LIABILITY INSURANCE—AN EXCESS INSURER WHO SETTLES A CASE AGAINST AN INSURED PRIOR TO TRIAL CAN RECOVER FROM THE PRIMARY INSURER THE AMOUNT OF THE LATTER'S POLICY LIMITS IF LIABILITY ON THE PART OF THE INSURED AND BAD FAITH ON THE PART OF THE PRIMARY INSURER ARE ESTABLISHED.—*Continental Casualty Co. v. Reserve Insurance Co.* (Minn. 1976).

Lucille Christianson sued Edward DeLange for injuries resulting from an automobile accident. DeLange brought a third-party claim against the City of Marshall under the Minnesota Dram Shop Act.[1] Reserve Insurance Company (Reserve) was the primary insurer for the city with policy limits of $50,000. Continental Casualty Company (Continental) was the city's excess carrier, providing coverage for losses from $50,000 to $950,000.

On the second day of trial, wherein both Reserve as primary insurer and Continental as excess insurer provided defense counsel, a settlement was reached between Christianson and DeLange's insurer and Continental.[2] Under Continental's settlement, it was determined that the city's liability would be $200,000. Continental then demanded that Reserve, as the city's primary insurer, tender its policy limits ($50,000) towards this settlement figure. Reserve refused, so Continental paid the full $200,000, reserving its right to pursue Reserve.[3] Continental instituted suit against Reserve, alleging that Reserve's failure to contribute to the settlement constituted bad faith. The district court granted Reserve judgment on the pleadings,[4] reasoning that without a prior judicial determination of the city's liability, Reserve could not be held liable for refusing to pay any part of its policy limits toward settlement. The Supreme Court of Minnesota *held*, unanimously, reversed. An excess insurer who settles a case against an insured prior to trial can recover from the primary insurer the amount of the latter's policy limits if liability on the part of the insured and bad faith on the part of the primary insurer are established. *Continental Casualty Co. v. Reserve Insurance Co.*, — Minn. —, 238 N.W.2d 862 (1976).

In confronting the central issue involved in the case at bar, "whether and under what circumstances an excess insurer who over the objection of the

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1. MINN. STAT. § 340.95 (1972). DeLange alleged that the city was liable under the Dram Shop Act for an illegal sale of liquor to him by the municipal liquor store. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976).

2. The settlement called for DeLange's insurance carriers to contribute $550,000 and Continental $200,000, for a total of $750,000.

3. Reserve did not participate in the settlement, not because of any claim that its policy did not cover the city of Marshall, but because it assessed the dram shop liability of the city as being nonexistent. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976).

4. The district court granted judgment on the pleadings pursuant to *Minnesota Civil Rule* 12.03. Because of this, for the purposes of appeal, it was taken as true that Reserve was mistaken in its evaluation that the city had no liability to the claimants. *Id.* at — n.1, 238 N.W.2d at 863 n.1.

primary insurer, settles a case against the insured prior to trial can recover from the primary insurer the amount of the latter's policy limits,"[5] the Minnesota supreme court initially found it necessary to resolve two underlying questions. First, the court had to decide whether the duty flowing from the primary insurer to its insured should likewise encompass the insured's excess carrier, thus creating a legal duty owed by the primary insurer to its insured's excess carrier. Second, it was necessary for the *Continental* court to make a determination as to whether a primary insurer could be held liable for failure to contribute to the settlement reached by the excess insurer without first requiring a judicial determination as to the insured's liability.

In attacking the question of whether or not the primary insurer actually owes a duty to the excess insurer, the Minnesota court first examined the nature of the legal duty which the primary insurer owes to its insured. It is well-established that any liability insurer owes its insured either a duty of good faith[6] or a duty of due care[7] in deciding whether to accept or reject a settlement offer. The duty of due care, in this context, is generally defined in terms of the classic negligence standard. The duty of good faith, followed by both Minnesota[8] and Iowa,[9] is founded upon a stricter standard. As the *Continental* court noted, "[t]his duty 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."[10] The Iowa court, in *Henke v. Iowa Home Mutual Casualty Co.*,[11] held that "[b]ad faith requires more than a showing of inadvertence or honest mistake of judgment. Where there is no clear and definite evidence that the claim could be settled within the policy limits or for a reasonable figure, . . . the insurer cannot be held liable for refusal to settle within the policy limits."[12] However, if there has been a breach of this duty by refusing in bad faith to accept an offer within

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5. *Id.* at —, 238 N.W.2d at 864.

