Are Damages for Wrongful Denial of Coverage Without Bad Faith Limited by Policy Limits Plus Defense Costs?

By

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I. Introduction

It is clear that bad faith denial of coverage by an insurer can have very dire consequences for an insurer. But what of a good faith denial *e.g.* when the insurer has a basis to believe that the act, damage or person in question is not covered by the policy or the complaint filed against the insured does not allege a wrong covered by the policy? The ostensible majority rule is that the damages for a wrongful denial of coverage that is not in bad faith are policy limits plus attorneys' fees while the minority rule is that damages are not so limited. The purpose of this article is to examine selected caselaw on point as to how the majority and minority rules actually are applied by the courts.

II. Majority Rule

Triple U Enterprises, Inc. v. New Hampshire Ins. Co., 766 F.2d 1278 (8th Cir. 1985) was a case under South Dakota law involving the sale of buffalo which, it turned out, were not suitable for breeding. The buyer sued the seller for breach of warranty and fraudulent misrepresentation but the seller's liability insurer denied coverage. The court fount that the allegations of the complaint did fall with the coverage of the policy but that the insurer's denial was in good faith. The court followed the majority rule that damages were limited to policy limits and the cost of defense:

> As a general rule, however, the amount of the insurer's liability will be limited by the policy's coverage provisions.
> . . . .
> Here there is no showing that [the insurer] acted in bad faith, or that [the insured] lacked effective representation during the state proceedings. It appears that the detriment to [the insured] caused by [the insurer's] failure to defend was limited to the cost of defense, plus the amount of [the insurer's] liability, if any, to [the insured] under the terms of the policy.[1]

There is interesting *dicta* on this point in a case under Wisconsin law in which the court found that coverage was not even arguable and the insurer was justified in denying coverage. *Hamlin*

Inc. v. Hartford Accident & Indem. Co., 86 F.3d 93 (7th Cir. 1996). While recognizing the majority rule with respect to lack of bad faith, the court observed:

> An insurance company that refuses a tender by its insured takes the risk not only that it may eventually be forced to pay the insured's legal expenses but also that it may end up having to pay for a loss that it did not insure against. If the lack of a defender causes the insured to throw in the towel in the suit against it, the insurer may find itself obligated to pay the entire resulting judgment or settlement even if it can prove lack of coverage.[2]

However, the *Hamlin* court observed that the insured was able to obtain very capable defense counsel so the adverse verdict which was obtained against the insured was not the result of a denial of coverage.

Employers National Ins. Corp. v. Zurich American Ins. Co., 72 F.2d 517 (5th Cir. 1986) adds another caveat to the majority rule on good faith denials of coverage. In this case the insurer denied coverage but after an excess verdict was rendered, offered to pay policy limits and defense costs but not the excess liability. The court, interpreting Texas law, followed the majority rule on lack of bad faith but with a caveat with respect to the possibility of settling within policy limits:

> The prevailing view is that without an offer or a showing that the claim could have been resolved for the policy limits, the excess judgment is not an injury caused to the insured by the insurer.[3]

A self-insured retention and an insurance policy applied to a loss in *Burgraff v. Menard, Inc.,* 875 N.W.2d 596 (Wis. 2016). The insurer settled for a proportionate share of liability and contended that it had no further obligation to fund ongoing litigation. The court disagreed, holding that the insurer had an obligation to provide a defense until its indemnity limits were exhausted. However, there were no allegations of bad faith and the court ruled that it would be a windfall to the insured if the insurer were required to pay the entire verdict resulting from the litigation.

George R. Winchell v. Norris, 633 P.2d 1174 (Ct. App. KS 1981) involved a denial of coverage on a tort claim that went to a default judgment that exceeded policy limits. The court found that the insurer's denial of coverage did not constitute bad faith and, absent a settlement offer within limits, the insurer was not liable for the excess judgment:

> Absent a settlement offer, the plain refusal to defend has no causal connection with the amount of the judgment in excess of policy limits. If the insured has employed competent counsel to represent him, there is no basis for concluding that the judgment would have been for a lesser sum had the defense been conducted by the insurer's counsel. If there were a settlement offer within the policy limits, however, then a causal connection would exist.[4]

III. Minority Rule

The recent decision of *Century Sur. Co. v. Andrew,* 2018 Nev. LEXIS 112 is an example of the minority view of the liability of an insurer for excess judgments when there is no bad faith denial of coverage. A federal court certified this issue to the Nevada Supreme Court that ruled that breach of the duty to defend leads to consequential damages that are not necessarily limited by policy limits:

