurer to the primary insurer, it would be more likely for such to exist in the minority jurisdictions.

In Love, *supra*, the court cautioned that the implied covenant of good faith and fair dealing

is implied as a supplement to the express contractual covenants, to prevent a contracting party from engaging in conduct which (while not technically transgressing the express covenants) frustrates the other party's rights to the benefits of the contract. . . . [the implied covenant] should not be endowed with an existence independent of its contractual underpinnings. Love, *supra*, 221 Cal.App.3d 1153.

By recognizing an independent duty of good faith and fair dealing owed by primary insurers to excess insurers, the minority view has opened the proverbial Pandora's Box. Judge Posner illustrates the potential consequences as follows:

We have described the duty of good faith to the insured as an implied contractual term. But since the opposite of good faith is bad faith, which sounds as if it might be tortious (though the duty of good faith is of course a familiar concept in contract law), since the relation between the insurer and the insured in the defense of legal claims is fiduciary in character, and since (for that reason) punitive damages are often imposed for breach of the duty of good faith settlement, many courts have recast the implied contractual duty of good faith settlement as a tort duty. [Citations.] Once the duty is thus preconceived, it is easy to imagine it running to any excess insurer as well as to the insured, at least if the primary insurer knows (as it did here) that there is an excess insurer in the picture. When this step is taken, the doctrine of equitable subrogation falls out of the picture. Twin City Fire Insurance Company, *supra*, at 1180.

Under the minority view, if an insurance company owes an independent tort duty of good faith and fair dealing, unencumbered by its contractual relationship to its insured, it is foreseeable that the duty will take on a life of its own.¹⁶ Therefore, the only

¹⁶ To underscore this point, in 1979, the California Supreme Court issued its decision in Royal Globe Ins. Co. v. Superior Court, 23 Cal.3d 880, 592 P.2d 329 (1979). In Royal Globe, the Court interpreted that California Unfair Insurance Practices Act (California Insurance Code sections 790 et seq.) provided a private cause of action against insurers who committed unfair practices as enumerated under the statute. Hence, the decision spawned a host of bad faith lawsuits brought by third party claimants against insurance companies. After acknowledging that the Court's holding has been subject to (More)

impediment to the recognition that such a duty exists in the minority jurisdictions is waiting for the right case with compelling facts, which will convince the courts to establish such a duty.

V. CONCLUSION

A. Representing the Primary Insurer

In the majority jurisdictions, an excess insurer can only assert a bad faith claim against a primary insurer as the equitable subrogee of the insured. Therefore, if the primary insurer has not breached the implied covenant of good faith and fair dealing in handling the insured's claim or defense, then it follows that an excess insurer will not be able to maintain a meritorious bad faith claim against the primary insurer.

In order to minimize the potential for bad faith liability, counsel for primary insurers are encouraged to 1) obtain the insured's written consent if an offer within policy limits is rejected and 2) keep the excess insurers informed of all significant developments in the case. With respect to the latter, subrogation is an equitable remedy, therefore, the excess insurer could be vulnerable to certain equitable defenses.¹⁷

B. Representing the Excess Insurer

As a corollary to the proper representation of primary insurers, counsel for excess insurers should also stay informed of all pertinent developments in the underlying matter and should promptly object to any improprieties in the primary insurer's handling of the insured's claim or defense. Should the primary insurer unreasonably fail to discharge its duties to the insured, the excess insurer must be prepared to act in accordance to the insured's best interests. Otherwise, the excess insurer's subrogation claim could be barred by the lack of superior equities.

Before initiating a bad faith claim against the primary insurer, counsel should ascertain the following:

1. Whether the jurisdiction in question recognizes a direct action by an excess insurer against the primary insurer;

considerable criticism by jurors and legal scholars as well as adverse consequences of increased litigation, suspicious claims, inflated settlements, and higher premiums, the California Supreme Court overruled Royal Globe in Moradi-Shalal v. Fireman's Fund Ins. Companies, 46 Cal.3d 287, 758 P.2d 58 (1988).

The vast majority of jurisdictions (including New York) refuse to recognize a private right of action for breach of the states' Unfair Insurance Practices statutes. Gucciardo v. Reliance Ins. Co., 84 F.Supp.2d 399 (E.D. N.Y. 2000).

¹⁷ For example: "He who consents to an act is not wronged by it." (Cal. Civil Code sec. 3514.) "Acquiescence in error takes away the right of objecting to it." (Cal. Civil Code sec. 3516.) "The law helps the vigilant, before those who sleep on their rights." (Cal. Civil Code sec. 3527.)

2. If the jurisdiction does not recognize a direct action, what is the substantive law dealing with equitable subrogation—the specific elements and limitations;¹⁸
3. What is the substantive law dealing with assignability of the insured's potential causes of action—breach of contract, bad faith, infliction of emotional distress, fraud, malpractice or other claims for compensatory and/or punitive damages;¹⁹
4. When the statute(s) of limitations on the excess insurer's equitable subrogation claim(s) accrued; and
5. Whether the insured, and ostensibly the excess insurer as the insured's equitable subrogee, is subject to any defenses that could be raised by the primary insurer.

¹⁸ It would also be helpful to contact the insured and secure an express assignment of rights.

¹⁹ Although an excess insurer can initiate and maintain a bad faith action against a primary insurer, other remedies may be available (i.e. a cause of action for breach of contract or indemnity.)