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**A PRIMER ON AN INSURER'S  
RIGHTS AND OBLIGATIONS TO  
SETTLE AND THE INSURED'S  
OPTIONS IF IT DISAGREES**

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**Lorman's – A Comprehensive Guide To Resolving  
Construction Disputes**

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## I. Introduction

In many cases an insured is sued for both covered and uncovered claims, and damages. Equally common is for an insured to be sued for damages beyond its policy limits. Not surprisingly, when an offer is made to settle such a case within the potentially available policy limits, the insured often wants to accept the offer so as to terminate any personal exposure. At the same time, the insurer or insurers potentially on the risk (including both direct and additional insurers) may claim that the entire case is uncovered, that it may be able to defend the case, or that the settlement demand is just too high. Conversely, there are cases where the insured feels there is little or no liability and wants to vindicate itself. At the same time, the defense costs through trial (which are being paid outside the aggregate limits) may easily approach or exceed the amount for which the case could be settled. Not surprisingly, it is now the insurer who wishes to settle and the insured does not. This article will explore the rights and obligations of an insurer under these circumstances to take its insured out of harm's way and the options of the insured if it disagrees with its insurer's decision.

## II. An Insurer's Implied Duty to Settle

Liability insurance policies typically contain a provision that gives an insurer the discretion to "settle any claim or 'suit' that may result." This does not mean that the insurer can arbitrarily decide whether to settle a claim. California law imposes an implied duty on the part of the insurer to accept reasonable settlement demands on claims against its insured within the policy limits. This duty is derived from the covenant of good faith and fair dealing implied by law in all contracts, and from the liability insurer's duty to defend and indemnify covered claims. (*Kransco v. American Empire Surplus Lines Ins. Co.* (2000) 23 Cal.4th 390, 401.) The covenant of good faith and fair dealing obligates an insurer to settle with policy limits "whenever there is a substantial likelihood of a recovery in excess of those limits." (*Johansen v. Cal. State Auto Ass'n Inter-Ins. Bureau* (1975) 15 Cal.3d 9, 15.) A liability insurer owes the same duty in settling third party claims against an additional insured as against a named insured. (See *Smith v. State Farm Mutual Automobile Insurance Co.* (1992) 5 Cal.App.4th 1104, 1109; *Maryland Casualty Co. v. Nationwide Ins. Co.* (1998) 65 Cal.App.4th 21, 31.)

Over 45 years ago, the California Supreme Court clarified the breadth of an insurer's implied duty to settle:

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 on its own interest. [Citation.] *When there is great risk of a*

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*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. Its unwarranted refusal to do so constitutes a breach of the implied covenant of good faith and fair dealing.*

(*Comunale v. Traders & General Ins. Co.* (1958) 50 Cal.2d 654, 659, italics added.)

The test for determining whether the insurer has given good faith consideration to the interests of the insured is whether a prudent insurer without policy limits would have accepted the settlement offer. (*Crisci v. Security Ins. Co.* (1967) 66 Cal.2d 425, 429.) In short, the insurer's settlement decision must be honest, intelligent, and knowledgeable. (*Merritt v. Reserve Ins. Co.* (1973) 34 Cal.App.3d 858, 872.)

### **III. Insurer's Rights and Obligations Concerning Settlement**

The "cooperation,"<sup>1</sup> "no-action,"<sup>2</sup> and "voluntary payments"<sup>3</sup> clauses in liability policies generally, as a threshold matter, allow an insurer to control the settlement of a claim. In fact, upon these provisions, courts have recognized an insurer's right to settle a claim even over its insured's objections. (See *Maryland Casualty Co. v. Imperial Contracting Co.* (1989) 212 Cal.App.3d 712, 720-721.)