6. Frank B. Connet Lumber Co. v. New Amsterdam Cas. Co., 236 F.2d 117 (8th Cir. 1956); Citizens Mut. Ins. Co. v. Nationwide Ins. Co., 29 Mich. App. 91, 185 N.W.2d 99 (1970); Olson v. Union Fire Ins. Co., 174 Neb. 375, 118 N.W.2d 318 (1962); Nichols v. United States Fidelity & Guar. Co., 37 Wis. 2d 238, 155 N.W.2d 104 (1967).

7. Gilley v. Farmer, 207 Kan. 536, 485 P.2d 1284 (1971); *In re* Kreloff, 65 Misc. 2d 692, 319 N.Y.S.2d 51 (Sup. Ct. 1971). An alternative standard to that of good faith or negligence, a standard of strict liability, has been suggested by the California court in *Crisci v. Security Ins. Co.*, 66 Cal. 2d 425, 426 P.2d 173, 58 Cal. Rptr. 13 (1967). The Minnesota court rejected this standard in a footnote. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, — n.10, 238 N.W.2d 862, 868 n.10 (1976).

8. Lange v. Fidelity & Cas. Co., 290 Minn. 61, 185 N.W.2d 881 (1971).

9. Kohlstedt v. Farm Bureau Mut. Ins. Co., 258 Iowa 337, 139 N.W.2d 184 (1965). Even when the standard is that of good faith and not negligence, negligence may be material to the issue of bad faith. Ferris v. Employers Mut. Cas. Co., 255 Iowa 511, 122 N.W.2d 263 (1963). For a comprehensive treatment of the difference between the standards of good faith and negligence, see Annot. 40 A.L.R.2d 168 (1955).

10. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, —, 238 N.W.2d 862, 864 (1976).

11. 250 Iowa 1123, 97 N.W.2d 168 (1959).

12. Henke v. Iowa Home Mut. Cas. Co., 250 Iowa 1123, 1129-30, 97 N.W.2d 168, 173 (1959) (citations omitted).

policy limits, the insured's remedy is a suit against the insurer for the amount of the judgment in excess of the policy limits.[13]

The *Continental* court held that this same duty applies between a primary insurer and excess insurer, the excess insurer being subrogated to the insured's rights against a primary insurer for breach of the primary insurer's good-faith duty to settle.[14] The court reasoned that when the insured purchases excess coverage, he is substituting the excess carrier for himself.[15] From this, it follows that the excess insurer assumes the rights and obligations of the insured in that position.[16] In addition, the Minnesota court cited two policy factors as supporting this result.

First, if the duty to exercise good faith in settlement is breached, the public's interest in the fair and reasonable settlement of suits is imperiled.[17] If the court had held that no such duty existed, Continental would have had to pay Reserve's $50,000 policy limits even if Reserve's bad faith had been established. In sum, a fair and reasonable settlement should not be obstructed by a primary insurer's bad faith.[18]

Second, if there were no cause of action for the excess insurer, there would be an unfair distribution of losses.[19] If the primary insurer refuses in bad faith to settle, it forces the excess carrier making a reasonable settlement to cover both primary and excess liability.[20] The excess insurer did not design his rates to cover primary liability, and if the primary insurer refuses a settlement offer in bad faith, he should be required to tender his policy limits toward that settlement.[21]

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13. Boerger v. American Gen. Ins. Co., 257 Minn. 72, 100 N.W.2d 133 (1959).
14. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, —, 238 N.W.2d 862, 864 (1976).
15. *Id.* This reasoning is logical since when the insured has no excess coverage he is in effect his own excess insurer.
16. *Id.*
17. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976).
18. *Id.*
19. *Id.*
20. *Id.* at —, 238 N.W.2d at 865. Continental could have refused to participate in the settlement, letting the jury determine whether the city was liable for over $50,000. Reserve would then have been liable for its policy limits. It could be argued that Continental, in this case, should have paid only $150,000 towards settlement and then have allowed the trial between those involved in the accident and the city to go forward. The question therefore becomes, if judgment then exceeded $200,000, would Reserve be liable for any excess? Minnesota law was unclear on this point, so Continental did not want to risk the action going to trial as it feared being liable for any excess over $200,000. Brief for Appellant at 11, Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976). The Minnesota court did not deal directly with this issue on appeal, but the principles applied by the court indicate that if Continental had paid only $150,000, it could have gone to court to compel Reserve to pay any judgment over $200,000 (assuming liability and bad faith on the part of Reserve could be proven). This logically follows from a consistent application of the doctrine of subrogation.
21. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976). The court dismissed the argument that the excess insurer (Continental) was acting as a gratuitous volunteer in settling the case and thus was not entitled to subrogation. *Id.* at — n.4, 238 N.W.2d at 864 n.4. The court probably should have dealt with this argument more