> The obligation of the insurer to defend its insured is contractual and a refusal to defend is considered a breach of contract. Consistent with general contract principles, the minority view provides that the insured may be entitled to consequential damages resulting from the insurer's breach of its contract to defend. . . . The determination of the insurer's liability depends on the unique facts of each case and is one that is left to the jury's determination.[5]

Andrew v. Century Sur. Co., 134 F. Supp. 3d 1249 (D. Nev. 2015) involved a coverage denial and a default judgment in excess of policy limits. Interpreting Nevada law, the court made a distinction between the insurer's duty to pay losses and the duty to defend and as to the latter:

> The duty to defend is not based on the contractual promise to pay a certain amount of money to an injury person. Instead, it is a promise to provide a defense, the breach of which may result on consequential damages to the insured beyond the policy limits.[6]

As to a default judgment as a consequential damage:

> When the insurer breaches the duty to defend, a default judgment is a reasonably foreseeable result because, in the ordinary course, when an insurer refuses to defend its insured, the probable result is that the insured will default.[7]

The court ruled that bad faith was not necessary to hold the insurer liable for such consequential damages:

> Thus, in the context of a breach of the duty to defend, bad faith is not required to impose liability on the insurer in excess of the policy limits.[8]

The insurer declined coverage and declined to settle within policy limits in *Comunale v. Traders & General Ins. Co.*, 328 P.2d 198 (Ca. 1958). As to the good faith obligation of the insurer to settle claims:

> The insurer, in deciding whether a claim should be compromised, must take into account the interest of the insured and give it at least as much consideration as it does to its own interest. When there is a great risk of recovery beyond the policy limits so that the most reasonable manner of disposing of the claim is a settlement that can be made within those limits, a consideration of good faith on the insured's interest requires the insurer to settle the claim. Its

> unwarranted refusal to do so constitutes a breach of the implied covenant of good faith and fair dealing.[9]

Breach of this obligation may result in the payment of an excess judgment:

> An insurer who denies coverage does so at its own risk, and although its position may not have been entirely groundless, if the denial is found to be wrongful it is liable for the full amount which will compensate the insured for all the detriment caused by the insurer's breach of the express and implied obligations of the contract.[10]

Stockdale v. Jamison, 330 N.W.2d 389 (Mich. 1982) is another case in which the insurer declined coverage and an excess judgment ensued. As to the issue of good faith, the court ruled that it was no defense to breach of a duty to defend:

> While good faith may limit an insurer's liability to policy limits in actions for failure to settle, it is not a defense to an action for breach of an insurer's obligation to defend its insured. The rule subjecting an insurer to liability to its insured in excess of policy limits for failure to act in good faith in settlement negotiations recognizes that where the insurer defends the action it has a substantial measure of control in the conduct of the lawsuit and is in a position to disregard the interests of the insured and expose him to the risk of a judgment in excess of policy limits.

The *Stockdale* court went on to find that consequential damages payable by the insurer are not limited by policy limits but determined by the loss to the insured by the breach. In this case, the insured was judgment-proof on the tort claim and, therefore, there were no consequential damages.

Thomas v. Western World Ins. Co., 343 So.2d 1298 (Ct. App. Fl. 1977) was another case in which the insurer denied coverage and a default judgment with excess liability was entered. The court ruled that bad faith was not "an absolute prerequisite to recovery of excess damages in the present case."[11] The court went on to rule that even in the absence of a settlement offer, the insured might be able to recover for an excess judgment:

> [E]ven in the absence of a settlement offer, the insurer may be liable for an excess judgment where (1) due to the actions of the insurer, the insured suffers a default or final judgment without benefit of an attorney; and (2) the insured can prove the final judgment would have been lower had the suit been properly defended.[12]

IV. Commentary

There is a great deal of nuance from jurisdiction to jurisdiction as to how the courts treat wrongful denial of coverage and the consequences that flow therefrom. However, it seems evident that even in those jurisdictions that have adopted, obstensibly, the majority rule, an insurer acts at its peril if

it denies coverage and (a) a settlement offer within limits is made and denied; or (b) the insured defaults or is unable to muster a credible defense.

ENDNOTES

[1] 766 F.2d at 1282.
[2] 86 F.3d at 94.
[3] 792 F.2d at 520.
[4] 633 P.2d at 1177 – 8.
[5] 2018 Nev. LEXIS 112 *13.
[6] 134 F. Supp.3d at 1256.
[7] *Id.* at 1255.
[8] *Id.* at 1257.
[9] 328 P.2d at 201.
[10] *Id.* at 202.
[11] 343 So. 2d at 1303.
[12] *Id.* at 1302.