Even though an insurer generally has the discretion to control settlement decisions, California courts have imposed certain guidelines on the insurer in its decision making. For example, in evaluating a settlement demand, the insurer may not consider its own coverage beliefs. Instead, the insurer must conduct itself as though it alone were liable for the entire amount of the judgment. (*Johansen v. Cal. State Auto Ass'n Inter-Ins. Bureau, supra*, 15 Cal.3d at p. 16.) The only permissible consideration "in evaluating the reasonableness of the settlement offer becomes whether, in light of the victim's injuries and the probable liability of the insured, the ultimate judgment is likely to exceed the amount of the settlement offer." (*Ibid.*) Further, the court admonished that such factors as the "limits imposed by the policy, a desire to reduce the amount of future settlements,

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<sup>1</sup> A typical "cooperation" clause provides that the insured must cooperate with the insurer "in the investigation, settlement or defense of the claim or 'suit.'"

<sup>2</sup> A typical "no-action" clause provides that "[n]o action shall lie against the company unless, as a condition precedent thereto, there shall have been full compliance with all of the terms of this policy, nor until the amount of the insured's obligation to pay has been finally determined by judgment against the insured after actual trial or by written agreement of the insured, the claimant, and the company."

<sup>3</sup> A "voluntary payments" clause provides that "the insured shall not, except at its own cost, voluntarily make any payment, assume any obligation or incur any expense other than for first aid to others at the time of the accident."

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or a belief that the policy does not provide coverage,” should not affect a decision as to whether the settlement offer is reasonable. (*Ibid.*)

Other factors an insurer should consider are:

- The strengths and weaknesses of all the evidence;
- The probabilities of an adverse verdict and its anticipated range;
- Results obtained in the past in similar litigation;
- The experience and capabilities of counsel defending the insured;
- The experience and capabilities of counsel representing the claimant;
- Whether the claimant appears to be a sympathetic witness with a believable case;
- What sort of witness will the insured and other witnesses make;
- The financial harm to the insured's business;
- The harm to the insured's business reputation; and
- The desire of the insured to settle the case.

(See *Garner v. American Mutual Liability Ins. Co.* (1973) 31 Cal.App.3d 843, 849-850.)

The test for reasonableness of a settlement demand can be shown by the following simple illustration:

Policy limits = \$100,000  
Settlement demand = \$75,000  
Claimant's likely recovery = \$150,000  
Insured's likely liability = 70%  
Insured's likely exposure = \$112,500 (\$150,000 x 70%)

Under this scenario, the insurer should accept the settlement demand since the likelihood of a judgment against the insured exceeds the limits and the settlement demand is within policy limits.

Another restriction of an insurer's discretion to settle is that it may not commit the insured's own funds toward any reasonable settlement without the insured's consent. (*Val's Painting & Drywall, Inc. v. Allstate Ins. Co.* (1975) 53 Cal.App.3d 576, 587, 588.)

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Nevertheless, an insurer may be able to reject a demand within policy limits if non-covered damages clearly are included in such demand. (*Camelot by the Bay Condominium Owners' Association v. Scottsdale Ins. Co.* (1994) 27 Cal.App.4th 33, 52.)<sup>4</sup> Alternatively, an insurer may be able to settle the case over the insured's objections and then seek reimbursement from the insured of the settlement amounts paid for non-covered claims if the reimbursement rights are expressly reserved. (*Blue Ridge Ins. Co. v. Jacobsen* (2001) 25 Cal.4th 489, 502.) The insurer, however, will have the burden of proving the amount actually paid solely for the non-covered claims. (See *Buss v. Superior Court* (1997) 16 Cal.4th 35, 53.)

In *Blue Ridge Ins. Co. v. Jacobsen, supra*, the California Supreme Court concluded an insurer may seek reimbursement for the settlement paid on behalf of its insured even in the absence of the insured's express agreement. There, the insureds operated a kennel business and were sued for personal injury after a customer was mauled by a Rottweiler. The insureds tendered the claim to Blue Ridge Insurance under their homeowner's insurance policy. Blue Ridge defended under a reservation of rights. (*Blue Ridge Ins. Co. v. Jacobsen, supra*, 25 Cal.4th at p. 493.) When a settlement offer was tendered, Blue Ridge determined it to be reasonable and informed the insureds that it proposed to accept the offer under a reservation of its right to seek recovery of the settlement. It also gave the insureds the option to assume their own defense if they found the settlement offer unreasonable. (*Id.* at p. 494.) The insureds objected to the settlement. Blue Ridge subsequently accepted the offer, with a reservation of rights, over the insureds' objection, and the trial court found the settlement to be in good faith. Blue Ridge later sought to recover the reasonable settlement paid for non-covered claims.