The bulk of authority from other jurisdictions supports the existence of a duty owed by a primary insurer to an excess insurer.[22] The case most often cited for this principle, *American Fidelity & Casualty Co. v. All American Bus Lines, Inc.*,[23] involved an injured party obtaining a verdict in excess of primary policy limits after the primary insurer had refused to settle. There, the court held that recovery may be had by an excess insurer against the primary insurer, where the primary insurer has been guilty of bad faith in not settling the claim by a third person against the insured.[24] However, *Peter v. Travelers Insurance Co.*,[25] a California case, appears to be the first to clearly articulate the nature of the duty, *i.e.*, subrogation. The *Peter* court stated: "the duty owed an excess insurer is identical to that owed the insured. The excess [insurer] will not be able to force the primary [insurer] into accepting any settlement which his duty to the insured would not require accepting."[26] The court in *Continental* adopts the *Peter* view of the nature of this duty without comment when it states, "[w]e hold that an excess insurer is *subrogated* to the insured's rights against a primary insurer for breach of the primary insurer's good-faith duty to settle."[27]

After determining that a duty does in fact exist between the primary and excess insurers, the *Continental* court next proceeded to delineate the circumstances under which such a duty is breached. Precisely, the Minnesota court had to determine whether a judicial determination of the insured's liability was essential to a finding of bad faith on the part of a primary insurer in failing to contribute to a settlement reached by the excess insurer.

In the present case, Reserve, the primary insurer, contended that its insured, the city of Marshall, was not liable under the Dram Shop Act, thus eliminating its obligation under the insurance contract and that, absent a determination of its liability, it was not bound to tender its policy limits towards settlement. In advancing this contention, Reserve relied chiefly upon the case of *St. Paul-Mercury Indemnity Co. v. Martin*.[28] In *St. Paul-Mercury*, the excess

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fully since the primary insurer has traditionally had the exclusive power to settle a claim. *See* Bloom, *Recovery Against Primary Insurer By Excess Carrier For Bad Faith or Negligent Failure to Settle*, 36 INS. COUNSEL J. 235, 236 (1969). However, the court did reach the proper result. Settlement is often in the best interest of all concerned; and if the primary insurer exercises bad faith, the excess carrier should be able to step into the settlement process and reach a good faith accord without being labeled a "volunteer."

22. St. Paul-Mercury Indem. Co. v. Martin, 190 F.2d 455 (10th Cir. 1951); Peter v. Travelers Ins. Co., 375 F. Supp. 1347 (C.D. Cal. 1974); Home Ins. Co. v. Royal Indem. Co., 68 Misc. 2d 737, 327 N.Y.S.2d 745 (Sup. Ct. 1972).

23. 190 F.2d 234 (10th Cir.), *cert. denied*, 342 U.S. 851 (1951).

24. American Fidelity & Cas. Co. v. All Am. Bus Lines, Inc., 190 F.2d 234 (10th Cir.), *cert. denied*, 342 U.S. 851 (1951).

25. 375 F. Supp. 1347 (C.D. Cal. 1974).

26. Peter v. Travelers Ins. Co., 375 F. Supp. 1347, 1350 (C.D. Cal. 1974); *see, e.g.*, United States Fidelity & Guar. Co. v. Tri-State Ins. Co., 285 F.2d 579 (10th Cir. 1960); American Fidelity & Cas. Co. v. All Am. Bus Lines, Inc., 190 F.2d 234 (10th Cir.), *cert. denied*, 342 U.S. 851 (1951).

27. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, —, 238 N.W.2d 862, 864 (1976) (emphasis added).

28. 190 F.2d 455 (10th Cir. 1951).