The court found Blue Ridge had satisfied the prerequisites for reimbursement of settlement for non-covered claims: "(1) a timely and express reservation of rights; (2) an express notification to the insureds of its intent to accept a proposed settlement offer; and (3) an express offer to the insureds that they may assume their own defense when the insurer and insureds disagree whether to accept the proposed settlement." (*Blue Ridge Ins. Co. v. Jacobsen, supra*, 25 Cal.4th p. 502.)

In deciding whether the insurer's refusal to settle constitutes a breach its duty to exercise in good faith, the following factors should be considered:

- The strength of the injured claimant's case on the issues of liability and damages;

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<sup>4</sup> For example, if in the illustration above one-half of the claimant's likely recovery of \$150,000 was for uncovered damages, the insurer may be able to properly reject the demand since the covered exposure would be only \$52,500 (\$75,000 x 70%). If, however, the uncovered exposure was only \$35,000, the insurer's refusal to settle arguably would constitute bad faith, as the covered exposure of \$80,500 (\$115,000 x 70%) is still in excess of the \$75,000 settlement demand.

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- Attempts by the insurer to induce the insured to contribute to a settlement;
  - Failure of the insurer to properly investigate the circumstances so as to ascertain the evidence against the insured;
  - The insurer's rejection of advice of its own attorney or agent;
  - Failure of the insurer to inform the insured of a compromise offer;
  - The amount of financial risk to which each party is exposed in the event of a refusal to settle;
  - The fault of the insured in inducing the insurer's rejection of the compromise offer by misleading facts; and
  - Any other factors tending to establish or negate bad faith on the part of the insurer.

(*Merritt v. Reserve Ins. Co.*, *supra*, 34 Cal.App.3d at p. 876, citing *Brown v. Guarantee Ins. Co.* (1957) 155 Cal.App.2d 679, 689.)

#### **IV. Settling Around Non-Defending Insurers**

California law is clear that once an insurer refuses to defend its insured, the insurer forfeits its right to control the defense. The insured therefore owes no duty to the insurer after a material breach of the duty to defend. (*Hartford Accident & Indemnity Co. v. Civil Service Employee's Ins. Co.* (1973) 33 Cal.App.3d 26, 35.) The insured is free to make a reasonable, non-collusive settlement without the insurer's consent. (*Hamilton v. Maryland Casualty Co.* (2002) 27 Cal.4th 718, 728.) The insured may then seek reimbursement for the settlement amount in an action for breach of the covenant of good faith and fair dealing or may assign its bad faith action to the injured party in exchange for a covenant not to execute. (*Ibid.*) The California Supreme Court explained why this should be the law:

In effect, when the insured tenders the suit, the carrier is receiving its chance to be heard. Having rejected the opportunity and waived the chance to contest liability, it cannot reach back for due process to avoid a deal the insured has entered to eliminate personal liability. [Citation and internal quotation omitted.]

(*Hamilton*, *supra*, 27 Cal.4th at p. 728.)

If the denial is unreasonable, the insurer will be liable in tort for all damages that proximately results, including the reasonable settlement amount, defense fees incurred in the underlying action, legal fees incurred in pursuit of policy benefits or *Brandt*<sup>5</sup> fees, and

<sup>5</sup> *Brandt v. Superior Court* (1985) 37 Cal.3d 813.

mental anguish. The insurer's wrongful conduct may give rise to punitive damages if malice, oppression, or fraud is shown by clear and convincing evidence. (See *Neal v. Farmers Insurance Exchange* (1978) 21 Cal.3d 910; Civ. Code, § 3294(a).) The insurer will even be liable for a judgment on a claim for which no coverage existed. This is so because "otherwise an insurance carrier could refuse to defend its insured on the slightest provocation and then resort to hindsight for the justification." (*Mullen v. Glens Falls Insurance Co.* (1977) 73 Cal.App.3d 163, 173; *Amato v. Mercury Casualty Co.* (1997) 53 Cal.App.4th 825, 831 [where an insurer tortiously breaches its duty to defend and the insured suffers a default judgment, the insurer is liable for that judgment, even if it is not covered].)

In *Mullen*, the insured was sued for negligence, assault, and battery. The insurer refused to defend or indemnify the insured, contending the underlying action was based on an intentional act which was excluded from coverage. The insured was forced to hire an attorney to defend him. The jury returned a verdict against the insured based on the assault claim. (*Mullen, supra*, 73 Cal.App.3d at p. 167.) The insured subsequently filed an action against the insurer for failure to defend even though the insurer had been vindicated in its belief of non-coverage.

The *Mullen* court ruled for the insured. It held that the insurer should have defended because at the time of the denial, it had factual information that the underlying lawsuit was potentially covered even though the ultimate judgment was based on non-covered willful and deliberate conduct. (*Mullen, supra*, 73 Cal.App.3d at p. 170.) The court remanded for a determination of damages "including the amount of the judgment" against the insured in the underlying action. (*Id.* at p. 174.)

If the insured settles the underlying claim, he may use the settlement as presumptive evidence of his liability and the amount of such liability in a subsequent bad faith coverage action against the insurer. (*Hamilton v. Maryland Casualty, supra*, 27 Cal.4th at pp. 728-729; *Isaacson v. California Ins. Guarantee Assn.* (1988) 44 Cal.3d 775, 791.)

## **V. Settling Around Defending Insurers**

Courts have held that the "cooperation," "no-action," and "voluntary payments" clauses prevent an insured from settling a case without an insurer's consent so long as the insurer is providing a defense. In particular, the "no action" clause bars any claim against the insurer based on such a settlement. (*Safeco Ins. Co. v. Superior Court* (1999) 71 Cal.App.4th 782, 788; *Clark v. Bellefonte Ins. Co.* (1980) 113 Cal.App.3d 326, 336-337.)

It is unclear from those decisions why an insurer was allowed to control the settlement even after it had breached an implied duty to settle but not when it breached

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the duty to defend. One commentator has opined that the reason is the timing of the resulting damage:

Where an insurer breaches its duty to defend, the insured suffers harm immediately in the form of mounting litigation bills, and the insured's purpose for entering into the insurance contract is undermined. . . . However, where the insurer rejects a reasonable policy limits settlement offer while providing a defense, the insured is not harmed until a judgment in excess of the policy limits is entered. . . . For this reason, courts are reluctant to abrogate the insured's duties under the insurance contract and sacrifice the societal benefits in the form of lower insurance premiums derived from allowing the insurer to retain control of the settlement decision.

(DiMugno, *Consent Judgments and Covenants Not to Execute: Good Deals or Too Good to Be True? Part I: Theoretical Hurdles to Enforcement in Insurance Litigation Reporter* (2002) pp. 733-734.) As DiMugno recognizes, the problem with this approach is that it overlooks the principles of contract law – that a party in breach of a contract may not insist that the other party perform his obligations under the same contract.

While an insurer may choose not to settle based on coverage doubts, the California Supreme Court warns that it does so at its own risk. Indeed, the insurer's good faith but erroneous belief that the policy does not provide coverage is no defense to liability for bad faith failure to settle. (*Johansen, supra*, 15 Cal.3d at pp. 15-16.) Thus, an unreasonable refusal to settle may subject the insurer to liability for the entire amount of the judgment and all tort damages proximately caused by the denial, including attorneys fees and punitive damages. (*Crisci v. Security Ins. Company, supra*, 66 Cal.2d at pp. 432-433.)