insurer demanded that the primary insurer accept the settlement offered by the injured parties. The primary insurer then commenced a declaratory judgment action, asserting its nonliability. Before this was tried, however, the primary insurer accepted settlement and the case was continued only to determine the respective liabilities of the primary and excess carriers. The court in *St. Paul-Mercury* held that the primary insurer "is not required to prophesy or foretell the results of litigation at its peril. If it acts in good faith and without negligence in refusing the proferred settlement, it has fulfilled its duty to its insured, and those in privity with it."[29] Therefore, that case merely indicated that in cases of questionable liability, the excess insurer under a liability policy cannot force the primary insurer to pay its full policy limits in settlement on the threat of liability for the full amount of a possible judgment if settlement is refused.[30] The court in *Continental* correctly distinguished *St. Paul-Mercury*, recognizing that that case dealt largely with the issue of good faith and was not on point as to whether there must be a prior determination of liability. As the *Continental* court notes, that particular holding is not in conflict with the determination in the instant case that the primary insurer must exercise good faith in regard to the excess carrier when both are involved in the settlement process. Moreover, this language appearing in *St. Paul-Mercury*, which concerned good faith in refusing settlement, is mere dicta; there was no issue of good or bad faith on the part of the primary insurer, as it had already entered into a settlement acceptable to the excess insurer.[31] Thus, the two cases are distinguishable in that while the court in *St. Paul-Mercury* did not need to deal with the issue of whether the primary insurer had exercised bad faith in the settlement process, it was a central issue to be decided under the *Continental* facts. Furthermore, the Minnesota court in *Continental* correctly discerned that the *St. Paul-Mercury* opinion expressed no view as to whether a primary insurer is entitled to have the principal action tried before tendering its policy limits.[32] Therefore, *St. Paul-Mercury* does not contradict the result reached in *Continental*; if the lower court on remand finds that Reserve has met its duty of good faith, Reserve will not be liable to Continental.[33]

The crucial difference between *Continental* and previous cases is that in *Continental* there was no trial and judgment in the main action. The cases of *Peter v. Travelers Insurance Co.*[34] and *Home Insurance Co. v. Royal Indemnity Co.*[35] both dealt with settlement by excess insurers *after* verdicts in excess

29. St. Paul-Mercury Indem. Co. v. Martin, 190 F.2d 455, 458 (10th Cir. 1951).
30. *Id.* at 457.
31. *Id.* In *St. Paul*, the primary insurer entered into the settlement *before* its liability had been established. Normally, this would establish the good faith of the primary insurer. However, it is possible that this settlement could be made in bad faith if it compromised the interests of the excess insurer in a way that would not be remedied by the excess insurer refusing to enter into the settlement.
32. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, 238 N.W.2d 862 (1976).
33. *Id.* at —, 238 N.W.2d at 868.
34. 375 F. Supp. 1347 (C.D. Cal. 1974).
35. 68 Misc. 2d 737, 327 N.Y.S.2d 745 (Sup. Ct. 1972).

of primary policy limits had been returned. Although there had not been a preliminary determination of the insured's liability, the *Continental* court had no difficulty in allowing the present litigation, again reasoning that the excess insurer is in the same position as the insured:

> 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 was made and not from hindsight, we see no reason to allow the primary insurer to force a trial of the principal action.[36]

It is important to grasp what the court is actually saying in this passage. The court did *not* hold that an excess insurer can settle for any amount it chooses and automatically recover from the primary insurer its policy limits. The court merely held that a cause of action exists, and that if in the action between primary and excess insurers, the excess insurer can prove *both* the liability of the insured and the bad faith of the primary insurer, then the excess carrier is entitled to the primary insurer's policy limits.[37] These issues can be resolved in one trial without the claimants in the main action being parties.[38]

The Iowa supreme court has not been presented with a case involving a factual situation similar to that found in *Continental.* However, in *Henke v. Iowa Home Mutual Casualty Co.*[39] the Iowa court found bad faith on the part of an insurer who disregarded the interest of the insured in failing to accept advice by its own attorneys to settle.[40] The Iowa court could easily extend these principles to a fact pattern similar to that in *Continental* by adopting the reasoning of the Minnesota court.

The Minnesota court has taken an enlightened approach in allowing an excess insurer to pursue a claim against a primary insurer who refuses in bad faith to contribute to a settlement negotiated by the excess insurer without a judicial determination of the insured's liability in the principal action. The court reasoned that settlement should be encouraged, yet the primary insurer is entitled to its day in court. The holding in the case at bar balanced both of these factors—the excess insurer may settle with the parties in the main action before trial, removing these parties from long and costly litigation; but before

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36. Continental Cas. Co. v. Reserve Ins. Co., — Minn. —, —, 238 N.W.2d 862, 867 (1976).
37. *Id.* at —, 238 N.W.2d at 868.
38. *Id.* at —, 238 N.W.2d at 867.
39. 250 Iowa 1123, 97 N.W.2d 168 (1959).
40. Henke v. Iowa Home Mut. Cas. Co., 250 Iowa 1123, 1137, 97 N.W.2d 168, 177 (1959).

the excess insurer can recover the primary insurer's policy limits, the excess insurer must prove in a subsequent action both that the primary insurer was liable to its insured and that the primary insurer exercised bad faith in refusing to settle. By requiring that bad faith be shown, the primary insurer will be protected from coerced settlements. It is suggested that if courts in other jurisdictions confront a factual pattern similar to that in *Continental*, Minnesota's approach to the duty owed an excess insurer by a primary insurer should be followed.

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