The consequences of an insurer's failure to settle were highlighted nearly 30 years ago in *Johansen v. Cal. State Auto Ass'n Inter-Ins. Bureau, supra*. In that case, the insured was sued for damages arising out of a car accident. Although the insurer provided a defense, it refused to accept a settlement offer of \$10,000 because it believed that the accident did not fall within the policy's coverage. (*Johansen, supra*, 15 Cal.3d at pp. 12-13.) Subsequently, a judgment in excess of the policy limits was entered against the insured. (*Id.* at p. 13.)

The California Supreme Court reiterated that the "implied covenant of good faith and fair dealing imposes a duty on the insurer to settle a claim against its insured within policy limits whenever there is a substantial likelihood of a recovery in excess of those

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limits.” (*Johansen, supra*, 15 Cal.3d at pp. 14-15, citing *Comunale v. Traders & General Insurance* (1958) 50 Cal.2d 654, 658.) The high court concluded the insurer breached its duty to its insured when it failed to accept the reasonable offer and found that the insurer was liable for the judgment. (*Johansen, supra*, at p. 19.)

An insurer, however, generally is not liable for punitive damages awarded against its insured even where its unreasonable refusal to settle a third party claim is a cause in fact of the punitive damages. (*PPG Industries, Inc. v. Transamerica Ins. Co.* (1999) 20 Cal.4th 310, 318-319.) In *PPG*, an insured of Transamerica was sued for personal injuries when the windshields it had installed “popped out” and the driver was ejected through the opening in a collision. (*Id.* at p. 313.) The insured sued Transamerica after Transamerica unreasonably refused to settle the underlying claim, resulting in compensatory and punitive damages against the insured. The court found two causes in fact of the punitive damages awarded against the insured: the insured’s own intentional and egregious misconduct; and Transamerica’s alleged negligent failure to settle the claim. (*Ibid.*) Even with such finding, the court concluded that Transamerica’s conduct was not a proximate cause of the punitive damages. Rather, the damages were awarded against the insured for the insured’s own intentional conduct and it is against California public policy to insure against intentional misconduct. (*Id.* at pp. 318-319.)

## **VI. An Insured’s Rights Following Defending Insurer’s Refusal to Accept a Settlement Demand within Policy Limits**

What should an insured do after a defending insurer rejects a reasonable settlement demand within policy limits? Essentially, the insured has five options:

(1) The insured can wait and see how the claim is resolved. If the claimant’s damages do not exceed the insured’s policy limits, the insurer is obligated to pay the judgment and the insurer’s failure to settle theoretically has caused no harm to the insured.<sup>6</sup> On the other hand, if a judgment in the underlying action exceeds those limits, the insured has a claim for bad faith against the insurer.

(2) If the non-settling insurer is willing to contribute to some part of the settlement offer, the insured may conclude a favorable settlement by contributing the deficit and recover the payment in a subsequent bad faith action. (*Hamilton v. Maryland Casualty, supra*, 27 Cal.4th at p. 732.)

(3) The insured may use its own fund to settle the underlying claims. However, no presumption of the insured’s liability would arise from the fact or amount of settlement even where the trial court in underlying action determined the settlement was

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<sup>6</sup> This, of course, ignores damage to the insured’s reputation and business relations, the unnecessary depletion of its policy limits, increased premiums and other harm to the insured.

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made in good faith under California Code of Civil Procedure section 877.6.<sup>7</sup> (*Hamilton v. Maryland Casualty, supra*, 27 Cal.4th at p. 729.) According to the *Hamilton* court, the purpose of a section 877.6 hearing is to ensure fairness to absent tortfeasors, not fairness to the settling defendant's insurer. Thus, "[a]s long as the insurer is providing a defense, the insurer is allowed to proceed through trial to judgment." (*Id.* at p. 732.) In his claim for bad faith against the insurer, the insured will have to prove his liability in the underlying action in excess of the settlement amount.

(4) The insured may enter into a stipulated judgment with a covenant not to execute and assign his right against his insurer to the claimant. The problem with this approach is that in a subsequent bad faith action against the insurer, the court will want assurances that the consent judgment or settlement was reasonable and not the product of fraud or collusion. This is so even where a good faith determination of the settlement was made, which would only show the absence of collusion, but not the existence and extent of the insured's liability to the claimant. (See *Hamilton v. Maryland Casualty, supra*, 27 Cal.4th at p. 729.)

(5) The insured may assign to the claimant his cause of action for bad faith refusal to settle in exchange for a covenant not to enforce the judgment against the insured's personal assets, without settling the underlying action. (*Hamilton v. Maryland Casualty, supra*, 27 Cal.4th at p. 732.) The assignment of the bad faith cause of action becomes operative only after an excess judgment has been rendered. Thus, there is no concern that the assignment was the product of fraud or collusion. The California Supreme Court approves this approach over (4) above.

## **VII. Settling Around More Than One Insurer**

When a developer is sued for construction defects, it generally tenders the claim to both its direct and its additional insurers for defense and indemnity. The scope of coverage afforded to the developer by its additional insurers will depend on the types of additional insured endorsements issued by the additional insurers. Regardless of the type of coverage, the additional insurers must provide the additional insured with an immediate, full and complete (100%) defense of all claims, covered and non-covered, arising out of a construction defect action. (*Presley Homes, Inc. v. American States Insurance Company* (2001) 90 Cal.App.4th 571.)

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<sup>7</sup> Code of Civil Procedure section 887.6 provides in part:

"(a) (1) Any party to an action in which it is alleged that two or more parties are joint tortfeasors or co-obligors on a contract debt shall be entitled to a hearing on the issue of the good faith of a settlement entered into by the plaintiff or other claimant and one or more alleged tortfeasors or co-obligors . . .

(c) A determination by the court that the settlement was made in good faith shall bar any other joint tortfeasor or co-obligor from any further claims against the settling tortfeasor or co-obligor for equitable comparative contribution, or partial or comparative indemnity, based on comparative negligence or comparative fault.

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In this time of seven figure self-insured retentions and deductibles it is not unusual to find a developer being defended solely by its additional insurers. Under these circumstances, it often is even more difficult to raise sufficient funds to settle the construction defect claims. In theory, all the defending additional insurers should contribute to the settlement the percentage that relates to the named insured subcontractor's liability. The total amount contributed should then satisfy the settlement. In reality, some defending additional insurers refuse to settle believing that their named insured subcontractors are not liable. Many more refuse to settle believing they are being asked to contribute more than their fair share.

What should the developer do if a defending additional insurer refuses to settle? In addition to the options stated in section VI, above, the developer may persuade one or more of the other defending insurers to fund the settlement. The settling insurers may then seek reimbursement from the other non-settling insurers. (*Maryland Casualty Co. v. Nationwide Mut. Ins. Co.* (2000) 81 Cal.App.4th 1082, 1089; *Fire Ins. Exchange v. American States Ins. Co.* (1995) 39 Cal.App.4th 653, 656.) The settling insurer may also seek contribution for the settlement and defense costs from any non-defending insurers.

### **VIII. Conclusion**

Although an insurer may have the right to control settlement decisions, its exercise of this right must be accompanied by considerations of good faith. Thus, while the insurer is required by law to consider the insured's interests in evaluating a settlement demand, the reality is that the interests of the insured often conflict with those of the insurer and the insurer might not always consider the insured's interests before accepting or rejecting a demand.

With the costs of litigation escalating and jury awards skyrocketing, it is imperative that insurers and their insureds work together to resolve claims expeditiously to avoid unnecessary trial expenses and unpredictable jury verdicts. Trials are not only costly, but time-consuming. A typical construction defect trial can cost hundreds of thousands of dollars and last several months or more. Both the insurer and insured benefit from a reasonable settlement within policy limits. The insurer will save substantial defense fees and costs and preserve its policy limits; while the insured will avoid personal liability, and preserve its business reputation and relationships.